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Weekly Fixed Income Commentary

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# Treasury yields rise with Fed's hawkish rhetoric

*U.S. Treasury yields rose last week as communications from U.S. Federal Reserve officials continued to skew hawkish. Chair Powell did not rule out a 50 basis points hike at the May meeting. Spread sectors outperformed similar-duration Treasuries amid the rise in rates.*

## HIGHLIGHTS

- **Investment grade and high yield corporates, preferreds, ABS and emerging markets all generated positive excess returns.**
- **Treasuries and mortgage-backed securities saw negative total returns.**
- **Municipal bond yields rose across the curve. New issue supply was $10B, with outflows of -$1.5B. This week's new issue supply is $10.6B ($3.4B taxable).**


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# Watchlist

- *10-year Treasury yields rose last week, and we continue to expect rates to rise further this year.*
- *Spread sectors outperformed similar-duration Treasuries amid the rise in rates.*
- *Municipal bonds appear attractive vs. Treasuries.*

### INVESTMENT VIEWS

**Accommodative 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 even after several rate hikes.

**The underlying growth outlook is healthy,** as consumers have strong balance sheets, businesses are reinvesting and Covid recedes. This should keep defaults low.

**Treasury yields are likely to rise this year,** but we don't expect the 10-year Treasury yield to rise much above 2.25%.

**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

- The Russia/Ukraine conflict continues to escalate.
- Inflation rises in a disorderly way, negatively affecting asset values.
- Policymakers remove accommodation too rapidly, undermining the global economic expansion.
- COVID-19 cases increase, including any new variants.





### INVESTMENT GRADE CORPORATE ISSUANCE REMAINS HEAVY

**Treasury yields rose sharply again,** as Fed Chair Powell and other officials raised the hawkish rhetoric. Powell said he expects to hike rates "expeditiously" and did not rule out a 50 basis points (bps) move, a shift from his language just the week before. We interpret this shift as signaling a faster and more front-loaded pace of hikes, and now pencil in two 50 bps hikes at each of the next two FOMC meetings in May and June. We then expect a return to a pace of 25 bps per meeting for the rest of this year, making 225 bps in total increases this year. This outlook will depend heavily on the evolving inflation outlook, which we still expect to moderate later this year, but from a higher base given the recent upside surprises to realized inflation.

**Investment grade corporates were mixed,** returning -1.73% for the week but outperforming similar-duration Treasuries by 34 bps. Spreads tightened -6 bps to 121 bps, but yields were 26 bps higher at 3.76%. New issuance remained heavy, with 21 new deals totaling $36 billion, taking the March total to $194 billion, easily exceeding consensus forecasts of $160 billion with four days left in the month. Concessions remained wide at around 6.5 bps, though they were tighter from almost 14 bps the prior week.

**High yield corporates performed better,** returning -0.64% but outperforming similar-duration Treasuries by 65 bps. Spreads tightened -29 bps, the best weekly performance in more than a year. Outflows continued at a high pace at -$2.7 billion, with most (around $1.9 billion) coming via ETFs. That takes the last 11 weeks total to -$24 billion, or 9% of the starting AUM, now outpacing Q1 2020 outflows. The loan market saw a healthy inflow of $1.4 billion after the prior week's outflow, helping prices to rally and the asset class to return 0.45%. Attention remains on the CLO pipeline, as volatility last week caused new issuance to largely pause after a pickup the prior week.

**Emerging markets continued their recent outperformance,** returning -0.96% but outperforming similar-duration Treasuries by 102 bps. The more hawkish Fed rhetoric, higher oil prices and lack of negotiation progress in Ukraine weighed on the sector, but buyers stepped in and the new issuance process restarted, especially in Asia. Several central banks hiked rates, including Mexico, Egypt and South Africa, and curves in those countries generally flattened, helping long-end performance.

## MUNICIPAL BONDS SELL OFF, WHILE THE MARKET REMAINS ORDERLY

**Municipal bond yields rose across the yield curve last week,** along with Treasuries. Short-term rates rose 35 bps and long-term rates increased 21 bps. Fund flows continued to be negative, and new issuance will need to be priced to sell to clear the market.

**Fed Chair Powell sounded the alarm** that he is concerned inflation may be worse than previously thought. He also stated that the Fed will raise short-term rates as much as it takes to curb inflation. Fixed income yields in general sold off dramatically as a result. The 10-year Treasury bond yield hit 2.5%, the highest since May 2019. Municipal bonds sold off in response to the Treasury selloff, but in an orderly fashion. Municipal bonds look cheap compared with Treasuries, a trend we expect to continue. From a credit standpoint, municipals are fundamentally sound.

**New York City** issued $899 million general obligation bonds (rated Aa2/AA). While the deal was priced to sell, bonds traded relatively less expensive as the week progressed. For example, 5% bonds due in 2032 came at a yield of 2.61% . Those bonds traded in the secondary market at 2.67%. This reflects how yields in general continued to rise as the week progressed.

