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Softer inflation data leave Treasury yields lower

U.S. Treasury yields fell on softer inflation data, helping fixed income to broadly gain. Markets continue to price in another U.S. Federal Reserve rate hike at the July meeting, in addition to a risk of another hike later this year.

HIGHLIGHTS

- **Treasuries, agencies, MBS, investment grade and high yield corporates, preferreds, senior loans and emerging markets all had positive total returns.**
- **Municipal bond yields declined across the curve. New issue supply was \$8.2B with outflows of -\$136M. This week's new issuance should be \$9.1B.**



Anders Persson

CIO of Global Fixed Income



Daniel Close

Head of Municipals

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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Watchlist

- *10-year U.S. Treasury yields fell, and we anticipate further declines over the course of 2023.*
- *Spread assets outperformed 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.

LOANS BENEFIT FROM THE RISK-ON TONE

U.S. Treasury yields fell sharply last week due to softer-than-expected inflation data. 10-year yields ended -23 basis points (bps) lower at 3.83%, while 2-year yields dropped -18 bps. The yield curve remained heavily inverted as a result. Markets continue to price in another Fed rate hike at the July meeting, plus a risk of another hike later this year. Apart from the inflation data, labor market data improved as initial jobless claims moderated, though inflation expectations moved higher. Overall, the incoming data remain consistent with a moderate slowing in the economy, not a rapid deterioration.

Investment grade corporates rallied strongly, gaining 1.60% for the week and outperforming similar-duration Treasuries by 11 bps. After hitting a year-to-date high in yields the prior week, the market snapped back robustly, with yields down -22 bps to 5.45% for the overall index. Issuance was somewhat light, with \$11 billion of new supply. Banks underperformed modestly, and preferreds gained 0.65% but lagged similar-duration Treasuries by -46 bps.

High yield corporates also rallied, returning 1.60% and beating similar-duration Treasuries by 62 bps. Despite the fall in yields, loans benefited from the risk-on tone as well, returning 0.60% for the week. In both asset classes, lower-quality names outperformed, with CCC rated credits advancing 2.11% and 0.81% in high yield and loan space, respectively. Despite the rally, both markets continued to see outflows, of -\$379 and -\$137 million in bonds and loans, respectively.

Emerging markets continued to outperform, returning 1.77% and beating similar-duration Treasuries by 36 bps. Sovereign spreads tightened -4 bps, and high yield (-22 bps) outperformed versus investment grade (7 bps). Local markets benefited from the fall in U.S. rates and the associated fall in the dollar, which weakened -2.3% for the week. Outflows continued from hard-currency funds at -\$199 million, but local funds returned to inflows at \$76 million. Issuance was light across emerging markets, with only \$3.6 billion of new supply coming to market.

THE MUNICIPAL BOND MARKET GAINS SUPPORT FROM JULY REINVESTMENT

Municipal bond yields declined across the curve last week. Short-term rates fell -7 bps and long-term rates declined -3 bps. It is no surprise that munis lagged the Treasury rally, as munis have been trading rich to Treasuries and continue to do so. New issue supply was well received but fund flows remained negative.

Fixed income markets in general have a good tone. Inflation has declined to 3%, and Fed officials indicate at least one more rate increase this year to get inflation down to their 2% target. Investors continue locking in long bond yields, as they think those rates will decline as early as the first part of 2024. Tax-exempt bonds also continue to be well bid due to more than \$100 billion to be reinvested this summer. The 1 July reinvestment of \$40 billion continues to support the market as it has not been completely deployed.

Denton Independent School District, TX, issued \$949 million unlimited tax school building bonds (rated NR/AA, with bonds having the Permanent School Fund guarantee rated AAA). The deal was well received. For example, 5% coupon bonds due in 2053 came at a yield of 4.08% and traded in the secondary market at 3.88%.

The high yield municipal market is beginning to form a more solid rally with 1) a more stable rate environment 2) strong fund flows and 3) limited supply. After 10 years of banishment, the City of Detroit came to the market with a deal that was massively oversubscribed. Credit selection and deal allocations are delivering strong alpha.

