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Weekly Fixed Income Commentary

28 February 2022

Inflation fears fuel rise in Treasury yields

U.S. Treasury yields rose last week, with inflation breakevens rising to reflect the risk of higher commodity prices due to the Russia/Ukraine conflict. Spread sectors were mixed, but mostly rallied after initial knee-jerk moves lower.

HIGHLIGHTS

- **Treasuries, agencies, MBS, taxable munis, investment grade corporates, preferreds, loans and emerging markets posted negative total returns.**
- **High yield corporates and convertibles had positive total returns.**
- **Municipal bond yields declined. New issue supply was muted at $5.6B, with flows of -$1.1B. This week's new issue supply should be $6.7B ($1.4B taxable).**

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Watchlist

- *10-year Treasury yields rose last week, and we anticipate further increases this year.*
- *Spread assets were weaker amid elevated uncertainty.*
- *Municipal bonds are moving closer to fair value.*

INVESTMENT VIEWS

Zero/negative global interest rate policy remains a key market support. While investors continue to focus on more hawkish Fed policy, overall rates are likely to remain relatively low.

Unprecedented global fiscal stimulus should continue to boost consumption and growth.

Record supply of investment grade corporates has been followed by high levels of issuance from high yield, middle market loans and the broadly syndicated loan market. Taxable municipal supply also continues to grow.

We favor a risk-on stance, focused on credits with durable free cash flow and solid balance sheets across a wide range of sectors. Mid-quality rating segments appear particularly attractive. Essential service municipal bonds also look compelling.

KEY RISKS

- Inflation rises in a disorderly way, negatively affecting asset values.
- Policymakers remove accommodation too rapidly, undermining the global economic expansion.
- Further complications with the Covid vaccine rollout, as well as new variants.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.

EMERGING MARKETS SIGNIFICANTLY UNDERPERFORM

U.S. Treasury yields ultimately rose last week, with 10-year yields ending 3 basis points (bps) higher at 1.96%. Yields briefly rallied as much as -15 bps on Thursday after Russia invaded Ukraine, but snapped back amid an easing in risk-off sentiment on Friday. The move higher was entirely driven by inflation breakevens, which rose 12 bps, as the conflict in Europe is likely to result in higher commodity prices and inflation for developed market economies. Market expectations for the Federal Reserve's withdrawal of accommodation were little changed last week, still pricing six rate hikes this year.

Investment grade corporates weakened, returning -0.53% for the week and underperforming similar-duration Treasuries by -12 bps. Spreads widened 3 bps to reach another 15-month high of 121 bps, though they tightened a bit on Friday after steeper moves in the immediate aftermath of Russia's invasion. The primary calendar dried up completely, but we expect most of that supply to be pushed into next month instead, with expectations for March supply now around $175 billion.

High yield corporates rallied, returning 0.37% for the week and outperforming similar-duration Treasuries by 57 bps. Spreads initially widened substantially, spiking 13 bps on Thursday, but rallied back by -19 bps on Friday. The asset class saw another outflow of around -$1 billion, taking the seven-week total to -$17.7 billion. Flows have been significantly skewed toward ETFs, which have experienced outflows totaling around 15% of their AUM, while active funds have seen only around 4% of their AUM in outflows.

Emerging markets underperformed, returning -1.99% for the week and underperforming similar-duration Treasuries by -167 bps. Russian and Ukrainian sovereign bonds fell -40 to -50 points in price on Thursday, before rallying somewhat to end the week around -30 points lower. Similarly, the ruble depreciated as much as -14% before ending -7.5% weaker. Russian CDS spiked 600 bps to reach around 950 bps, before ending around 270 bps higher. The rally on Friday was driven by: a) relatively lighter sanctions than initially feared, with Russia not (yet) kicked off the SWIFT banking network, b) no direct military involvement from the West and c) headlines suggesting still-open avenues of negotiation. Broader emerging markets were also pressured weaker, though not nearly to the extent of Russia and Ukraine assets.

MUNICIPAL YIELDS REPRESENT FAIR VALUE

Municipal bond yields fell across the curve last week. Short-term rates ended 3 bps lower, while long-term rates declined 4 bps.

