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Weekly Fixed Income Commentary

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Markets look past Fitch ratings downgrade

10-year U.S. Treasury yields rose again after strong economic data, increased auction sizes and a downgrade to the U.S. credit rating. While the timing of the downgrade was surprising, Fitch had signaled the move earlier this year. Nevertheless, we expect no material market fallout or change in investor behavior.

HIGHLIGHTS

- **Spread sectors, including preferreds, ABS and emerging markets all had positive excess returns, and senior loans also gained.**
- **Treasuries, agencies, taxable munis, investment grade and high yield corporates, preferreds, and emerging markets all had negative total returns**
- **Municipal bond yields rose across the curve. New issue supply was $11.9B with outflows of -$990M. This week's new issuance should be $6.6B.**

Anders Persson
CIO of Global Fixed Income

Daniel Close
Head of Municipals

Watchlist

- *10-year U.S. Treasury yields rose, but we anticipate modest 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 business 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 3.35%.

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.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

SENIOR LOANS SEE TENTH CONSECUTIVE WEEK OF GAINS

U.S. Treasury yields ended mixed last week, with the 10-year yield up 8 basis points (bps). The selloff was initially sharper, thanks to economic data early in the week surprising to the upside, the Treasury Department announcing an increase in auction sizes for later this year, and Fitch downgrading the U.S. credit rating. On Friday, the July employment report disappointed, showing the U.S. economy added 187,000 jobs for the month. The unemployment rate remained low at 3.5%, and average hourly earnings continued to expand at a 4.4% year-over-year rate. Overall, markets interpreted the report as consistent with a slightly less hawkish Federal Reserve moving forward, and 2-year yields fell -11 bps for the week.

Investment grade corporates weakened, returning -0.79% for the week and lagging similar-duration Treasuries by 43 bps. Spreads widened 3 bps, the biggest move since early June, but remain low versus year-to-date averages. The asset class saw outflows of -$1.8 billion, while supply surprised to the upside. Almost $35 billion priced this week, but demand was very strong, with average concessions of less than 5 bps. The heavy supply calendar is expected to continue next week, with $30-40 billion of new deals expected.

High yield corporates also sold off, returning -0.37% and underperforming similar-duration Treasuries by 64 bps. Senior loans returned 0.07%, the tenth consecutive weekly gain. As in IG markets, outflows continued, with -$1.0 billion leaving high yield bond funds and -$278 million exiting from loan funds. Supply was also healthy, with $3 billion and $7 billion the high yield and loan markets, respectively. In a sign of continued market strength, banks are reportedly planning to bring a large leveraged finance deal this week, for last year's buyout of Tenneco, an auto parts supplier. The deal failed to gain traction last year, but the rally in risk assets so far this year means there is likely to be appetite now.

Emerging markets outperformed, returning -0.73% for the week but beating similar-duration Treasuries by 60 bps, outpacing other major asset classes. Trading volumes were thin amid summer holidays and are likely to only deteriorate moving forward. That dynamic leads to outsized moves in asset prices amid volatility, as experienced last Friday when rates sold off.

MUNICIPAL BONDS HAVE BEEN EXPENSIVE VERSUS TREASURIES

Municipal bond yields ended last week higher across the curve. Weekly new issue supply was priced to sell, and most deals were well received. Weekly fund flows were negative. This week's new issue calendar will still need to be priced to sell to pique investor interest.

The fixed income market is experiencing a paradigm shift. Investors still believe the Fed will win its battle against inflation, but some also see the U.S. dodging a hard landing. If the U.S. avoids a recession, long-term yields may be higher in 2024. Munis sold off along the curve last week, which is not surprising since munis have been expensive to Treasuries recently. However, we think munis should remain well bid, as a good portion of the $46 billion of summer reinvestment money has yet to be deployed.

The state of Minnesota issued $264 million general obligation state trunk highway bonds (rated Aaa/AAA). Balances remained when the deal was awarded. Bonds traded at a discount in the secondary market. For example, 5% coupon bonds due in 2035 came at a yield of 2.88% and traded in the secondary market at 3.03%. This shows how dealers are eager to move inventory.

