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Weekly Fixed Income Commentary

20 February 2024

Treasury yields rise as inflation data climb

U.S. Treasury yields moved higher again last week as inflation moderated less than expected. This caused the market to reduce the number of U.S. Federal Reserve rate cuts expected in 2024 to fewer than four, with the first one anticipated in June.

HIGHLIGHTS

- **Total returns were positive for senior loans, and excess returns were positive for investment grade and high yield corporates, preferreds and emerging markets.**
- **Mortgage-backed securities produced negative excess returns.**
- **Municipal bond yields increased. New issue supply was $5.8B and fund outflows were -$142M. This week's new issuance is estimated to be undersized at $4B.**

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Watchlist

- *The 10-year U.S. Treasury yield rose last week, but 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

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 CORPORATE SPREADS MATCH THEIR 2024 LOW

U.S. Treasury yields rose last week, as consumer price index (CPI) data showed U.S. inflation moderating less than anticipated. The market expected year-over-year CPI to fall below 3% from 3.4%, but instead it declined to 3.1%. On the heels of the CPI release, Atlanta Federal Reserve President Raphael Bostic asserted that it is not yet clear that inflation is moderating to 2%. The front end of the yield curve rose the most, as the 2-year yield increased 16 basis points (bps) for the week, closing at 4.64%. The market is now pricing in fewer than four Fed rate cuts in 2024, with the first cut anticipated in June.

Investment grade corporates declined, returning -0.45% for the week given the increase in Treasury yields. However, the asset class outperformed similar-duration Treasuries by 21 bps, as spreads narrowed by 3 bps to match the low of 92 bps year-to-date. The asset class saw another week of strong inflows at $5.9 billion, nearly evenly split between mutual funds and exchange-traded funds. The new issue market saw $37 billion in supply, slightly lower than the $40 billion expected. Demand was strong, with average oversubscription rates of 3.7x and new issue concessions of about 1 bps. Supply is up 16% year-to-date compared to the same period in 2023.

High yield corporates also declined, returning -0.32% for the week but narrowly outpacing similar-duration Treasuries by 5 bps. The asset class saw outflows of -$89 million, driven by ETF redemptions. Senior loans returned 0.23% for the week, making it the only taxable asset class with positive total returns. The higher-for-longer narrative is positive for the asset class given its floating-rate nature. In contrast to high yield corporates, senior loans saw inflows of $418 million. The new issue market was active, with $7.8 billion and $11.4 billion issued in the high yield and loan markets, respectively.

Emerging markets ended nearly neutral, returning -0.01% for the week and beating similar-duration Treasuries by 58 bps. Spreads compressed in both sovereign and corporate markets, with high yield names once again leading the way. Emerging markets saw fund outflows, led by hard currency funds, after seeing the first inflows in two months the prior week. The new issue market was quiet, with only two deals pricing for a total of $5.5 billion.

HIGH YIELD MUNI INFLOWS ARE BOOSTING PERFORMANCE

Municipal bond yields ended higher last week, with short- and long-term yields rising 3 bps and 2 bps, respectively. The new issue calendar was priced to sell and well received. Fund flows were negative for the second week in a row, and ETF flows were also negative at -$471 million. This week's new issue calendar should be light due to the U.S. holiday-shortened week.

The muni bond story remains the same: A large amount of cash remains on the sidelines to be reinvested, and supply is tepid. Munis remain rich relative to Treasuries, and this trend should continue as long as muni new issuance remains light.

Humble Independent School District, Texas, issued $146 million general obligation school building bonds (rated AAA/AAA, as they are backed by the permanent school fund). The deal was well received, and some bonds traded in the secondary market at a premium. For example, 4% coupon bonds due in 2054 came at a yield of 4.24% and traded in the secondary market at 4.19%.

