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Weekly Fixed Income Commentary

10 July 2023

Economic data leave Treasury yields mixed

U.S. Treasury yields rose last week amid positive economic data. U.S. employment numbers missed expectations, but the details and other labor data were strong. Overall, the growth backdrop should support at least one more U.S. Federal Reserve rate hike this year.

HIGHLIGHTS

- **Treasuries, investment grade and high yield corporates, MBS, CMBS, preferreds and emerging markets all had negative total returns.**
- **Senior loans had positive total returns, while preferreds, ABS and emerging markets also had positive excess returns.**
- **Municipal bond yields rose slightly across the curve. New issue supply was $1.0B with outflows of -$856M. This week's new issuance should be $8.2B.**

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OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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Watchlist

- *10-year U.S. Treasury yields rose, but we anticipate further declines over the course of 2023.*
- *Spread assets were mixed relative to Treasuries.*
- *Increased seasonal supply should provide an attractive entry point for municipal bonds.*

INVESTMENT VIEWS

"Higher for longer" rates remains as a theme, as the Fed battles to control inflation. Higher interest rates are likely to cause additional volatility.

The underlying growth outlook remains healthy thanks to strong consumer balance sheets and solid levels of businesses investment. This combination should keep corporate defaults low.

Treasury yields are likely to fall slightly this year, and we expect the 10-year Treasury yield to end 2023 around 3.25%.

We favor selectively taking on risk in this environment of attractive prices and yields. Credit selection is key as we search for bonds with favorable income and solid fundamentals.

KEY RISKS

- Inflation fails to moderate as expected, weighing on asset prices.
- Policymakers tighten too rapidly, undermining the global economic expansion.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.

INVESTMENT GRADE CORPORATE SPREADS REMAIN NEAR RECENT LOWS

U.S. Treasury yields rose last week, with the 10-year yield ending 23 basis points (bps) higher at 4.07%, its highest level since November. 2-year yields moved more modestly, up 5 bps for the week. In the June jobs report, the headline number missed expectations for the first time in more than a year, but the details and other labor market data were strong. The unemployment rate fell to 3.6%, the number of hours worked per week ticked up and private-sector measures of job growth accelerated. The ISM survey of services sector activity also rebounded, to 53.9, though the manufacturing gauge slipped further into contractionary territory at 46.0. Overall, the growth backdrop remains strong, supporting market pricing for at least one more Fed rate hike this year.

Investment grade corporates sold off alongside the move in rates, returning -1.43% for the week. The asset class lagged similar-duration Treasuries by -7 bps. Overall spread levels in investment grade corporates moved a few basis points wider, but remain near the recent lows at 124 bps. On the other hand, index-level yields reached new year-to-date highs of 5.67%, which is still around -46 bps lower than the peak from last fall. Investment grade funds saw inflows of $5.9 billion, while the new issuance market totaled almost $13 billion, more than expected for the U.S. holiday-shortened week.

High yield corporates also weakened, returning -0.60% for the week and underperforming similar-duration Treasuries by -6 bps. Senior loans performed better, returning 0.38% and outperforming for the third straight week. High yield funds saw outflows of -$283 million, while loan funds had modest inflows of $53 million. Both markets had light new issuance calendars, with high yield seeing no new deals and loans with $3.9 billion of new supply.

Emerging markets joined the selloff but outperformed. The asset class returned -1.11% for the week but beat similar-duration Treasuries by 8 bps. Spreads tightened across both sovereign and corporate space. The dollar rallied amid the rise in U.S. rates, which weighed on performance somewhat, especially for local funds, which fell -0.76%. Both local and hard currency funds saw outflows, of -$15 and -$369 million, respectively, while there was no new issuance.

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THE MUNICIPAL MARKET REMAINS RESILIENT

Municipal bond yields rose slightly across the curve last week, directly due to the increase in Treasury yields. New issuance was low due to the U.S. holiday. Overall fund flows were negative, while short-term tax-exempt money market funds gained $3.8 billion. That means investors are utilizing the asset class, albeit on the short end. This week's new issue calendar should be priced to sell and well received.

Municipal bond yields should be constructive overall during the summer months. The industry is now reinvesting $40 billion that entered the system 01 July. In aggregate, $105 billion is expected to be available to reinvest through the end of August.

