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Weekly Fixed Income Commentary

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A dovish Fed drives Treasury yields lower

U.S. Treasury yields declined after the U.S. Federal Reserve kept rates steady at their 22-year high. Updated economic projections showed lower U.S. inflation expectations for 2024, and the Fed discussed the timing of potential rate cuts for the first time.

HIGHLIGHTS

- **Total returns were positive across the board, including Treasuries, investment grade and high yield corporates, MBS, ABS, preferreds, senior loans and emerging markets.**
- **Municipal bond yields declined. New issue supply was constrained at $5B and fund outflows were -$524M. This week's new issuance is estimated to be only $2B.**

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Watchlist

- *The 10-year U.S. Treasury yield fell last week, and we anticipate declines in overall rates in the months ahead.*
- *Spread assets broadly outperformed 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.

INVESTMENT GRADE CORPORATES RALLY STRONGLY

U.S. Treasury yields resumed their rally after a dovish Fed meeting. 10-year yields ended -32 basis points (bps) lower at 3.91%, dipping below 4% for the first time since July. 2-year yields fell -28 bps to end at 4.45%. The rally was driven primarily by the Fed policy meeting, where officials kept rates steady at their 22-year high of 5.25%-5.50%. However, updated economic projections showed lower inflation expectations for 2024, and the dotplot of rate expectations showed 75 bps of cuts next year. Chair Powell also leaned dovish in his press conference, telling reporters that the committee discussed the timing of rate cuts for the first time and suggested that the risks around weaker growth are now roughly balanced with the risks for higher inflation.

Investment grade corporates rallied strongly, returning 2.68% for the week. This best single-week performance since early 2020 outpaced similar-duration Treasuries by 31 bps. Spread levels tightened to 100 bps, their tightest level since January 2022. Inflows were sizeable once again at $4.4 billion, while new issuance was relatively muted at $2.5 billion. Those deals met healthy demand and were oversubscribed by 3.2x overall. New issuance is set to end at $1.19 trillion for 2023 as a whole, almost exactly flat versus 2022's levels and in line with expectations.

High yield corporates also advanced, rallying 1.92% for the week and beating similar-duration Treasuries by 76 bps. Meanwhile, senior loans returned 0.57% for the week and are on track for a 2023 full-year performance of 12.3%, the second-best on record after 2009. Both asset classes experienced inflows, with $759 million into high yield bonds and $83 million into senior loans. Unlike in the investment grade market, the new issue calendar remained relatively busy in leveraged finance, with $4.1 billion and $9.9 billion pricing ion bonds and loans, respectively.

Emerging markets also gained, returning 2.22% for the week and outperforming similar-duration Treasuries by 18 bps. In the sovereign space, spreads tightened -9 bps, entirely driven by high yield names, as a risk-on sentiment dominated. The asset class was helped by the weaker dollar, which depreciated -1.40% for the week and is down -4% from its recent peak in early October. Despite those tailwinds, outflows continued, with -$1.1 billion exiting hard currency funds and -$356 million leaving local currency funds. The new issue market saw no activity for the week.

WE EXPECT THE MUNI BOND RALLY TO CONTINUE

Municipal bond yields rallied last week, along with Treasuries. Short-term munis declined -16 bps, while long-term yields ended -18 bps lower. New issuance was constrained due to the Fed meeting, but all deals were well received. Fund outflows totaled -$524 million, while exchange-traded fund inflows were $86 million. This week's new issue is expected to be low, as the new issue market is essentially finished for the year.

The muni bond yield rally has traced Treasuries, and then some. The 10-year Municipal Market Data (MMD) benchmark was 3.59% in late October and closed Friday 126 bps lower at 2.33%. In November alone, the muni index gained more than 6%. We believe the rally in munis may continue. Investors are still deploying the $36 billion of reinvestment money that came into the market 01 December. And more than $32 billion more is expected 01 January. Yet the new issue calendar should be very low for the next several weeks due to the holidays. We expect munis to remain extremely well bid for the foreseeable future.

