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Weekly Fixed Income Commentary

23 May 2022

Treasury yields decline as growth concerns continue

U.S. Treasury yields fell again last week, supporting core fixed income returns. However credit spreads continued to widen on economic growth concerns.

HIGHLIGHTS

- **Total returns were positive for Treasuries, agencies, MBS, CMBS, taxable munis, investment grade corporates and emerging markets.**
- **Returns were negative for high yield corporates, convertibles, preferreds and senior loans.**
- **Municipal bond yields declined across the curve. New issue supply was $7.1B, with outflows of -$2.7B. This week's new issue supply is undersized at $6B.**

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Watchlist

- *10-year Treasury yields declined, but we expect them to move modestly higher this year.*
- *Spread sectors were weaker amid elevated uncertainty.*
- *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 3%.

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 fails to decline as expected, negatively affecting asset values.
- Policymakers remove accommodation too rapidly, undermining the global economic expansion.
- COVID-19 cases increase, or new variants emerge.

INVESTMENT GRADE CORPORATE SUPPLY IS DIFFICULT TO DIGEST

Treasury yields declined again last week, as concerns over the economic growth outlook intensified. Official retail sales numbers for April were strong, but earnings reports from several large retailers disappointed. Walmart and Target showed healthy revenue growth in the first quarter, of 2.4% and 4.0% year-over-year, respectively, consistent with the signal from the official data, but earnings fell -16% and -34%, respectively. Inflation is eroding profit margins quicker and more acutely than previously expected, sparking a further selloff in risk assets and a bid for relative safety in the form of Treasuries.

Though investment grade corporates benefited from the rally in Treasuries, with total returns of 0.44%, they underperformed similar-duration Treasuries by -48 basis points (bps). Any market stability was met with increased supply, which remains heavy and difficult to digest. The primary calendar totaled $33.4 billion last week, with elevated average concessions of 13.5 bps. Overall spreads moved 8 bps wider, with Target and Walmart spreads widening around 10 bps and 9 bps, respectively.

High yield corporates continued to weaken, returning -0.70% and underperforming similar-duration Treasuries by -111 bps. Senior loans returned -0.49%. Both asset classes were pressured by the broader concern over economic weakness and continued unfavorable technicals. In the retail space, stressed names like Macy's, Michael's, Bath and Body Works and Staples fell as much as -5 pts in price in a single session. High yield and loan funds saw outflows of -$2.6 and -$1.6 billion, respectively. The latter was the largest single-week outflow since March 2020. In both asset classes, BBs continue to outperform CCCs.

Emerging markets eked out positive returns of 0.07% last week, though they underperformed similar-duration Treasuries by -75 bps. High yield continues to lag investment grade, with spreads moving 25 bps wider in the former versus 1bp in the latter. In European markets, the dynamic continued to pivot from concerns around higher inflation to worries about lower growth, exacerbated by rhetoric from European Central Bank officials signaling a July rate hike. The 30-year German bund yield, which had increased 83 bps since the end of February, is now down -13 bps from that peak, and its auction reopening last week was oversubscribed by 3.1x, the highest in over 20 years.

MUNICIPAL MARKET IS SUPPORTED BY SEVERAL FACTORS

Municipal bond yields finally declined across curve last week. Short-term yields declined 6 bps and long-term rates lost 3 bps. Weekly municipal fund outflows continued for the fourteenth straight week. Next week's new issue supply is undersized due to the Memorial Day holiday in the U.S.

Municipal bonds are increasing in value for a few reasons. Reinvestment money from June 1 and July 1 is expected to be about $92 billion dollars, yet summer supply is typically muted. Tax-exempt municipal yields continue to show value at more than 100% of the taxable Treasury curve. Finally, Treasury bonds remain attractive, as some people think a recession may come sooner than most thought only a couple weeks ago. We think these factors should support the municipal market for the foreseeable future.

The state of Illinois issued $1.6 billion general obligation bonds (rated Baa1/BBB+). The deal included 5% coupon bonds due in of 2030 that came at a yield of 4.2%, then traded in the secondary market at 4.14%. This shift shows the need for high yield tax-exempt credits, as well as the value. The Illinois bonds are trading more than 100 bps higher than the taxable 10-year Treasury yield.