The high yield municipal market saw inflows of $214 million last week. Inflows total $1.4 billion year-to-date, despite ETF outflows of -$490 million. Continued inflows and February reinvestment flows have strengthened demand, resulting in the high yield muni market outperforming more volatile fixed income asset classes. New issue deals have been routinely oversubscribed recently. New issuance should be typically light in this holiday week, with only five deals on the calendar. On 16 February, the U.S. Federal Energy Regulatory Commission (FERC) provided conditional approval of the merger and consolidation of Energy Harbor and Vistra assets, allowing the formation of a new company named Vistra Vision.

Investment grade corporate supply is up 16% year-to-date compared to the same period in 2023.

In focus

Warm CPI cools rate cut hopes

Last Tuesday, traders anxiously awaited the outcome of January's U.S. Consumer Price Index (CPI) readings, looking for signs that progress on inflation would resume after stalling in December. Instead, prices rose more than expected, demonstrating the challenges the Fed faces in taming inflation.

Headline CPI increased 0.3% last month, with food costs rising at their fastest pace in a year. Meanwhile, core CPI, which strips out volatile food and energy prices, popped 0.4% on the strength of a 0.9% rise in the "supercore" gauge (core services ex-shelter) — the Fed's preferred sub-index — which notched its largest monthly increase in almost two years.

Although this report covered just one month of data, it comes on the heels of January's blowout job creation. Taken together, they point to a U.S. economy that's showing few signs of letting up despite the Fed's aggressive tightening.

Markets reacted sharply to the CPI print. The 2-year Treasury yield, which is highly sensitive to the Fed's near-term monetary policy outlook, soared 18 bps for the day, to 4.66%, before closing the week at 4.64%.

The market-implied odds of a March rate cut are now near zero, with lower rates in May no longer an odds-on bet. We think six cuts are possible in 2024 if U.S. GDP slows materially in coming quarters, but four are more likely, reflecting our base case for cooler inflation in the near term.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	4.64	0.16	0.43	0.39
5-year	4.28	0.14	0.44	0.43
10-year	4.28	0.11	0.37	0.40
30-year	4.44	0.06	0.27	0.41

Source: Bloomberg L.P., 16 Feb 2024. **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	2.76	0.03	0.12	0.24
5-year	2.46	0.05	0.10	0.18
10-year	2.46	0.03	0.08	0.18
30-year	3.59	0.02	0.07	0.17

Source: Bloomberg L.P., 16 Feb 2024. **Performance data shown represents past performance and does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	57
30-year AAA Municipal vs Treasury	81
High Yield Municipal vs High Yield Corporate	72

Source: Bloomberg L.P., Thompson Reuters, 16 Feb 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

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	3.44	–	6.11	-0.10	-0.20	-0.71
High yield municipal	5.64	237[1]	7.11	-0.09	-0.11	-0.57
Short duration high yield municipal[2]	5.30	286	3.82	0.18	0.17	0.82
Taxable municipal	5.15	69[3]	7.92	-0.62	-1.73	-1.78
U.S. aggregate bond	4.92	39[3]	6.25	-0.55	-1.74	-2.01
U.S. Treasury	4.48	–	6.06	-0.58	-1.76	-2.03
U.S. government related	4.96	45[3]	5.24	-0.42	-1.37	-1.50
U.S. corporate investment grade	5.40	92[3]	6.93	-0.45	-1.73	-1.90
U.S. mortgage-backed securities	5.12	46[3]	6.26	-0.63	-1.86	-2.31
U.S. commercial mortgage-backed securities	5.49	105[3]	4.33	-0.45	-1.17	-0.46
U.S. asset-backed securities	5.22	56[3]	2.64	-0.16	-0.52	-0.06
Preferred securities	6.74	172[3]	4.62	-0.16	-0.31	2.30
High yield 2% issuer capped	7.87	314[3]	3.22	-0.32	-0.15	-0.15
Senior loans[4]	9.50	525	0.25	0.23	0.42	1.21
Global emerging markets	7.29	281[3]	6.02	-0.01	-0.39	-0.95
Global aggregate (unhedged)	3.82	40[3]	6.65	-0.34	-1.75	-3.11

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, 16 Feb 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, 16 Feb 2024. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 14 Feb 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.

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