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Weekly Fixed Income Commentary

03 October 2022

Market volatility continues as Treasury yields rise further

U.S. Treasury yields continued to rise and market volatility picked up materially, in part due to challenges in the UK government bond market. These events led to weakness across risk assets.

HIGHLIGHTS

- **Core fixed income asset classes broadly suffered negative returns, including Treasuries, agencies, MBS, investment grade and high yield corporates, taxable munis, convertibles and leveraged loans.**
- **Municipal bond yields increased yet again. New issue supply remained light at $5.5B, with outflows of -$3.6B. This week's new issue supply should be muted again at $4.1B.**

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OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.
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Watchlist

- *10-year Treasury yields moved higher last week.*
- *Spread assets weakened amid elevated volatility.*
- *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 remains 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 the pace of long-term increases should remain relatively modest.

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 fails to moderate as expected, negatively affecting asset values.
- Policymakers remove accommodation too rapidly, undermining the global economic expansion.
- The Russia/Ukraine conflict continues to escalate.
- Covid-19 cases increase, or new variants emerge.

INVESTMENT GRADE CORPORATE SPREADS TOUCH A YEAR-TO-DATE HIGH

U.S. Treasury yields rose again last week, with 10-year yields ending 14 basis points (bps) higher. They had moved as much as 33 bps higher early in the week, due to volatility in the UK government bond market. Reports of margin calls and forced liquidation by large, liability-driven, UK-based pension funds caused a sharp selloff in the long end of the UK bond market, with 30-year gilt yields rising as much as 109 bps. The Bank of England stepped in on Wednesday, promising to buy substantial amounts of long-end bonds to restore market function, and yields subsequently fell sharply. Separately, U.S. personal consumption expenditures (PCE) inflation surprised to the upside on Friday, prompting another increase in global bond yields.

Investment grade corporates weakened substantially, returning -1.89% for the week and underperforming similar-duration Treasuries by -98 bps. Spreads widened materially and touched a new year-to-date high, ending 13 bps wider at 159 bps. Outflows accelerated, with -$7.9 billion leaving the asset class. That was the second-largest outflow of the year and the fifth-largest on record. Amid the selloff and volatility, issuers largely refrained from bringing new supply. Only three deals priced, totaling $1.7 billion, substantially less than the $15-20 billion expected. Overall September issuance was smaller than August, for the first time since 2008.

High yield corporates also sold off, returning -1.36% for the week and underperforming similar-duration Treasuries by -103 bps. Higher-quality segments outperformed, with BBs returning -1.08% versus bigger drawdowns of -1.53% and -2.07% for Bs and CCCs, respectively. As with investment grade, there was another elevated outflow, with -$3.0 billion leaving high yield and -$1.9 billion exiting from leveraged loans. Loans returned -1.06% for the week.

Emerging markets lagged, returning -2.44% and underperforming similar-duration Treasuries by -175 bps. Decompression dominated market action, with high yield spreads widening much more than investment grade. In the sovereign space, high yield names widened 100 bps versus 32 bps for investment grade. For corporates, high yield widened 53 bps versus 26 bps for investment grade. Outflows accelerated at -$4.2 billion, the year's largest single-week outflow.

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THE HIGH YIELD MUNICIPAL MARKET STEADIES

Municipal bond yields increased across the curve last week. Short- and long-term rates rose 17 bps. Weekly new issuance for munis continued to be light and fund flows were negative for the eighth consecutive week. New issue supply for this week will still need to be priced to sell.

The tax-exempt municipal bond curve remains very flat. Orderly market flow continues, as new issue supply remains muted along with strong institutional demand. Individual investors are buying bonds at 4% tax-exempt yield, a level that hasn't been seen in years. The U.S. Federal Reserve should be done raising rates by the first quarter of 2023, when fixed income should begin to rally. Until then, we expect volatility to continue for all of fixed income, including municipal bonds.