Russia/Ukraine military action keeps markets in a precarious position. Yields rose at the beginning of last week, reflecting inflation fears, then rallied later in the week as the conflict in Ukraine escalated. The market wants interest rates to rise to compensate for higher inflation, but the conflict in Ukraine is keeping fixed income yields artificially low as investors seek high grade bonds in a flight-to-quality rally.

The Fed maintains it will raise rates in March to combat inflation. U.S. Treasury bonds should remain in a trading range for the foreseeable future. Municipal yields currently represent fair value, as the 10-year high grade tax-exempt bond currently yields 81% of the U.S. Treasury bond. We believe municipal bonds should remain well bid in the current rate environment, with new issue supply remaining relatively muted.

Maryland Stadium Authority issued $373 million revenue bonds for schools (rated A1/AA). The deal was priced to sell and well received. The deal included 30-year bonds with a 4% coupon issued at a yield of 2.94%. Those same bonds traded at a slight premium of 2.93% in the secondary market.

High yield municipal credit spreads widened for an asset class with broadening improvement in credit quality. A new issue supply vacuum is forming, making market access and credit selection even more valuable. The Puerto Rico GO exchange should provide a major liquidity injection and boost to secondary market trading heading into the last weeks of a very atypical first quarter. Investors are best supported by focusing on long-term fundamental outlooks and viewing short-term technical weakness as a potential advantage.

Municipal bond new issue supply should remain relatively muted.

In focus

Geopolitics: not a time to overreact

Broader credit markets have experienced volatility due to Russia's invasion of Ukraine. Credit spreads for risk assets have at times moved wider in response, causing periods of significant underperformance relative to similar-duration Treasuries.

Geopolitical risks are a wildcard in investing, and nearly impossible to forecast. We don't think this is a time to overreact or adjust plans. Institutional investors should focus on long-term policy objectives, and individual investors should remain committed to their portfolio growth and income objectives. All should stick with the broad diversification, asset allocation and portfolio rebalancing plans already in place.

Over the near term, we may see tactical opportunities across public and private markets as energy prices remain elevated and certain asset classes become oversold (such as select emerging markets debt). However, due to market volatility in recent weeks, the optimal entry points may well have passed.

The North American energy sector may benefit from higher oil and natural gas prices, and these sectors have already been among the top performers in the past year.

These events certainly bear watching. The Ukraine crisis, if anything, puts upward pressure on inflation and some downward pressure on growth. But from a long-term investment view, they shouldn't be driving portfolio strategy changes.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	1.57	0.10	0.39	0.84
5-year	1.87	0.05	0.26	0.60
10-year	1.96	0.03	0.19	0.45
30-year	2.28	0.03	0.17	0.37

Source: Bloomberg L.P., 25 Feb 2022. **Past performance is no guarantee of future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	1.08	-0.03	0.18	0.84
5-year	1.36	-0.05	0.14	0.77
10-year	1.60	-0.05	0.05	0.57
30-year	1.98	-0.04	0.03	0.49

Source: Bloomberg L.P., 25 Feb 2022. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	81
30-year AAA Municipal vs Treasury	87
High Yield Municipal vs High Yield Corporate	66

Source: Bloomberg L.P., Thompson Reuters, 25 Feb 2022. AAA municipals represented by the MMD scale. The high yield ratio equals the yield-to-worst for the Bloomberg High Yield Municipal Index divided by the yield-to-worst for the Bloomberg High Yield Corporate Index. **Past performance is no guarantee of future results.**

Characteristics and returns

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	1.88	–	5.14	0.17	-0.44	-3.17
High yield municipal	3.71	189[1]	7.08	0.10	-0.31	-3.10
Short duration high yield municipal[2]	3.39	189	3.74	0.09	-0.36	-1.77
Taxable municipal	2.93	81[3]	9.40	-0.58	-1.98	-4.47
U.S. aggregate bond	2.44	42[3]	6.60	-0.33	-1.88	-4.00
U.S. Treasury	1.88	–	6.92	-0.34	-1.49	-3.35
U.S. government related	2.36	51[3]	5.88	-0.39	-1.65	-3.60
U.S. corporate investment grade	3.19	121[3]	8.19	-0.53	-2.94	-6.21
U.S. mortgage-backed securities	2.58	27[3]	5.02	-0.12	-1.55	-3.01
U.S. commercial mortgage-backed securities	2.67	83[3]	4.98	-0.52	-1.83	-3.38
U.S. asset-backed securities	1.99	44[3]	2.28	-0.28	-0.91	-1.46
Preferred securities	4.49	222[3]	4.97	-0.09	-3.25	-5.63
High yield 2% issuer capped	5.67	354[3]	4.07	0.37	-1.21	-3.91
Senior loans[4]	6.32	449	0.25	-0.17	-0.52	-0.16
Global emerging markets	5.41	347[3]	6.78	-1.99	-3.42	-5.97
Global aggregate (unhedged)	1.83	44[3]	7.33	-0.64	-1.63	-3.64

