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Weekly Fixed Income Commentary

20 May 2019

Geopolitical concerns push Treasury yields lower

U.S. Treasury yields declined again last week, as global trade worries worsened. The largest declines occurred on Monday and Wednesday, led by the 5- and 2-year maturities. The Federal Reserve (Fed) reinforced a patient outlook for interest rate policy, taking a wait-and-see approach.

HIGHLIGHTS

- **Commercial mortgage-backed securities delivered the highest weekly total return.**
- **The municipal market rallied, following Treasuries.**
- **High yield corporates posted a slight loss, marking their first back-to-back negative weeks this year.**

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TRADE WORRIES SIMMER, PUSHING TREASURY YIELDS LOWER

Last week began with rates moving lower, as trade worries worsened and geopolitical concerns added to the risk-off market sentiment. The flight-to-quality assets propelled Treasury yields lower, with 2- to 5-year maturities falling 7 to 8 basis points (bps) on Monday.[1] The declines on Monday and Wednesday were the biggest yield changes of the week, both led by the 5-year closely followed by 2-year maturities.[1] Despite the drop in most short-maturity yields, the 3-month T-bill rate fell only modestly and the 3-month/10-year Treasury yield relationship inverted again.[1] Stronger-than-expected U.S. economic data later in the week lifted rates modestly higher into the weekend, although yields on all maturities closed the week lower.[1]

Trade concerns loomed over the market, weighing down the overall sentiment. All U.S. sectors except high yield corporates saw positive total returns, but most underperformed similar-duration Treasuries.[1] Only commercial mortgage-backed securities (CMBS) and asset-backed securities outperformed duration-matched Treasuries, and CMBS delivered the highest weekly total return across fixed income.[1] High yield corporates posted the weakest performance again last week.[1] The global aggregate sector also posted a negative total return as both Europe and Asia returns fell into negative territory.

Fed officials generally reinforced a patient outlook for interest rate policy, citing low inflation as supporting a wait-and-see approach. However, investors continue to believe there is a high likelihood of a rate cut this year with market-based probabilities reflecting more than a 70% chance in 2019.

Record municipal market fund flows continued for the 19th week at $1.3 billion.

RECORD MUNICIPAL DEMAND CONTINUES

The municipal market rallied last week, following U.S. Treasuries. New issue supply of $6.5 billion was well received.[2] Record fund flows continued for the 19th week at $1.3 billion.[3] New issue supply is expected to be $5.2 billion this week and should be readily absorbed.[2]

Fixed income in general rallied last week. Fed funds futures are pricing in at least one rate cut by year end, leading to a rally in Treasury prices. Municipals followed suit, and continue to outperform due to imbalanced supply and demand. We expect this trend to continue until the new issue calendar builds, which is unlikely until the fall.

University of Pennsylvania Medical Center (UPMC) issued $725 million revenue bonds for Alleghany Co Hospital Development Authority, PA (rated A1/A+).[4] The deal was priced cheaply, as it is a hospital deal of good size. Demand was so great for a higher-yield name that underwriters were able to lower the yield upon final pricing. Bonds broke to a premium in the secondary market. UPMC is a nationally recognized medical center, and the higher yield appealed to most institutional investors.

High yield municipal credit spreads tightened last week, as high yield municipal bond yields decreased more than high grade bonds.[1] We believe the dramatic supply/demand imbalance will continue to put downward pressure on credit spreads for the foreseeable future. However, major credit spread contraction, reflecting the full strength of the imbalance, is limited to the low number of issuers coming to market or limited secondary trading activity. Due to the prolonged supply constraint, the market cannot fully price in demand. Investors added another $397 million to high yield municipal bond funds last week.[3]

The tobacco sector is lagging many high yield municipal sectors year to date.[1] As tobacco credit fundamentals continue to deteriorate, downside risk continues to build.