High yield municipal credit spreads cushioned investors somewhat last week, but yields retraced higher. Volatility was most pronounced in higher beta names like Puerto Rico and tobacco. For instance, Buckeye Tobacco 5% coupon bonds are yielding 40 bps more than just a few weeks ago. Most new issue deals were completed last week. Outflows were modest, but reinvestment flows for 01 August are much larger. New issuance remains constrained for the coming week, so investors should look for high yield municipal bonds at attractive yields in the secondary market.

Emerging markets saw thin trading volumes, leading to outsized moves in asset prices amid volatility.

In focus

Minimal market impact from U.S. credit downgrade

Last week, Fitch Ratings downgraded the U.S.'s credit rating one notch from AAA (its highest) to AA+. While the timing surprised us, Fitch had signaled the move earlier this year. Nevertheless, we expect no material market fallout or change in investor behavior.

Fitch cited several issues in its decision, notably the U.S.'s high debt burden, lack of a medium-term fiscal framework, complex budgeting process and repeated political standoffs over the debt ceiling. While we believe these concerns are legitimate, they're offset by the country's strong, diversified economy; robust governance and rule of law; and deep, liquid capital markets.

The AAA rating has never significantly driven investors' allocations into Treasuries. Instead, the market's size, depth, and liquidity — none of which will be affected by the downgrade —play a greater role. Government-sponsored enterprises and municipal bonds are also unlikely to be materially influenced.

Healthy U.S. economic growth and greater net Treasury supply have fueled the latest upswing in Treasury yields. Incoming data has been broadly positive, with second-quarter GDP growth topping forecasts and jobless claims falling toward recent lows. And last week, the U.S. Treasury announced that it will increase nominal security auction sizes, which lifted yields across the curve. These dynamics should affect U.S. debt markets more than Fitch's decision.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	July 2023	Year-to-date
2-year	4.77	-0.11	-0.02	0.34
5-year	4.14	-0.04	0.02	0.13
10-year	4.04	0.08	0.12	0.16
30-year	4.20	0.19	0.15	0.24

Source: Bloomberg L.P., 04 Aug 2023. **Performance data shown represents past performance and does not predict or guarantee future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	July 2023	Year-to-date
2-year	3.17	0.17	0.17	0.57
5-year	2.84	0.18	0.18	0.32
10-year	2.77	0.20	0.20	0.14
30-year	3.73	0.22	0.22	0.15

Source: Bloomberg L.P., 04 Aug 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	69

Source: Bloomberg L.P., Thompson Reuters, 04 Aug 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	July 2023	Year-to-date
Municipal	3.72	–	6.11	-1.26	0.40	1.79
High yield municipal	5.87	237[1]	7.64	-1.72	0.65	3.26
Short duration high yield municipal[2]	5.48	275	4.08	-0.51	0.35	3.97
Taxable municipal	5.20	94[3]	8.06	-0.71	-0.45	3.47
U.S. aggregate bond	4.91	49[3]	6.24	-0.59	-0.07	1.29
U.S. Treasury	4.43	–	6.03	-0.40	-0.35	0.70
U.S. government related	4.97	49[3]	5.21	-0.31	0.09	2.05
U.S. corporate investment grade	5.55	118[3]	6.98	-0.79	0.34	2.51
U.S. mortgage-backed securities	4.97	55[3]	6.24	-0.81	-0.07	0.92
U.S. commercial mortgage-backed securities	5.67	129[3]	4.42	0.22	0.22	1.57
U.S. asset-backed securities	5.38	60[3]	2.70	0.15	0.42	2.26
Preferred securities	7.36	239[3]	4.72	-0.11	1.61	3.87
High yield 2% issuer capped	8.53	392[3]	3.47	-0.37	1.38	6.23
Senior loans[4]	10.07	576	0.25	0.07	1.30	7.71
Global emerging markets	7.50	315[3]	6.13	-0.73	1.18	3.53
Global aggregate (unhedged)	3.89	48[3]	6.67	-0.83	0.69	1.37

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, 04 Aug 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, 04 Aug 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 02 Aug 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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