We see strong interest in two specific areas on the yield curve. Institutional investors are rearranging portfolios out long on the curve to pre-specified mandates, as they believe those yields will be lower in 2024. However, others are enjoying outsized ultra-short-term yields of 3% and higher.

We suggest investors reposition portfolios out longer to get to pre-specified target durations, and we believe it makes sense to tactically invest in short-term yields and enjoy the outsized yield while it remains.

High yield municipal bond funds saw a burst of rate volatility and resulting outflows last week, but the market remains well bid due to strong 01 July cash flows. New issue supply remains light and competitive. A court ruling on Puerto Rico Electric Power Authority (PREPA) bondholder claim estimations effectively mirrored a new fiscal plan submitted by the Oversight Board, moving prices of PREPA bonds significantly lower.

Consider repositioning muni portfolios out longer while also tactically investing in outsized short-term yields.

In focus

Why are CPI and PCE diverging?

The inflation outlook remains a key dynamic for markets moving forward. Wednesday's release of the latest consumer price index (CPI) report is expected to show a further moderation in headline inflation year-over-year, to around 3%. That is a significant decline from last year's peak of 9.1%.

However, the U.S. Federal Reserve's official metric for gauging inflation is the personal consumption expenditures (PCE) price index. While the broad trends in CPI and PCE are similar, the two measures sometimes diverge due to important methodological differences.

Both metrics have been buffeted by the same dynamics in recent years. Higher goods prices amid Covid-driven supply chain disruptions initially drove inflation higher. This was exacerbated by higher food and energy costs, accelerated by the war in Ukraine. Over the last year, core services – especially housing prices – have risen as well, though that trend is starting to reverse.

Methodological differences can have a material impact in this situation. Housing prices make up around 35% of the CPI basket, but only 18% of the PCE basket. Therefore, as housing prices have moderated from a 9% annualized pace to around 6%, CPI has declined faster than the PCE.

The Fed targets 2% PCE inflation. We expect PCE inflation to remain somewhat stickier at elevated levels versus CPI this year, since it will benefit less from the improvement in housing prices. This will likely keep the Fed in "hawkish" mode, supporting at least one more rate hike this year.

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U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	4.95	0.05	0.05	0.52
5-year	4.36	0.21	0.21	0.36
10-year	4.07	0.23	0.23	0.19
30-year	4.05	0.19	0.19	0.08

Source: Bloomberg L.P., 07 Jul 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	2.97	0.04	0.04	0.37
5-year	2.67	0.05	0.05	0.15
10-year	2.64	0.08	0.08	0.01
30-year	3.54	0.05	0.05	-0.04

Source: Bloomberg L.P., 07 Jul 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	87
High Yield Municipal vs High Yield Corporate	66

Source: Bloomberg L.P., Thompson Reuters, 07 Jul 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	3.58	–	6.09	-0.32	-0.32	2.34
High yield municipal	5.77	245[1]	7.57	-0.50	-0.50	3.91
Short duration high yield municipal[2]	5.38	276	3.92	-0.08	-0.08	3.52
Taxable municipal	5.26	97[3]	8.13	-1.68	-1.68	3.00
U.S. aggregate bond	5.00	51[3]	6.31	-1.29	-1.29	0.77
U.S. Treasury	4.54	–	6.13	-1.20	-1.20	0.37
U.S. government related	5.07	50[3]	5.27	-0.93	-0.93	1.44
U.S. corporate investment grade	5.67	124[3]	7.05	-1.43	-1.43	1.74
U.S. mortgage-backed securities	5.00	55[3]	6.26	-1.44	-1.44	0.40
U.S. commercial mortgage-backed securities	5.88	135[3]	4.43	-0.84	-0.84	0.34
U.S. asset-backed securities	5.60	66[3]	2.72	-0.24	-0.24	1.50
Preferred securities	7.52	246[3]	4.63	-0.50	-0.50	2.35
High yield 2% issuer capped	8.74	400[3]	3.53	-0.60	-0.60	4.75
Senior loans[4]	10.27	583	0.25	0.38	0.38	6.73
Global emerging markets	7.69	325[3]	6.15	-1.11	-1.11	2.15
Global aggregate (unhedged)	3.96	50[3]	6.70	-0.66	-0.66	0.76

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, 07 Jul 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, 07 Jul 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 05 Jul 2023.

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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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