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Weekly Fixed Income Commentary

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Treasury yields rise as the Fed hikes aggressively

U.S. Treasury yields ended the week higher after the U.S. Federal Reserve hiked policy rates 75 basis points. Fixed income returns were dragged down by rising yields and widening spreads. Volatility ran high, especially for short-maturity rates and risk assets.

HIGHLIGHTS

- **Total returns were negative across all fixed income sectors for the second consecutive week.**
- **A negative risk sentiment weighed on non-Treasury sectors, and credit spreads widened.**
- **Municipal bond yields sold off again. New issue supply was only $3.4B, with outflows of -$5.3B. This week's new issue supply ticks up to $5.6B.**

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Watchlist

- *10-year Treasury yields rose. We expect them to remain volatile, but end the year near current levels.*
- *Credit sectors continued to struggle.*
- *Net-negative supply should provide some support to municipal bonds.*

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 3.25%.

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 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.

HIGH YIELD CORPORATES SEE SIGNIFICANT OUTFLOWS

U.S. Treasury yields ended modestly higher last week, led again by short-term rates. Yields were extremely volatile. All maturities started the week sharply higher as they continued the recent climb fueled by more aggressive expectations for Fed rate increases. Ironically, yields across maturities dropped precipitously mid-week after the Fed delivered the largest policy hike since 1994. Rates declined after Chair Powell characterized the size of the hike as uncommon. Although 2-year rates ended the week 12 basis points (bps) higher, intraweek volatility was high, including Monday's increase of more than 29 bps and Wednesday's drop of almost 24 bps. The 10-year Treasury yield saw two moves of almost 20 bps during the week before ending 7 bps higher.

Investment grade corporates struggled again last week as investor outflows picked up. Spreads widened 8 bps, just inside recent highs reached in May. The shorter-maturity range suffered the most and underperformed on a relative basis. The overall sector posted a total return of -1.19% and underperformed similar-duration Treasuries by almost -59 bps. Last week saw the largest investor outflows in 6 weeks, and marked the 16th consecutive week with net outflows. The lack of new issue supply helped keep the secondary market flows more orderly, as investors stepped in to buy on weakness. Last week was the first week without new deals since 2020 for traditional investment grade corporate bonds.

High yield corporates followed other risk assets lower, with returns falling -2.90% and lagging similar-duration Treasuries by -257 bps. Similar to the investment grade sector, high yield experienced significant investor outflows throughout the week. The increase in outflows more than eclipsed the total inflows from the previous two weeks.

Emerging markets endured another week of negative returns and soft performance. The global EM index fell -2.00% for the week and underperformed similar-duration U.S. Treasuries by more than -151 bps. EM spreads were wider across the board, with sovereign high yield bonds suffering the most pronounced underperformance.

MUNI BONDS REPRESENT FAIR VALUE

Municipal bond yields rose 25 bps across the curve as of last Monday's close, the highest one-day increase since March 2020. New issue supply was low for the week, with some deals pulled due to market uncertainty. Fund flows showed the third largest redemption since records have been kept. New issuance this week should be priced cheaply.

Investors are very concerned about inflation, particularly as the Consumer Price Index (CPI) recently reported its highest reading in 40 years. Both Treasury and municipal bonds sold off dramatically at the beginning of the week, then calmed down somewhat after the Fed's 75 bps rate hike on Wednesday.

Inflation fears have stressed fixed income markets in general. The 10-year Treasury yield eclipsed 3.32% midweek, the previous high set in 2011. Municipal bond yields followed suit, but we think muni yields represent fair value right now. The tax-exempt 10-year AAA MMD curve is yielding 2.91% versus the taxable 10-year Treasury at 3.22%, or approximately 90%. We expect this ratio to continue, as both markets should remain range bound for the foreseeable future.

Boise City, Idaho, issued $76 million water renewal revenue bonds (rated Aa2). The deal included a 5% coupon bond due in 2032 yielding 3.24%, which was attractive compared to the 10-year Treasury at 3.22%.