The state of Illinois issued $280 million tax-exempt general obligation bonds (rated Baa1/BBB+). The deal was priced to sell and well received. Some bonds traded in the secondary market at a premium to where they were issued. For example, 5.25% coupon bonds due in 2046 came at a yield of 5.48%. Those bonds traded in the secondary market at 5.44%.

The high yield municipal market steadied and became slightly firmer by the end of last week, despite accelerating outflows. Demand is strong in the secondary market away from mutual funds. The rapid rise in rates has slowed deal flow, but opportunities are pronounced in the secondary market. The bankruptcy court ordered the Puerto Rico Oversight Board and PREPA bondholders back into third-party mediation with a deadline to produce an approvable restructuring plan by year end.

Orderly market flow continues in the muni market, as new issue supply remains muted along with strong institutional demand.

In focus

Muni bond tax loss selling offers opportunity

Due to rising interest rates, many fixed income investors have the opportunity to harvest tax losses to offset current or future realized gains and take advantage of higher yields.

Given the magnitude and speed of interest rate increases in 2022, the fourth quarter will likely see elevated levels of tax loss selling within the municipal market. Investors began the process earlier than usual this year, and we expect the trend to continue through year end.

Tax loss harvesting allows investors to sell bonds purchased in lower yield environments and replace them with higher yielding bonds. This exchange increases net investment income, as less principal may be used to purchase income than was available previously. The process can be done as part of portfolio rebalancing heading into the fourth quarter.

It is important to start tax loss harvesting for municipal bonds early, as it can be a longer process than in other areas of the market given the over-the-counter nature of municipal bonds. We recommend beginning the process in October, as issuance tends to be elevated during the month, allowing greater investment opportunities before issuance declines during the holiday season.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	September 2022	Year-to-date
2-year	4.28	0.07	0.79	3.55
5-year	4.09	0.11	0.74	2.83
10-year	3.83	0.14	0.64	2.32
30-year	3.78	0.17	0.49	1.88

Source: Bloomberg L.P., 30 Sep 2022. **Past performance does not predict or guarantee future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	September 2022	Year-to-date
2-year	3.09	0.17	0.81	2.85
5-year	3.12	0.17	0.80	2.53
10-year	3.30	0.19	0.71	2.27
30-year	3.90	0.17	0.61	2.41

Source: Bloomberg L.P., 30 Sep 2022. **Past performance does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	86
30-year AAA Municipal vs Treasury	103
High Yield Municipal vs High Yield Corporate	62

Source: Bloomberg L.P., Thompson Reuters, 30 Sep 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	September 2022	Year-to-date
Municipal	4.04	–	7.15	-0.96	-3.84	-12.13
High yield municipal	6.03	230[1]	10.58	-1.50	-6.16	-16.03
Short duration high yield municipal[2]	5.84	269	4.34	-0.73	-3.09	-7.61
Taxable municipal	5.20	119[3]	9.08	-1.54	-5.21	-19.28
U.S. aggregate bond	4.75	62[3]	6.20	-0.99	-4.32	-14.61
U.S. Treasury	4.13	–	6.10	-0.71	-3.45	-13.09
U.S. government related	4.74	59[3]	5.15	-0.85	-3.48	-12.71
U.S. corporate investment grade	5.69	159[3]	7.09	-1.89	-5.26	-18.72
U.S. mortgage-backed securities	4.83	69[3]	5.94	-0.69	-5.05	-13.66
U.S. commercial mortgage-backed securities	5.17	105[3]	4.70	-0.55	-3.11	-11.81
U.S. asset-backed securities	4.84	53[3]	2.16	-0.07	-1.16	-5.06
Preferred securities	7.19	257[3]	5.05	-1.23	-3.91	-14.87
High yield 2% issuer capped	9.69	554[3]	4.11	-1.36	-3.97	-14.73
Senior loans[4]	10.96	668	0.25	-1.06	-2.17	-3.31
Global emerging markets	8.16	405[3]	5.94	-2.44	-5.53	-20.50
Global aggregate (unhedged)	3.70	61[3]	6.74	-0.72	-5.14	-19.89

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, 30 Sep 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, 23 Sep 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 21 Sep 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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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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