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Weekly Fixed Income Commentary

23 October 2023

Treasury yields rise, anticipating a Fed pause

The U.S. Treasury yield curve steepened as the U.S. Federal Reserve indicates a pause at the November meeting. The market has essentially priced out any chance of a November hike and is pricing in only a 20% likelihood of a December rate increase.

HIGHLIGHTS

- **Treasuries, agencies, investment grade and high yield corporates, taxable munis, preferreds and emerging markets all had negative total returns.**
- **Municipal bond yields increased. New issue supply was $12.3 billion and outflows totaled -$297M. This week's new issuance is estimated at $9.5B.**

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

- *The 10-year U.S. Treasury yield rose, but we anticipate modest declines in overall rates during the rest of 2023.*
- *Spread assets, except senior loans, underperformed versus Treasuries.*
- *Increased seasonal supply should provide an attractive entry point for municipal bonds.*

INVESTMENT VIEWS

"Higher for longer" rates remains as a theme, as central banks battle 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.

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 intensify: China, Russia, Turkey, Iran and Israel.

SENIOR LOANS EKE OUT A POSITIVE RETURN

U.S. Treasury yields rose and the yield curve steepened last week. The front-end of the curve was mostly anchored, with the 2-year yield increasing 2 basis points (bps). 10- and 30-year yields rose the most, increasing 30 and 32 bps, respectively. The steepening was driven by the reversal of last week's flight-to-quality trade, strength of economic data and comments by Fed Chair Jerome Powell suggesting no rate hike at the November meeting. Several Fed members acknowledged that recent increases in longer-term interest rates should result in the tightening of financial conditions, negating the need for a near-term hike. The market has essentially priced out any chance of a November hike and is pricing in only a 20% likelihood of a December rate increase.

Investment grade corporates declined by -2.06% for the week. The asset class underperformed similar-duration Treasuries by -37 bps. Spreads widened by 6 bps and the index yield-to-worst rose to 6.37%. Last week's new issuance totaled $25.5 billion, led by financials as they exited earnings season. Deals were about 3.2 times over-subscribed, on average, with narrow new issue concessions. Outflows returned at -$2.2 billion, driven entirely by mutual funds.

High yield corporates also declined, returning -1.17% for the week and underperforming similar-duration Treasuries by -62 bps. However, senior loans eked out a 0.02% positive return, making it the only asset class to post a positive total return last week. The high yield new issuance calendar was subdued, with high yield and senior loan issuance of $4 billion and $3 billion, respectively. High yield and senior loan outflows totaled -$1.9 billion and -$26 million, respectively.

Emerging markets declined, returning -1.22% last week but outperforming similar-duration Treasuries by 28 bps. Spreads compressed across hard currency sovereigns and corporates, with the investment grade components outperforming high yield. The new issue market was marginally weak and led by corporates, with just over $9.5 billion pricing. Emerging markets bond funds saw outflows of -$1.9 billion, driven by hard currency funds. Exchange-traded fund outflows eased marginally to -$627 million.

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MUNICIPAL BOND YIELDS APPEAR ATTRACTIVE

Municipal bond yields rose last week. New issue supply was priced to sell and fund flows were negative once again. This week's new issue supply will need to be priced at very cheap levels for deals to clear the market.

The increase in yields is understandable. Muni new issue supply continues to be outsized. Traders are reluctant to stock many bonds because so many sponsors are executing billions of dollars of tax-loss swaps daily. While this choppy market should continue through the rest of the year, we believe investors should maintain exposure to tax-exempt bonds. Yields are 4% on the short end, nearly 5% in the intermediate range and up to 6% on the long end. The taxable-equivalent yields look even more attractive. And investors may continue to book tax losses where practical.

The Commonwealth of Massachusetts issued more than $1 billion of bonds in four tranches (rated Aa1/AA+). Bonds traded at a discount in the secondary market. For example, 10-year bonds priced with a 5% coupon came at a yield of 3.53%. Those bonds traded later at 3.64%, reflecting the general fixed selloff as the week progressed.