OUTFLOWS AND VOLATILITY HIT HIGH YIELD CORPORATE BONDS

High yield corporates posted a slight loss, marking their first back-to-back down weeks this year.[1] The volatile week got off to a poor start as U.S./China trade uncertainty took a toll on high yield returns. Performance improved over the next few days but not enough to lift the asset class into positive territory. Spreads widened by 11 bps and outflows exceeded $2.5 billion—the largest in 15 months.[1,3] New issuance was relatively active and deals were well received, despite the overall volatility. Higher-quality (BB) bonds were essentially flat for the week and outperformed both Bs and CCCs.[1]

Investment grade credit finished near the top among taxable sectors. Although trading was choppy, investment grade corporate spreads finished the week barely changed (+1 bp), and returns were positive.[1] Intraday volatility was driven more by trade tensions and geopolitical risk than by issuer-specific headlines. The asset class experienced its 16th consecutive week of inflows.[3] Signs of bearish sentiment increased, suggesting spreads could widen significantly if trade talks fail.

Higher-quality (BB) bonds were essentially flat for the week, outperforming both Bs and CCCs

Emerging markets (EM) debt eked out a gain despite trade worries and U.S. dollar strength.[1] Sovereign spreads in Asia widened early on but improved as the week progressed. Latin American performance was hurt by political and economic uncertainty in Argentina and Brazil. Almost all EM currencies declined against the dollar.

In focus

Deteriorating technicals weigh on U.S. Treasuries

The supply and demand dynamics of fixed income sectors have an important influence on their relative value. Over the next weeks, we examine these evolving dynamics for the Treasury, corporate and municipal markets.

The U.S. Treasury market supply has grown substantially over the last 10 years. Since the end of 2008, the market has nearly tripled, from $5.8 trillion in securities outstanding to $15.6 trillion today.[5] Issuance increased the fastest from 2008 to 2012, at a pace of $1.3 trillion per year.[5] The rate slowed from 2013 to 2017, but bounced back to a post-crisis level of $1.1 trillion per year in 2018.[5] We expect this trend to continue until we see an effort to reduce the federal deficit or gross domestic product (GDP) growth increases.

On the demand side, Fed transactions associated with the quantitative easing program have produced the largest shifts. The Fed's Treasury holdings ballooned from $475 billion in 2009 to $2.5 trillion in 2017.[6] Fed holdings began to decline in late 2017, and now total $2.1 trillion.[6]

Despite the reduction of Fed holdings, global demand for Treasuries remains solid. Treasuries are viewed as the highest quality, most liquid securities in the world. U.S. yields remain attractive relative to other sovereign debt such as Japan, Germany and the U.K.

U.S. Treasury market

Maturity	Yield	Change (%) Week	Month-to-date	Year-to-date
2-year	2.20	-0.07	-0.07	-0.29
5-year	2.18	-0.09	-0.10	-0.34
10-year	2.39	-0.08	-0.11	-0.29
30-year	2.83	-0.06	-0.10	-0.19

Source: Bloomberg L.P. As of 17 May 2019. **Past performance is no guarantee of future results.**

Municipal market

Maturity	Yield to Worst	Change (%) Week	Month-to-date	Year-to-date
2-year	1.46	-0.07	-0.11	-0.32
5-year	1.49	-0.07	-0.14	-0.45
10-year	1.72	-0.03	-0.14	-0.56
30-year	2.40	-0.03	-0.15	-0.62

Source: Bloomberg L.P. As of 17 May 2019. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	72
30-year AAA Municipal vs Treasury	85
High Yield Municipal vs High Yield Corporate	71

Source: Bloomberg L.P., Thompson Reuters. As of 17 May 2019. AAA municipals represented by the MMD scale. The high yield ratio equals the yield-to-worst for the Bloomberg Barclays High Yield Municipal Index divided by the yield-to-worst for the Bloomberg Barclays High Yield Corporate Index. **Past performance is no guarantee of future results.**