1 Yield difference between the Bloomberg High Yield Municipal Index and the 20-year AAA MMD scale. **2** Data is a subset of the S&P Short Duration Municipal Yield Index that is below investment grade/nonrated. Spread is the yield difference between this subset and the subset rated AAA. **3** Option-adjusted spread to Treasuries. **4** Spread refers to the 3-year discount margin. Duration is estimated based on the frequency of the reset date.

Source: Bloomberg L.P. and Credit Suisse, 25 Feb 2022. **Past performance is no guarantee of future results.** Unless otherwise noted, the index is Bloomberg. All index returns are shown in U.S. dollars. **Yield to worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting. **Effective duration** (expressed in years) measures the price sensitivity of a fixed-income investment to a change in interest rates, considering that expected cash flows will fluctuate as interest rates change. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account.

For more information, please visit nuveen.com.

Performance: Bloomberg, L.P. **Issuance:** The Bond Buyer, 25 Feb 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 23 Feb 2022.

Any reference to credit ratings refers to the highest rating given by one of the following national rating agencies: S&P, Moody's or Fitch. Credit ratings are subject to change. AAA, AA, A and BBB are investment grade ratings; BB, B, CCC, CC, C and D are below-investment grade ratings.

Representative indexes: municipal: Bloomberg Municipal Index; **high yield municipal:** Bloomberg High Yield Municipal Index; **short duration high yield municipal:** S&P Short Duration Municipal Yield Index; **taxable municipal:** Bloomberg Taxable Municipal Bond Index; **U.S. aggregate bond:** Bloomberg U.S. Aggregate Bond Index; **U.S. Treasury:** Bloomberg U.S. Treasury Index; **U.S. government related:** Bloomberg U.S. Government-Related Index; **U.S. corporate investment grade:** Bloomberg U.S. Corporate Index; **U.S. mortgage-backed securities;** Bloomberg U.S. Mortgage-Backed Securities Index; **U.S. commercial mortgage-backed securities:** Bloomberg CMBS ERISA-Eligible Index; **U.S. asset-backed securities:** Bloomberg Asset-Backed Securities Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **high yield 2% issuer capped:** Bloomberg High Yield 2% Issuer Capped Index; **senior loans:** Credit Suisse Leveraged Loan Index; **global emerging markets:** Bloomberg Emerging Market USD Aggregate Index; **global aggregate:** Bloomberg Global Aggregate Unhedged Index.

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A word on risk

Investing involves risk; principal loss is possible. Debt or fixed income securities are subject to market risk, credit risk, interest rate risk, call risk, derivatives risk, dollar roll transaction risk and income risk. As interest rates rise, bond prices fall. Below investment grade or high yield debt securities are subject to liquidity risk and heightened credit risk. Preferred securities are subordinated to bonds and other debt instruments in a company's capital structure and therefore are subject to greater credit risk. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. Asset-backed and mortgage-backed securities are subject to additional risks such as prepayment risk, liquidity risk, default risk and adverse economic developments. The value of convertible securities may decline in response to such factors as rising interest rates and fluctuations in the market price of the underlying securities. Senior loans are subject to loan settlement risk due to the lack of established settlement standards or remedies for failure to settle. These investments are subject to credit risk and potentially limited liquidity, as well as interest rate risk, currency risk, prepayment and extension risk, and inflation risk

Investors should contact a tax professional regarding the appropriateness of tax-exempt investments in their portfolio. If sold prior to maturity, municipal securities are subject to gain/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on the state of residence. Income from municipal bonds held by a portfolio could be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

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