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Weekly Fixed Income Commentary

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# Steady inflation data pressure Treasury yields

*U.S. Treasury yields fell and risk assets rallied after U.S. inflation data met expectations. This trend should give the U.S. Federal Reserve more confidence that the overall disinflationary trend remains intact. The market is pricing 83% odds of a rate cut by the March Fed meeting.*

## HIGHLIGHTS

- **Total returns were positive across the board for taxable fixed income, including Treasuries, investment grade and high yield corporates, MBS, ABS, preferreds, senior loans and emerging markets.**
- **Municipal bond yields showed mixed results. New issue supply was $10.5B and fund inflows were $4M. This week's new issuance is estimated to be $6.3B.**


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# Watchlist

- *The 10-year U.S. Treasury yield fell last week, and we anticipate further 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

**Rates have probably peaked for this cycle,** as attention pivots toward rate cuts in response to softer growth and easing inflation.

**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.

**Risk premiums may widen further,** with entry points for taxable fixed income likely to become more attractive over the coming quarters. Credit selection is key as we search for bonds with favorable income and solid fundamentals.

## KEY RISKS

- Inflation fails to continue moderating as expected, weighing on asset prices.
- Policymakers unsuccessfully juggle fighting inflation with supporting economies still struggling to gain traction.
- Geopolitical flare-ups intensify: Israel, China, Russia and Iran.

## INVESTMENT GRADE CORPORATES EXPERIENCE STRONG TECHNICALS

**U.S. Treasury yields declined and the curve steepened** after consumer price inflation data mostly met expectations. The 10-year yield fell -11 basis points (bps) to 3.94%. Though headline inflation was slightly hotter than expected, at 3.4% year-over-year, core inflation came in line with expectations. Shelter and other core services inflation moderated, which should give the Fed more confidence that the overall disinflationary trend remains intact. The market is pricing 83% odds of a rate cut by the March Fed meeting, with 168 bps of total cuts this year.

**Investment grade corporates rallied,** returning 1.26% and beating similar-duration Treasuries by 60 bps. Spreads tightened -6 bps, reaching their tightest levels in two years at 97 bps. The asset class was boosted by a very strong week of $10.3 billion flowing into mutual funds and exchange-traded funds. That was the eighth largest weekly inflow on record, and the biggest since September 2020. The new issue market was active at $42.3 billion. Demand for these new deals has been robust, with oversubscription rates of 4.4x and new issue concessions of just 3 bps. Overall, the technical backdrop for investment grade corporates is significantly stronger than it was over the same period last year.

**High yield corporates gained as well,** returning 0.98% for the week and outpacing similar-duration Treasuries by 35 bps. Senior loans returned 0.19%. Inflows were healthy, with $523 million entering the high yield market and $87 million flowing into loans. That helped the market to digest a robust slate of new issuance, with $4.6 billion pricing in the high yield market and $20.2 billion in loans. Many issuers have been taking advantage of the recent market strength to refinance, reprice or amend-and-extend their liabilities while demand is robust.

**Emerging markets advanced 0.78%** and outperformed similar-duration Treasuries by 12 bps. Despite the positive price action, with spreads broadly compressing, outflows continued from hard currency funds, with -$615 million leaving the market. Local markets eked out a gain of 0.08%, helped by a reversion to inflows of $73 million. As in other markets, the new issue market was active, with $22 billion of new supply. More than half of that was a single, three-tranche deal from Saudi Arabia, which totaled $12 billion. As in other markets, overall demand was strong and oversubscription rates tracked almost 4x.

## MUNICIPAL BOND YIELDS ARE THE CHEAPEST IN YEARS

**Municipal bond yields sold off on the short end last week,** but the rest of the curve remained basically unchanged. The 2- and 30-year portions of the curve ended -15 bps and -2 bps cheaper, respectively, while the rest of the curve was unchanged. New issue supply was well received. In fact, investors were disappointed with what they considered meager allotments. Total muni fund turned positive, but municipal exchange-traded funds saw outflows of - $939 million. New issue supply should be light due this week to the holiday in the U.S., but it should be well received.

**Municipal bond yields held steady as asset class trends continue.** The market is still absorbing $33 billion of 01 January reinvestment money. Supply is appearing, but remains less than demand. Also, while munis remain rich to Treasuries, muni yields are cheaper than they have been in years. These levels continue to pique investor interest. We expect munis to remain range bound for the next few weeks, until we see the price pressure that typically occurs in February.

**Jefferson County, Alabama,** issued $2.2 billion sewer revenue warrants (rated Baa1/BBB+). The deal was 15 times oversubscribed, and the bonds traded in the secondary market as much as 24 bps tighter than the original pricing of 120 bps.

