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Weekly Fixed Income Commentary

21 February 2023

Inflation data boost Treasury yields further

U.S. Treasury yields rose yet again last week, the fourth consecutive weekly increase and the longest streak since October. Unfavorable inflation data showed many categories with increased prices, and median CPI printed at the highest rate since September.

HIGHLIGHTS

- **Total returns were negative across all major fixed income asset classes.**
- **Agencies, CMBS and ABS outperformed similar-duration Treasuries.**
- **Municipal bond yields increased. New issue supply was $8.2B with outflows of -$68M. This week's new issuance should be muted at $3.4B.**

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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.*

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 relatively low by historical standards.

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.

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.

INVESTMENT GRADE CORPORATES HIT WITH DUAL TECHNICAL HEADWINDS

U.S. Treasury yields moved higher again last week, the fourth consecutive weekly increase and the longest streak since October. 10-year yields ended 8 basis points (bps) higher, while 2-year yields rose 10 bps. That sent the 2-year/10-year curve -2 bps flatter at -81 bps, after it touched a new 42-year low of -92 bps at mid-week. The main catalyst for the bear flattening was a CPI report showing higher-than-expected inflation. Although the headline numbers were in-line with consensus, the underlying details were adverse. Many categories saw increased prices, with median CPI printing at the highest rate since September. The headline numbers were only held down by further deflation in core goods prices, which is likely to reverse in the coming months.

Investment grade corporates weakened again, retreating -0.68% and underperforming similar-duration Treasuries by -22 bps. The asset class was hit with dual technical headwinds of slowing inflows and heavy supply. Inflows totaled $2.5 billion, down -40% from the prior week, while the new issue market ramped up with $50 billion of new supply across 17 issuers. Longer-duration segments underperformed amid the selloff in Treasuries.

High yield corporates also sold off, returning -0.88% for the week and lagging similar-duration Treasuries by -61 bps. Senior loans outperformed, as higher rates generally help the asset class, but still returned -0.09% for the week. In both asset classes, lower-quality segments outperformed, while flows turned less supportive. High yield funds experienced an outflow of -$2.8 billion and loan funds lost -$529 million. The new issue market was very muted amid the unfavorable price action.

Emerging markets underperformed as well, returning -0.77% for the week and underperforming similar-duration Treasuries by -36 bps. Across both sovereigns and corporates, investment grade outperformed high yield names. After five weeks of inflows, the hard currency sovereign space saw outflows of -$526 million, while local funds lost -$216 million. The new issue market was also somewhat calm, with just over $6.5 billion of new supply brought for the week.

DEMAND FOR MUNICIPAL BONDS REMAINS ELEVATED

Municipal bond yields increased dramatically last week. Underwriters struggled to sell new deals and fund flows turned negative once again. This week's new issue supply should be muted, and it must be priced cheaply to be sold.

Fixed income in general sold off considerably last week, as ample data suggested the economy continues to be strong. Thus, the Fed remains under pressure to keep raising short-term rates, which we believe will top 5% by the end of March. The Fed will win eventually, but we expect interest rates in general to be higher for longer.

Municipal bonds followed in lock step with last week's Treasury sell off, and municipal-to-Treasury yield ratios are now more attractive. We expect muni's to be range bound for the foreseeable future. However, demand for municipal bonds remains elevated, as rates are back near year-end 2022 levels.

Washington Suburban Sanitary District, Maryland, issued $318 million consolidated public improvement bonds (rated Aaa/AAA). The deal included 5% coupon bonds maturing in 2033 that came at a yield of 2.25%. Those bonds traded Friday in the secondary market at 2.60%.

High yield municipal bond yields are increasing due to the recent burst of Treasury volatility. While this trend has given back a portion of January's rally, demand remains strong. We are seeing a concentrated relative value rotation from short-duration into long-duration high yield municipals. New issue supply remains suppressed, supporting secondary market demand. If the longer-term trend of rates and inflation holds, we think February feels like an attractive opportunity to participate in a fuller technical rally on top of historically strong fundamentals.

Senior loans outperformed, as higher rates generally help the asset class, but still returned -0.09% for the week.

In focus

Three possible paths for the U.S. economy

The Fed appears to be in the later stages of its rate hike cycle, and investors are focused on the potential effects of higher interest rates on the U.S. economy in 2023. Below are the three most commonly discussed economic scenarios, along with the outlook for fixed income.

Soft landing: This is the Fed's goal, where the economy slows enough to lower inflation to around 2% — the central bank's long-term target — but averts recession. Although the Fed historically has had little success navigating a soft landing, Chair Jerome Powell recently stated that he still harbored hopes for achieving one. This backdrop potentially offers the best opportunity for fixed income broadly.

Hard landing: The Fed achieves a Pyrrhic victory by taming inflation while driving the economy into a severe recession. U.S. Treasuries and high quality corporate bonds (especially longer-duration securities) could outperform not only higher risk fixed income segments such as high yield debt and senior loans, but also equities.

No landing: Economic growth remains strong, and because inflation stays sticky, the Fed raises interest rates higher than investors or central bankers had expected. With rates on the upswing, fixed income would likely struggle, although senior loans could offer a measure of protection thanks to their floating-rate coupons.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	4.62	0.10	0.42	0.19
5-year	4.03	0.11	0.41	0.03
10-year	3.82	0.08	0.31	-0.06
30-year	3.87	0.05	0.24	-0.10

Source: Bloomberg L.P., 17 Feb 2023. **Performance data shown represents past performance and does not predict or guarantee future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	2.79	0.44	0.62	0.19
5-year	2.47	0.35	0.42	-0.05
10-year	2.49	0.25	0.30	-0.14
30-year	3.50	0.22	0.30	-0.08

Source: Bloomberg L.P., 17 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	65
30-year AAA Municipal vs Treasury	90
High Yield Municipal vs High Yield Corporate	66

Source: Bloomberg L.P., Thompson Reuters, 17 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.**

Characteristics and returns

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	3.52	–	6.15	-1.43	-1.86	0.96
High yield municipal	5.72	242[1]	7.77	-2.44	-2.64	1.69
Short duration high yield municipal[2]	5.34	291	4.07	-0.78	-0.82	1.61
Taxable municipal	4.98	95[3]	8.30	-0.40	-1.75	3.20
U.S. aggregate bond	4.66	46[3]	6.30	-0.47	-1.95	1.07
U.S. Treasury	4.23	–	6.20	-0.39	-1.86	0.60
U.S. government related	4.79	53[3]	5.32	-0.33	-1.40	0.92
U.S. corporate investment grade	5.35	121[3]	7.14	-0.68	-2.42	1.49
U.S. mortgage-backed securities	4.60	41[3]	6.06	-0.44	-1.83	1.40
U.S. commercial mortgage-backed securities	5.18	100[3]	4.55	-0.29	-1.27	1.33
U.S. asset-backed securities	5.13	58[3]	2.84	-0.12	-0.63	0.78
Preferred securities	6.75	203[3]	4.90	-0.66	-1.68	6.81
High yield 2% issuer capped	8.62	428[3]	3.80	-0.88	-1.56	2.19
Senior loans[4]	10.21	576	0.25	-0.09	0.64	3.22
Global emerging markets	7.43	327[3]	6.13	-0.77	-2.04	1.10
Global aggregate (unhedged)	3.70	46[3]	6.75	-0.95	-2.38	0.83

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 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.

For more information, please visit nuveen.com.

Performance: Bloomberg, L.P. **Issuance:** The Bond Buyer, 17 Feb 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 15 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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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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