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Weekly Fixed Income Commentary

26 February 2024

Fed outlook continues to sway Treasury yields

U.S. Treasury yields were mixed as the market continues to push out the pricing for the first U.S. Federal Reserve rate cut, but risk sentiment was well supported.

HIGHLIGHTS

- **Total returns were positive across the board, including in Treasuries, investment grade and high yield corporates, MBS, preferreds, senior loans and emerging markets.**
- **Municipal bond yields remained essentially unchanged. New issue supply was $5.4B and fund outflows were -$142M. This week's new issuance should pick up to $7.6B.**

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Watchlist

- *The 10-year U.S. Treasury yield declined slightly last week, and we expect yields to moderate over the course of the year.*
- *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 CONTINUE TO TIGHTEN

U.S. Treasury yields were mixed last week, with the 10-year yield falling -3 basis points (bps) and the 2-year yield rising 5 bps. The U.S. holiday-shortened week offered limited economic data, with jobless claims remaining low but existing home sales rising by less than expected. A survey of services-sector activity was slightly weaker than expected but still indicated economic expansion. Markets focused on the minutes of the FOMC's January meeting, plus additional communications from Fed members. Overall, their tone matched Chair Powell's comments earlier this year, indicating no urgency to cut rates in the near-term and a preference to wait for additional data before expressing confidence that inflation is truly returning to the Fed's 2% target.

Investment grade corporates gained, returning 0.41% for the week and outperforming similar-duration Treasuries by 6 bps. Spreads tightened for the third straight week, led by financials. That sector was boosted by CapOne's acquisition of Discover, sparking a -30 bps tightening in Discover's bonds. Inflows into investment grade funds continued as well at $5.7 billion. Demand was strong for a relatively heavy week of new issuance, with $60 billion of new deals pricing. Those deals were oversubscribed by 4x on average, leading to narrow new issue concessions of 1.8 bps.

High yield corporates outperformed, returning 0.42% for the week and outpacing similar-duration Treasuries by 33 bps. Senior loans returned 0.28%. Both asset classes reflected a constructive tone, with lower-rated names outperforming. High yield funds had slim inflows of $11 million, while loan funds saw healthier inflows of $210 million. Both asset classes continued to see relatively softer new issuance compared to the investment grade market, with $4.3 billion pricing in high yield and $11.3 billion in loans.

Emerging markets performed well, returning 0.58% for the week and outpacing similar-duration Treasuries by 30 bps. Spreads compressed across sovereign and corporate markets, and high yield names outperformed high grade in both markets. For example, high yield sovereign spreads tightened -25 bps versus -7 bps for investment grade. The new issuance market was open but relatively quiet, with only $6.6 billion pricing across the asset class, skewed heavily toward investment grade issuers. This may explain some of their relative underperformance.

MUNICIPAL BOND DEMAND OUTPACES SUPPLY

The municipal bond yield curve remained range bound last week. New issue supply was undersized due to the U.S. holiday-shortened week, and fund flows were negative. However, “hot money” saw inflows as investors look for places to park cash, including muni exchange-traded funds at $103 million and tax-exempt money market funds at $614 million. New issuance was priced to sell, and investors were disappointed with allotments. Supply should pick up this week and still be priced to sell as dealers want to keep inventory moving. It should be well received.

Muni bonds remain rich relative to Treasuries, but are also very well bid. There is just not enough supply to satisfy demand. Outsized investment money has come into the market over the last three months, and investors are scrambling to get cash invested. While new issue supply has begun to build, it is not keeping pace with demand. Munis should remain well bid until new issue supply picks up dramatically.

The Board of Regents of The University of Texas System issued $412 million permanent university fund bonds (rated Aaa/AAA). Bonds traded at a premium in the secondary market to where they were issued. For example, 4% coupon bonds due in 2053 came at a yield of 4.17% and traded in the secondary market at 4.14%.

High yield municipal bond yields decreased and credit spreads compressed last week. Net flows totaled $400 million. Both mutual funds and exchange-traded funds saw inflows, bringing total high yield muni inflows to $1.9 billion year-to-date. The average high yield muni bond currently yields 5.62%, contracting 5 bps so far in 2024. New issuance is expected to remain heavily oversubscribed. We are tracking 11 deals this week offering only $400 million in par across land-secured, charter schools, higher education, housing, health care and industrial development sectors.

Investment grade corporate demand was strong for a relatively heavy week of new issuance.

In focus

Opportunity exists in high yield munis

The municipal market has benefited from improving investor flows, strong fundamentals and attractive absolute yields. 2023 flows were concentrated in separately managed accounts and exchange-traded funds, and flows have recently returned in open-end funds. With this positive trend, we see opportunity in bonds more commonly owned in the open-end structure.

In 2023, S&P High Yield Municipal Index performance diverged meaningfully with and without Puerto Rico and tobacco. Those two sectors make up approximately 20% of the index, representing well-known credit stories with a high correlation to the benchmark (beta).

This heavy weighting benefited investors in the fourth quarter. High yield muni ETF inflows exploded, adding 1.18% of return for the year versus the index performance excluding Puerto Rico and tobacco. With strong market fundamentals and flows trending into open-end funds, we see opportunity to generate additional income and total return from bonds less correlated to the market.

The S&P High Yield Municipal Index, excluding Puerto Rico and tobacco, is providing nearly 20 bps of additional income over the broader high yield index as of 23 February, and we believe other bonds exist that offer even greater yield opportunity. While risk may be elevated, proper credit analysis and bond surveillance is critical in bond selection.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	4.69	0.05	0.48	0.44
5-year	4.28	0.01	0.45	0.43
10-year	4.25	-0.03	0.34	0.37
30-year	4.37	-0.07	0.20	0.34

Source: Bloomberg L.P., 23 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	2.74	-0.02	0.10	0.22
5-year	2.44	-0.02	0.08	0.16
10-year	2.46	0.00	0.08	0.18
30-year	3.59	0.00	0.07	0.17

Source: Bloomberg L.P., 23 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	58
30-year AAA Municipal vs Treasury	82
High Yield Municipal vs High Yield Corporate	72

Source: Bloomberg L.P., Thompson Reuters, 23 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	3.42	–	6.10	0.15	-0.05	-0.56
High yield municipal	5.62	235[1]	7.11	0.42	0.31	-0.16
Short duration high yield municipal[2]	5.27	283	3.77	0.25	0.42	1.07
Taxable municipal	5.13	70[3]	7.92	0.34	-1.39	-1.45
U.S. aggregate bond	4.92	40[3]	6.23	0.25	-1.50	-1.77
U.S. Treasury	4.48	–	6.05	0.28	-1.48	-1.76
U.S. government related	4.97	46[3]	5.24	0.23	-1.15	-1.28
U.S. corporate investment grade	5.37	91[3]	6.95	0.41	-1.33	-1.50
U.S. mortgage-backed securities	5.14	50[3]	6.20	0.07	-1.79	-2.24
U.S. commercial mortgage-backed securities	5.48	105[3]	4.32	0.19	-0.99	-0.27
U.S. asset-backed securities	5.25	57[3]	2.63	0.06	-0.46	0.00
Preferred securities	6.60	158[3]	4.55	0.85	0.53	3.16
High yield 2% issuer capped	7.80	306[3]	3.19	0.42	0.27	0.26
Senior loans[4]	9.48	521	0.25	0.28	0.71	1.50
Global emerging markets	7.23	277[3]	6.02	0.58	0.19	-0.37
Global aggregate (unhedged)	3.80	40[3]	6.64	0.43	-1.33	-2.69

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, 23 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, 23 Feb 2024. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 21 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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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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