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# Treasury yields rise on strong jobs data

*U.S. Treasury yields rose sharply last week, initially on follow-through from the prior week's strong jobs numbers. The trend extended after hawkish commentary from U.S. Federal Reserve Chair Powell. Investors and markets will pay close attention to this week's inflation data.*

## HIGHLIGHTS

- **Total returns were negative across all major fixed income asset classes.**
- **Senior loans had positive total returns, while CMBS and ABS had positive excess returns.**
- **Municipal bond yields increased. New issue supply was \$4.9B with inflows of \$775M. This week's new issuance should increase to \$8.2B.**



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OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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# Watchlist

- *U.S. Treasury yields rose across the curve.*
- *Spread assets weakened after a strong start to the year.*
- *Net-negative supply should provide some support to municipal bonds.*

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## INVESTMENT VIEWS

**The end to U.S. central bank tightening appears near**, as we expect Fed rate hikes to cease early this year. The overall level of rates is likely to remain historically low.

**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 fall this year**, and we expect the 10-year Treasury yield to end the year around 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.

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## KEY RISKS

- Inflation fails to moderate as expected, negatively affecting asset values.
- Policymakers remove accommodation too rapidly, undermining the global economic expansion.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.
- Covid cases increase, or new variants emerge.

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## HIGH YIELD CORPORATES WEAKEN AFTER A STRONG START TO THE YEAR

**U.S. Treasury yields moved higher last week**, initially on follow-through from the prior week's strong jobs numbers. The trend extended after hawkish commentary from Fed Chair Powell on Tuesday and a weak 30-year Treasury auction on Thursday. Ultimately, 10-year yields ended 21 basis points (bps) higher at 3.74%. The 2-year/10-year yield curve inverted further, touching a new 42-year low of -87.2 bps, ahead of this week's highly anticipated CPI data report.

**Investment grade corporates sold off**, returning -1.82% for their first weekly loss of the year. The asset class lagged similar-duration Treasuries by -33 bps. The new issue market remained active at nearly \$33 billion. Overall, deals were 3.6x oversubscribed and came with concessions around 6 bps, indicating healthy demand. The asset class was supported by the sixth consecutive weekly inflow, with \$4.1 billion entering the asset class on the week.

**High yield corporates also weakened**, returning -1.78% for their worst weekly performance since September after a hot start to the year. The asset class underperformed similar-duration Treasuries by -95 bps. Almost \$10 billion of new supply hit the market, as the new issue market continues to accelerate. High yield funds had inflows of \$871 million. Though loan funds had outflows of -\$256 million, the loan asset class performed well, returning 0.38% for the week. CLO issuance has picked up, providing a steady set of additional buyers across the asset class.

**Emerging markets underperformed as well**, returning -1.83% for the week and lagging similar-duration Treasuries by -53 bps. Within sovereign space, high yield names underperformed, widening 22 bps versus a -1 bps rally in investment grade. Inflows slowed again but remained positive, with \$417 million entering hard currency funds. Local currency funds were nearly flat. The new issue market picked up, with more than \$20 billion pricing, with the balance of supply skewed toward corporates instead of sovereigns for the first time this year.

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## MUNIS FACE CHALLENGING TECHNICALS IN FEBRUARY

**Municipal bond yields ended the week higher.** Short-term muni yields increased 16 bps and long-term rates rose 11 bps. Fund flows turned positive again, and this week's larger new issue supply will need to be priced cheaply to pique investor interest.

**U.S. Treasury rates in general are selling off** as investors are increasingly questioning the Fed's resolve in conquering inflation. The next Fed rate hike will likely put short-term rates at 5%, and it is hard to see inflation running rampant at that level. Some believed the Fed may begin lowering rates by the end of 2023, a scenario that now looks unlikely. But with rates in general so much cheaper than they were last year at this time, a fair number of investors should be willing to support fixed income at current levels.

**Tax-exempt municipals remain well bid.** However, the February 1 coupon reinvestment is relatively small and new issue supply is building. Munis may sell off slightly as a result, but we would look at any selloff as potential buying opportunity.

**New York City Transitional Finance Authority** issued \$1 billion of tax-secured subordinate bonds (rated Aa1/AAA). The deal included 5% coupon bonds due in 2041 that came at a yield of 3.46%. Those bonds traded later in the secondary market at 3.53%.

**High yield municipal bonds have outperformed this year** and are only modestly higher in yield, despite a rather significant retracement in U.S. Treasury yields. With liquidity normalizing, high yield muni credit spreads are starting to reflect more of the underlying fundamental bullishness that should anchor the asset class. Net inflows totaled \$530 million last week, affirming continued strength in demand. New issue supply remained subdued, so demand is mainly being met by secondary supply. Trade volumes suggest cash balances are building with the magnitude of fund flows.