The Mayor and City Council of Ocean City, MD, issued $26 million general obligation bonds (rated Aa1/AA+). While balances remained initially, the deal rallied sharply after the Fed meeting. For example, 5% coupon bonds maturing in 2031 were issued at a yield of 2.51% and traded later in the week at 2.36%.

High yield municipal bonds continued their rally last week. Average yields decreased by -17 bps, and average credit spreads remain elevated at 240 bps. A robust new issue calendar was heavily oversubscribed. We saw another week of net outflows for mutual funds and positive inflows for exchange-traded funds. This week should see limited new issuance as the year winds down. We are tracking just six deals with $288 million in par offering.

Investment grade corporates saw their best single-week performance since early 2020.

In focus

The Fed releases the doves

The Fed's decision last week to keep interest rates at 5.25%-5.50% came as no surprise to investors. What put them in a holiday mood, though, was the Fed's dovish stance.

In its policy statement, the central bank tweaked the language to add the word "any" before "additional policy firming" — a slight change that could signal that officials are done tightening policy. As part of their updated summary of economic projections, Chair Jerome Powell and his colleagues now expect lower inflation in 2024 compared to their September outlook, and a rise in the unemployment rate. This combination supports the Fed's forecast for 75 bps of rate cuts next year, up from 50 bps in September.

During his post-meeting Q&A, Powell specified that further tightening is still possible but also that "we are likely at or near the peak rate for this cycle." In the catalogue of cryptic Fedspeak, this language is one of the more definitive and dovish comments available. Moreover, Powell argued for easing off the monetary brakes prior to inflation returning to the Fed's 2% target. Doing so would trim the odds of inadvertently curbing economic growth too much and risking a recession.

Investors cheered Powell's policy pivot. The 10-year Treasury yield fell -14 bps in the wake of the meeting on 13 December, finishing the day at 4.02%. The 10-year yield ended the week at 3.91%, its first sub-4% close since August.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	4.45	-0.28	-0.24	0.02
5-year	3.91	-0.33	-0.36	-0.09
10-year	3.91	-0.32	-0.42	0.04
30-year	4.01	-0.30	-0.49	0.04

Source: Bloomberg L.P., 15 Dec 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	2.56	-0.16	-0.28	-0.04
5-year	2.31	-0.16	-0.28	-0.21
10-year	2.33	-0.17	-0.30	-0.30
30-year	3.53	-0.18	-0.24	-0.05

Source: Bloomberg L.P., 15 Dec 2023. **Performance data shown represents past performance and does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	60
30-year AAA Municipal vs Treasury	88
High Yield Municipal vs High Yield Corporate	71

Source: Bloomberg L.P., Thompson Reuters, 15 Dec 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	3.27	–	6.09	1.15	1.87	5.93
High yield municipal	5.56	240[1]	7.15	1.81	2.76	8.95
Short duration high yield municipal[2]	5.38	308	3.94	0.80	1.36	6.22
Taxable municipal	4.93	84[3]	8.10	2.72	4.30	8.15
U.S. aggregate bond	4.63	45[3]	6.30	2.16	3.19	4.88
U.S. Treasury	4.17	–	6.23	1.97	2.85	3.54
U.S. government related	4.68	47[3]	5.30	1.72	2.48	5.29
U.S. corporate investment grade	5.15	100[3]	7.14	2.68	3.83	7.99
U.S. mortgage-backed securities	4.81	54[3]	5.97	2.08	3.33	4.06
U.S. commercial mortgage-backed securities	5.42	130[3]	4.41	1.70	2.26	4.63
U.S. asset-backed securities	5.15	72[3]	2.73	0.95	1.34	4.96
Preferred securities	6.95	222[3]	4.73	2.04	2.68	8.75
High yield 2% issuer capped	7.80	336[3]	3.23	1.92	2.63	12.24
Senior loans[4]	9.24	538	0.25	0.57	0.95	12.31
Global emerging markets	7.12	297[3]	6.10	2.22	3.39	8.23
Global aggregate (unhedged)	3.60	45[3]	6.74	2.44	3.11	4.65

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, 15 Dec 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, 15 Dec 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 13 Dec 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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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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