High yield municipal bond funds reported outflows of -$190 million last week, as the average yield for the Bloomberg High Yield Municipal Bond index increased 20 bps to 6.41%. We are tracking 10 high yield muni new issue deals this week totaling $1.7 billion, headlined by Chicago Board of Education and NY LaGuardia Delta. The secondary market remains well bid.

While the choppy muni bond market should continue, we believe investors should maintain exposure to tax-exempt bonds.

In focus

The 10-year Treasury yield defies gravity

After soaring 50 bps in September, the 10-year U.S. Treasury yield has jumped another 33 bps in October, to 4.92%, en route to its highest level since 2007.

Similar outsized moves took place in 2022, when inflation was rising sharply and the Fed was hiking rates. But inflation has cooled since then, and the Fed is proceeding cautiously. What's behind the recent ascent?

U.S. economic data continues to top forecasts. Although households have exhausted nearly all of their pandemic savings, retail sales rose for the sixth straight month in September, fueled by increasing real wages (i.e., after inflation). And initial jobless claims, a proxy for layoffs, fell to a nine-month low last week, signaling further strength in the job market.

Also, a wave of long-term Treasury issuance has hit the market to fund an ever-growing federal deficit amid waning demand for Treasuries from the Fed, other central banks and foreign governments. All told, investors are now expecting a higher-for-longer interest rate environment.

Although headlines are sounding the alarm about the surging 10-year yield, we believe the security currently offers good value. It should provide sufficient income to outpace inflation. And if the economy and inflation slow as we expect, the 10-year yield should fall, boosting its price and offering the potential for capital appreciation.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	5.08	0.02	0.03	0.65
5-year	4.86	0.22	0.25	0.86
10-year	4.92	0.30	0.34	1.04
30-year	5.08	0.32	0.38	1.11

Source: Bloomberg L.P., 20 Oct 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	3.67	0.14	0.01	1.07
5-year	3.49	0.20	0.08	0.97
10-year	3.59	0.23	0.14	0.96
30-year	4.53	0.29	0.19	0.95

Source: Bloomberg L.P., 20 Oct 2023. **Performance data shown represents past performance and does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	73
30-year AAA Municipal vs Treasury	89
High Yield Municipal vs High Yield Corporate	68

Source: Bloomberg L.P., Thompson Reuters, 20 Oct 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	4.48	–	6.42	-1.42	-0.85	-2.22
High yield municipal	6.42	209[1]	7.88	-2.13	-1.42	-1.42
Short duration high yield municipal[2]	6.17	263	4.44	-0.92	-0.84	1.41
Taxable municipal	5.88	85[3]	7.74	-2.17	-2.37	-1.51
U.S. aggregate bond	5.67	57[3]	6.05	-1.73	-1.95	-3.13
U.S. Treasury	5.03	–	5.72	-1.33	-1.42	-2.92
U.S. government related	5.53	48[3]	4.99	-1.08	-1.17	-0.83
U.S. corporate investment grade	6.37	130[3]	6.58	-2.06	-2.27	-2.25
U.S. mortgage-backed securities	6.01	80[3]	6.48	-2.23	-2.71	-4.92
U.S. commercial mortgage-backed securities	6.40	139[3]	4.33	-0.89	-1.06	-0.90
U.S. asset-backed securities	5.89	76[3]	2.56	-0.36	-0.28	1.71
Preferred securities	8.30	278[3]	4.92	-1.01	-3.37	-0.81
High yield 2% issuer capped	9.46	437[3]	3.59	-1.17	-1.85	3.91
Senior loans[4]	10.35	564	0.25	0.02	0.15	10.07
Global emerging markets	8.42	335[3]	5.66	-1.22	-2.00	-1.11
Global aggregate (unhedged)	4.38	54[3]	6.49	-1.01	-1.35	-3.52

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, 20 Oct 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, 20 Oct 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research,18 Oct 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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