The high yield municipal market ended last week with much needed stability, despite a record -$1.78 billion in outflows as municipal bond yields surged leading up to the Fed meeting. Yields for high-beta liquidity benchmarks led the selloff, including IA Tobacco, Golden St Tobacco and COFINA. Thursday and Friday were much more stable, with the market tone and liquidity improving in the aftermath of the Fed meeting. This week's new issue calendar is light, but many deals from last week still need to clear.

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In focus

The Fed turns up its tightening

Amid decades-high levels of inflation that show no sign of relenting, last week the Fed raised its target for the federal funds rate by 75 bps, to 1.50%-1.75%. This marked the largest such increase at a single Fed meeting since 1994.

A 50 bps hike had been expected. But May's hotter-than-anticipated Consumer Price Index (CPI) reading (+8.6%) was released just a few days before the meeting, resulting in market turmoil and forcing the Fed's hand to lift rates more aggressively. At his post-meeting press conference, Chair Jerome Powell laid out the Fed's goal for lowering inflation to its 2% target while preserving a strong labor market. Doing so, he stated, includes plans for either a 50 bps or 75 bps increase when the Fed reconvenes in July.

Investors have priced in a high probability of another 75 bps move next month, with hikes of declining magnitude expected over the balance of 2022 and into 2023. We anticipate economic data — notably, job openings, wage growth and other measures of price inflation — to soften between now and the end of summer, helping to temper those rate expectations.

As for engineering an economic soft landing, Powell believes such an outcome is still possible, but it has been made more challenging by factors beyond the Fed's control, such as rising commodity prices and supply chain issues.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	3.18	0.12	0.62	2.45
5-year	3.34	0.09	0.52	2.08
10-year	3.23	0.07	0.38	1.72
30-year	3.28	0.09	0.24	1.38

Source: Bloomberg L.P., 17 Jun 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	2.06	0.31	0.23	1.82
5-year	2.36	0.31	0.25	1.77
10-year	2.91	0.33	0.28	1.88
30-year	3.38	0.31	0.27	1.89

Source: Bloomberg L.P., 17 Jun 2022. **Past performance does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	90
30-year AAA Municipal vs Treasury	102
High Yield Municipal vs High Yield Corporate	64

Source: Bloomberg L.P., Thompson Reuters, 17 Jun 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	3.38	–	6.97	-2.00	-2.80	-10.06
High yield municipal	5.43	219[1]	10.47	-3.56	-4.83	-13.26
Short duration high yield municipal[2]	5.09	244	4.41	-1.83	-2.40	-6.54
Taxable municipal	4.49	113[3]	9.29	-0.74	-1.89	-15.42
U.S. aggregate bond	3.93	55[3]	6.45	-0.92	-2.81	-11.48
U.S. Treasury	3.32	–	6.38	-0.52	-2.18	-10.34
U.S. government related	3.86	56[3]	5.47	-0.70	-2.25	-10.07
U.S. corporate investment grade	4.79	144[3]	7.58	-1.19	-3.37	-14.89
U.S. mortgage-backed securities	4.04	53[3]	5.90	-1.35	-3.38	-10.43
U.S. commercial mortgage-backed securities	4.35	103[3]	4.83	-0.56	-2.21	-9.62
U.S. asset-backed securities	4.02	79[3]	2.25	-0.28	-1.19	-4.47
Preferred securities	6.49	275[3]	5.03	-2.97	-4.63	-14.25
High yield 2% issuer capped	8.52	503[3]	4.26	-2.90	-5.54	-13.08
Senior loans[4]	9.58	607	0.25	-1.38	-0.90	-3.32
Global emerging markets	7.06	374[3]	6.32	-2.00	-3.96	-16.61
Global aggregate (unhedged)	3.08	54[3]	6.99	-1.36	-4.20	-14.80

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, 17 Jun 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, 17 Jun 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 15 Jun 2022.

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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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