**High yield municipal bonds saw mutual fund inflows** of $490 million last week versus exchange-traded fund outflows of -$143 million. The new issue calendar this week demonstrates the lower-than-average supply, with 8 deals offering $221 million in par. Buckeye Tobacco 5% coupon bonds have returned 0.05% year-to-date, while Buckeye 0% coupon bonds have returned -7%, making the 5% coupon bonds look overvalued given the impending impact of 2023 tobacco consumption declines.

***Healthy inflows helped the high yield corporate and senior loan markets digest a robust slate of new issuance.***

*In focus*

# Senior loans could take center stage again

*Loans posted a stellar 13% total return in 2023 — their best one-year performance since 2009 and second highest ever. Investors may be wondering what the asset class can do for an encore. In our view, the 2024 outlook is bright.*

Outperformance for senior loans continued in 2023, driven by three main factors: (1) increases in the fed funds rate flowing through to higher income levels; (2) a benign default environment leading to stable prices and (3) balanced supply and demand, as collateralized loan obligation (CLO) formation, coupled with institutional demand, was relatively in line with new issue supply.

In 2024, we believe senior loans should continue offering high levels of income. And active managers have opportunities to drive attractive total return potential from select discount to par loans where fundamental risks appear mispriced.

Although the Fed has signaled an end to tightening for this cycle and telegraphed rate cuts in 2024, loans have performed well during prior periods of monetary easing. This reinforces the case for a strategic allocation to the asset class. Finally, while defaults may edge up above long-term averages, we expect most of that increase to be concentrated among lower-quality loans, meaning selectivity should be critically important.

## U.S. Treasury market

| Maturity | Yield | Change (%) Week | Month-to-date | Year-to-date |
|---|---|---|---|---|
| 2-year | 4.15 | -0.24 | -0.11 | -0.11 |
| 5-year | 3.83 | -0.18 | -0.02 | -0.02 |
| 10-year | 3.94 | -0.11 | 0.06 | 0.06 |
| 30-year | 4.18 | -0.03 | 0.15 | 0.15 |

Source: Bloomberg L.P., 12 Jan 2024. **Performance data shown represents past performance and does not predict or guarantee future results.**

## Municipal market

| Maturity | Yield to Worst | Change (%) Week | Month-to-date | Year-to-date |
|---|---|---|---|---|
| 2-year | 2.62 | 0.15 | 0.10 | 0.10 |
| 5-year | 2.25 | 0.00 | -0.03 | -0.03 |
| 10-year | 2.28 | 0.00 | 0.00 | 0.00 |
| 30-year | 3.45 | 0.02 | 0.03 | 0.03 |

Source: Bloomberg L.P., 12 Jan 2024. **Performance data shown represents past performance and does not predict or guarantee future results.**

## Yield ratios

| | Ratio (%) |
|---|---|
| 10-year AAA Municipal vs Treasury | 58 |
| 30-year AAA Municipal vs Treasury | 82 |
| High Yield Municipal vs High Yield Corporate | 73 |

Source: Bloomberg L.P., Thompson Reuters, 12 Jan 2024. 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 | 3.30 | – | 6.05 | 0.05 | -0.24 | -0.24 |
| High yield municipal | 5.60 | 247[1] | 7.07 | 0.28 | -0.37 | -0.37 |
| Short duration high yield municipal[2] | 5.29 | 303 | 3.83 | 0.21 | 0.27 | 0.27 |
| Taxable municipal | 4.92 | 82[3] | 8.00 | 0.77 | -0.65 | -0.65 |
| U.S. aggregate bond | 4.55 | 40[3] | 6.26 | 0.92 | -0.29 | -0.29 |
| U.S. Treasury | 4.07 | – | 6.17 | 0.67 | -0.36 | -0.36 |
| U.S. government related | 4.58 | 48[3] | 5.33 | 0.76 | -0.23 | -0.23 |
| U.S. corporate investment grade | 5.07 | 97[3] | 7.07 | 1.26 | -0.30 | -0.30 |
| U.S. mortgage-backed securities | 4.74 | 45[3] | 5.99 | 1.03 | -0.24 | -0.24 |
| U.S. commercial mortgage-backed securities | 5.22 | 121[3] | 4.40 | 0.95 | 0.23 | 0.23 |
| U.S. asset-backed securities | 4.86 | 66[3] | 2.68 | 0.57 | 0.28 | 0.28 |
| Preferred securities | 6.80 | 211[3] | 4.72 | 1.21 | 1.06 | 1.06 |
| High yield 2% issuer capped | 7.71 | 338[3] | 3.18 | 0.98 | -0.16 | -0.16 |
| Senior loans[4] | 8.93 | 524 | 0.25 | 0.19 | 0.44 | 0.44 |
| Global emerging markets | 7.13 | 303[3] | 6.11 | 0.78 | -0.69 | -0.69 |
| Global aggregate (unhedged) | 3.57 | 43[3] | 6.70 | 0.38 | -1.01 | -1.01 |

**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, 12 Jan 2024. **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, 12 Jan 2024. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 10 Jan 2024.

**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.



### Important information on risk

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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