High yield municipals ended last week with two consecutive positive days of performance. Following heavy oversubscription on the Illinois deal, market tone strengthened and carried throughout the week. By Friday afternoon, demand became highly competitive and the market potentially formed what we think could be the beginning of a recovery rally. Average high yield municipal credit spreads began the week at 213 bps, but many higher-beta bonds offer substantially wider spreads. Heavy outflows continued, but those flows lagged the timing of the Thursday/Friday rally.

Tax-exempt municipal yields continue to show value at more than 100% of the taxable Treasury curve.

In focus

How to navigate the value trap

After a punishing year to date for most traditional fixed income asset classes, yields have shown signs of stabilizing. As investors consider adding duration back into portfolios, they must carefully navigate the value trap.

One way to add duration is to allocate to high yield corporate bonds, which have relatively limited duration and interest rate risk. Some investors now view high yield as attractively valued after the asset class lost 11% since the beginning of the year, versus just 2.6% for senior loans. But just because high yield prices have struggled mightily doesn't necessarily mean they represent the best bargain. Comparing the relative value of these two below-investment grade segments can be challenging given the differences in duration, sector breakdowns and credit risk.

To illustrate the pitfalls of focusing exclusively on price, consider companies that have issued both high yield bonds and senior loans. Returns on their high yield securities have declined sharply in 2022, while their loans have fallen far less. One might conclude the high yield credits offer better value, but the loans often trade with a higher spread, potentially providing more room for price appreciation.

Floating-rate loan funds that are focused on bottom-up security selection and fundamental research may help investors avoid getting trapped in what looks like a superior value opportunity, only to find that looks can indeed be deceiving.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	2.58	0.00	-0.13	1.85
5-year	2.80	-0.07	-0.16	1.54
10-year	2.78	-0.14	-0.15	1.27
30-year	2.99	-0.09	-0.01	1.09

Source: Bloomberg L.P., 20 May 2022. **Past performance does not predict or guarantee future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	2.25	-0.06	0.03	2.01
5-year	2.53	-0.05	0.06	1.94
10-year	2.93	-0.06	0.06	1.90
30-year	3.29	-0.03	0.08	1.80

Source: Bloomberg L.P., 20 May 2022. **Past performance does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	105
30-year AAA Municipal vs Treasury	110
High Yield Municipal vs High Yield Corporate	68

Source: Bloomberg L.P., Thompson Reuters, 20 May 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 does not predict or guarantee future results.**

Characteristics and returns

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	3.42	–	6.63	-0.02	-1.47	-10.16
High yield municipal	5.33	217[1]	10.05	-0.68	-3.49	-13.00
Short duration high yield municipal[2]	5.03	227	4.35	-0.23	-1.78	-6.62
Taxable municipal	4.14	122[3]	9.20	1.05	-0.32	-13.47
U.S. aggregate bond	3.42	53[3]	6.52	0.59	0.36	-9.18
U.S. Treasury	2.79	–	6.54	0.73	0.45	-8.09
U.S. government related	3.37	61[3]	5.58	0.47	0.22	-8.32
U.S. corporate investment grade	4.36	149[3]	7.71	0.44	-0.29	-12.99
U.S. mortgage-backed securities	3.49	41[3]	5.79	0.58	0.85	-7.53
U.S. commercial mortgage-backed securities	3.79	102[3]	4.89	0.32	0.24	-7.55
U.S. asset-backed securities	3.33	75[3]	2.27	-0.01	0.35	-3.29
Preferred securities	6.18	291[3]	5.09	-0.64	-2.96	-13.01
High yield 2% issuer capped	7.82	484[3]	4.28	-0.70	-3.07	-11.02
Senior loans[4]	8.54	565	0.25	-0.49	-2.68	-2.61
Global emerging markets	6.54	371[3]	6.47	0.07	-1.56	-14.51
Global aggregate (unhedged)	2.57	52[3]	7.14	0.99	0.01	-11.29

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, 20 May 2022. **Past performance does not predict or guarantee 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, 20 May 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 18 May 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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Important information 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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