Characteristics and returns

Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Returns (%) Week	Month-to-date	Year-to-date
Municipal	2.15	–	5.45	0.31	0.92	4.24
High Yield Municipal	4.54	230[7]	8.00	0.39	0.98	5.44
High Yield Municipal, ex Puerto Rico	4.48	224[7]	7.74	0.43	1.04	5.08
Short Duration High Yield Municipal[8]	3.84	228	3.80	0.26	0.65	3.64
Short Duration High Yield Municipal, ex Puerto Rico[8]	3.78	222	3.68	0.27	0.37	3.42
U.S. Aggregate Bond	2.89	46[9]	5.83	0.33	0.58	3.57
U.S. Treasury	2.32	–	6.29	0.38	0.76	2.60
U.S. Government Related	2.94	61[9]	5.55	0.33	0.50	3.81
U.S. Corporate Investment Grade	3.58	118[9]	7.44	0.38	0.35	6.09
U.S. Mortgage-Backed Securities	3.06	43[9]	3.89	0.21	0.54	2.66
U.S. Commercial Mortgage-Backed Securities	2.91	64[9]	5.26	0.48	0.73	4.22
U.S. Asset-Backed Securities	2.55	32[9]	2.19	0.22	0.39	2.15
Preferred Securities	4.10	148[9]	4.51	0.31	0.27	10.11
High Yield 2% Issuer Capped	6.39	393[9]	3.47	-0.07	-0.56	8.17
Senior Loans[10]	6.58	439	0.25	0.10	0.00	5.43
Global Emerging Markets	5.32	298[9]	5.87	0.05	0.12	5.98
Global Aggregate (unhedged)	1.76	48[9]	7.03	-0.11	0.37	2.27

7 Yield difference between the Bloomberg Barclays High Yield Municipal Index and the 20-year AAA MMD scale. **8** 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. **9** Option-adjusted spread to Treasuries. **10** 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. As of 17 May 2019. **Past performance is no guarantee of future results.** Unless otherwise noted, the index is Bloomberg Barclays. 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. All indices are unmanaged and unavailable for direct investment.

For more information, please visit nuveen.com.

1 Bloomberg L.P. **2** The Bond Buyer, 17 May 2019. **3** Lipper Fund Flows. **4** Market Insight, MMA Research, 15 May 2019. **5** Securities Industry and Financial Markets Association (SIFMA). **6** St. Louis Federal Reserve.

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.

Bloomberg Barclays Municipal Index covers the USD-denominated tax-exempt bond market. **Bloomberg Barclays High Yield Municipal Index** covers the USD-denominated, below investment grade tax-exempt bond market. **S&P Short Duration Municipal Yield Index** tracks the municipal bond market with maturities from 1 to 12 years. **Bloomberg Barclays U.S. Aggregate Bond Index** covers the U.S. investment grade fixed rate bond market. **Bloomberg Barclays U.S. Treasury Index** includes public obligations of the U.S. Treasury. **Bloomberg Barclays U.S. Government-Related Index** includes debt guaranteed, owned and sponsored by the U.S. government; it does not include debt directly issued by the U.S. government. **Bloomberg Barclays U.S. Corporate Index** is a broad-based benchmark that measures the investment grade, fixed-rate, taxable corporate bond market. **Bloomberg Barclays U.S. Mortgage-Backed Securities Index** is the MBS component of the U.S. Aggregate index and includes the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). **Bloomberg Barclays CMBS ERISA-Eligible Index** is the CMBS component of the U.S. Aggregate index and includes CMBS investment grade securities that are ERISA eligible under the underwriter's exemption. **Bloomberg Barclays Asset-Backed Securities Index** is the ABS component of the U.S. Aggregate index and includes credit and charge cards, autos and utilities. **ICE BofA Merrill Lynch U.S. All Capital Securities Index** is a subset of the BofA Merrill Lynch U.S. Corporate Index including all fixed-to-floating rate, perpetual callable and capital securities. **Bloomberg Barclays High Yield 2% Issuer Capped Index** measures the market of USD-denominated, non-investment grade bonds and limits each issue to 2% of the index. The **Credit Suisse Leveraged Loan Index** is designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market. Loans are added to the index if they qualify according to the following criteria: The highest Moody's/S&P ratings are Ba1/BBB+, only funded term loans are included, and the tenor must be at least one year. **Bloomberg Barclays Emerging Market USD Aggregate Index** is a flagship hard currency Emerging Markets debt benchmark that includes USD denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. **Bloomberg Barclays Global Aggregate Unhedged Index** measures the performance of global bonds. It includes government, securitized and corporate sectors and does not hedge currency. One **basis point** equals .01%, or 100 basis points equal 1%.

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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 advisor regarding the suitability 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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