**High yield corporate new supply hit almost \$10 billion, as the new issue market continues to accelerate.**

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## In focus

# High yield munis offer attractive risk- adjusted income

*High yield municipals currently provide investors with high levels of income. The Bloomberg High Yield Municipal Bond Index is yielding 5.48%, equal to a tax-equivalent yield of 9.26%.<sup>1</sup> And this attractive income comes with a number of additional benefits.*

Municipal bonds have provided relatively low default risk. For example, on a rolling 10-year average, municipal bonds rated C have been more than two times less likely to default than similarly rated corporate debt.<sup>2</sup> In today's environment, significant tax revenues and federal stimulus as a result of the pandemic have left municipal issuers fundamentally strong.

Additionally, high yield municipals are more sensitive than high yield corporates to changes in interest rates, with a duration of 7.69 years compared to 3.69 years. If rates decline, either due to Fed policy or market expectations, this attractive total return profile may allow investors to offset spread widening risk if the economy slows down.

With recent economic data coming out stronger than expected, adding high yield municipals to a portfolio can provide investors with attractive income and return in a risk-conscious manner to better hedge if conditions change.

1 Based on the highest individual marginal federal tax rate of 37%, plus the 3.8% Medicare tax on investment income (the Net Investment Income Tax). Individual tax rates may vary.

2 Data source: Moody's Investors Service, *U.S. Municipal Bond Defaults and Recoveries, 1970 – 2021*, 21 Apr 2022.

## U.S. Treasury market

Maturity	Change (%)			
	Yield	Week	Month-to-date	Year-to-date
2-year	4.52	0.23	0.32	0.09
5-year	3.92	0.26	0.31	-0.08
10-year	3.74	0.21	0.23	-0.14
30-year	3.82	0.20	0.18	-0.15

Source: Bloomberg L.P., 10 Feb 2023. Performance data shown represents past performance and does not predict or guarantee future results.

## Municipal market

Maturity	Yield to Worst	Change (%)		
		Week	Month-to-date	Year-to-date
2-year	2.35	0.16	0.18	-0.25
5-year	2.12	0.08	0.07	-0.40
10-year	2.24	0.06	0.05	-0.39
30-year	3.28	0.11	0.08	-0.30

Source: Bloomberg L.P., 10 Feb 2023. Performance data shown represents past performance and does not predict or guarantee future results.

## Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	60
30-year AAA Municipal vs Treasury	86
High Yield Municipal vs High Yield Corporate	65

Source: Bloomberg L.P., Thompson Reuters, 10 Feb 2023. 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. Performance data shown represents past performance and does not predict or guarantee future results.

## For more information, please visit nuveen.com.

**Performance:** Bloomberg, L.P. **Issuance:** The Bond Buyer, 10 Feb 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 08 Feb 2023.

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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## Characteristics and returns

Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Returns (%)		
				Week	Month-to-date	Year-to-date
Municipal	3.22	–	6.13	-0.55	-0.44	2.42
High yield municipal	5.48	240 <sup>1</sup>	7.69	-0.83	-0.20	4.23
Short duration high yield municipal <sup>2</sup>	5.14	300	4.03	-0.30	-0.04	2.41
Taxable municipal	4.92	97 <sup>3</sup>	8.35	-1.57	-1.36	3.61
U.S. aggregate bond	4.56	45 <sup>3</sup>	6.35	-1.43	-1.48	1.55
U.S. Treasury	4.14	–	6.26	-1.25	-1.47	1.00
U.S. government related	4.70	54 <sup>3</sup>	5.37	-1.17	-1.08	1.26
U.S. corporate investment grade	5.23	118 <sup>3</sup>	7.20	-1.82	-1.75	2.19
U.S. mortgage-backed securities	4.52	42 <sup>3</sup>	6.10	-1.46	-1.40	1.85
U.S. commercial mortgage-backed securities	5.09	101 <sup>3</sup>	4.57	-0.91	-0.98	1.63
U.S. asset-backed securities	5.06	61 <sup>3</sup>	2.85	-0.45	-0.51	0.90
Preferred securities	6.60	200 <sup>3</sup>	4.94	-1.27	-1.03	7.52
High yield 2% issuer capped	8.39	416 <sup>3</sup>	3.79	-1.78	-0.69	3.09
Senior loans <sup>4</sup>	9.96	566	0.25	0.38	0.73	3.31
Global emerging markets	7.28	321 <sup>3</sup>	6.19	-1.83	-1.28	1.88
Global aggregate (unhedged)	3.61	46 <sup>3</sup>	6.80	-1.63	-1.44	1.80

**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, 10 Feb 2023. Performance data shown represents past performance and 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.

by way of example. Performance data shown represents past performance and does not predict or guarantee future results. Investing involves risk; principal loss is possible.

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### Important information on risk

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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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