Munis lagged the Treasury rally, as they have been trading rich to Treasuries and continue to do so.

In focus

Cooler times for the CPI

After hitting a multi-decade high of 9.1% (year-over-year) in June 2022, headline Consumer Price Index inflation has declined for 12 straight months. It registered 3.0% last month — the lowest since March 2021. Core inflation, which strips out food and energy costs, also moderated, to 4.8%. On a month-over-month basis, both headline and core CPI weighed in at just 0.2%.

Details of the CPI print were encouraging. Used car prices, which helped drive inflation higher early last year amid a shortage of computer chips necessary to build new vehicles, dipped 0.5%. For those taking to the skies, airline tickets dropped 8.1%. And although the broad food index edged up 0.1%, a basket measuring the cost of meat, poultry, fish and eggs dropped 0.4%. The shelter index, up 0.4% and accounting for about 70% of the increase in headline CPI, slowed from the recent pace of increases.

Investors cheered the inflation moderation. Both stocks and bonds rallied following the CPI release last Wednesday, as market pricing removed around 6 bps of expected hikes for this year. While we're pleased that inflation appears less hot and sticky, we still expect the Fed to hike interest rates by 25 bps at its 26 July meeting and keep its options open thereafter. Several voting members lean hawkish. And, importantly, other central bankers, including Chair Jerome Powell, have vowed to bring inflation fully down to the Fed's 2% target.

U.S. Treasury market

Maturity	Change (%)			
	Yield	Week	Month-to-date	Year-to-date
2-year	4.77	-0.18	-0.13	0.34
5-year	4.05	-0.31	-0.11	0.04
10-year	3.83	-0.23	-0.01	-0.04
30-year	3.93	-0.12	0.07	-0.04

Source: Bloomberg L.P., 14 Jul 2023. Performance data shown represents past performance and does not predict or guarantee future results.

Municipal market

Maturity	Change (%)			
	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	2.90	-0.07	-0.03	0.30
5-year	2.58	-0.09	-0.04	0.06
10-year	2.59	-0.05	0.03	-0.04
30-year	3.51	-0.03	0.02	-0.07

Source: Bloomberg L.P., 14 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	68
30-year AAA Municipal vs Treasury	89
High Yield Municipal vs High Yield Corporate	68

Source: Bloomberg L.P., Thompson Reuters, 14 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

Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Returns (%)		
				Week	Month-to-date	Year-to-date
Municipal	3.51	—	6.08	0.48	0.16	2.84
High yield municipal	5.70	241 ¹	7.58	0.81	0.31	4.75
Short duration high yield municipal ²	5.33	280	3.88	0.30	0.22	3.83
Taxable municipal	5.04	97 ³	8.18	1.83	0.12	4.88
U.S. aggregate bond	4.76	50 ³	6.33	1.51	0.20	2.29
U.S. Treasury	4.30	—	6.22	1.35	0.14	1.73
U.S. government related	4.84	50 ³	5.33	1.29	0.35	2.75
U.S. corporate investment grade	5.45	124 ³	7.13	1.60	0.16	3.37
U.S. mortgage-backed securities	4.76	52 ³	6.13	1.73	0.27	2.14
U.S. commercial mortgage-backed securities	5.61	134 ³	4.44	1.37	0.52	1.72
U.S. asset-backed securities	5.41	67 ³	2.75	0.64	0.40	2.15
Preferred securities	7.43	254 ³	4.66	0.65	0.15	3.02
High yield 2% issuer capped	8.34	381 ³	3.46	1.60	0.99	6.42
Senior loans ⁴	9.83	567	0.25	0.60	0.99	7.37
Global emerging markets	7.43	321 ³	6.23	1.77	0.65	3.97
Global aggregate (unhedged)	3.81	49 ³	6.78	2.28	1.60	3.06

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,14 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, 14 Jul 2023. Fund flows: Lipper. New deals: Market Insight, MMA Research, 12 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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