**High yield municipal credit spreads remain stable** after a positive week of inflows. High beta elements of the market are tightening in spread, but the overall interest rate environment should continue to be a larger market driver. The recent Puerto Rico adjustment plan has inserted more cash into the market, and credit fundamentals remain strong.

***Municipal bonds look cheap compared with Treasuries, a trend we expect to continue.***

*In focus*

# Puerto Rico strides forward

*Puerto Rico's debt adjustment plan for the central government became effective in mid-March, marking a significant advance for the Commonwealth and municipal market.*

The consensually negotiated plan reduced Puerto Rico's direct debt obligations to $7.4 billion from $34.3 billion, a meaningful 78% reduction.

The bankruptcy, which took nearly five years to complete, represents the largest municipal restructuring ever. Annual debt service costs have been cut to $1.1 billion from $4.2 billion and new level debt service schedule provides much needed budgetary certainty. Defaulted general obligation bonds were exchanged for new bonds, a cash consideration and contingent value instrument tied to sales tax performance.

The new GO bonds have been well received by the high yield municipal market. Near-term, there appears very little risk of default or slipping back into bankruptcy while the oversight board remains in place. The board will continue to oversee and approve annual fiscal plans, budgets and spending. The PROMESA statute requires the board remain in place until four consecutive years have ended with balanced operations, based on audited financials.

Puerto Rico's electric utility (PREPA) and the Highway and Transportation Authority (HTA) remain in bankruptcy. The Puerto Rican government recently terminated an agreement reached with PREPA bondholders in 2019. Creditor negotiations are expected to restart soon under the guidance of a court appointed mediator.

## U.S. Treasury market

| | | Change (%) | | |
|---|---|---|---|---|
| Maturity | Yield | Week | Month-to-Date | Year-to-date |
| 2-year | 2.27 | 0.33 | 0.84 | 1.54 |
| 5-year | 2.55 | 0.40 | 0.83 | 1.28 |
| 10-year | 2.48 | 0.33 | 0.65 | 0.97 |
| 30-year | 2.59 | 0.16 | 0.42 | 0.68 |

Source: Bloomberg L.P., 25 Mar 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 | 1.72 | 0.33 | 0.66 | 1.48 |
| 5-year | 1.96 | 0.31 | 0.66 | 1.37 |
| 10-year | 2.18 | 0.25 | 0.62 | 1.15 |
| 30-year | 2.54 | 0.21 | 0.62 | 1.05 |

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

## Yield ratios

| | Ratio (%) |
|---|---|
| 10-year AAA Municipal vs Treasury | 88 |
| 30-year AAA Municipal vs Treasury | 98 |
| High Yield Municipal vs High Yield Corporate | 69 |

Source: Bloomberg L.P., Thompson Reuters, 25 Mar 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 | 2.57 | – | 5.57 | -1.37 | -3.20 | -6.19 |
| High yield municipal | 4.27 | 186[1] | 8.02 | -1.52 | -3.49 | -6.41 |
| Short duration high yield municipal[2] | 4.12 | 208 | 3.64 | -0.72 | -1.82 | -3.49 |
| Taxable municipal | 3.58 | 94[3] | 9.25 | -2.20 | -6.11 | -9.32 |
| U.S. aggregate bond | 3.04 | 44[3] | 6.60 | -1.82 | -3.76 | -6.89 |
| U.S. Treasury | 2.50 | – | 6.71 | -1.83 | -3.91 | -6.36 |
| U.S. government related | 2.98 | 50[3] | 5.81 | -1.42 | -3.21 | -6.15 |
| U.S. corporate investment grade | 3.76 | 121[3] | 8.06 | -1.73 | -3.95 | -9.04 |
| U.S. mortgage-backed securities | 3.14 | 32[3] | 5.46 | -1.98 | -3.52 | -5.87 |
| U.S. commercial mortgage-backed securities | 3.36 | 86[3] | 4.92 | -1.61 | -3.55 | -6.22 |
| U.S. asset-backed securities | 2.88 | 60[3] | 2.26 | -0.65 | -1.87 | -3.04 |
| Preferred securities | 5.00 | 209[3] | 5.00 | -1.07 | -2.18 | -7.61 |
| High yield 2% issuer capped | 6.24 | 342[3] | 4.05 | -0.64 | -2.01 | -5.66 |
| Senior loans[4] | 7.33 | 465 | 0.25 | 0.45 | -0.45 | -0.59 |
| Global emerging markets | 5.80 | 328[3] | 6.75 | -0.96 | -3.84 | -10.62 |
| Global aggregate (unhedged) | 2.21 | 44[3] | 7.28 | -1.63 | -3.98 | -7.06 |

**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 Mar 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 Mar 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 23 Mar 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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