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Weekly Fixed Income Commentary

18 February 2020

Treasury yields rise slightly, with all eyes on the coronavirus

U.S. Treasury yields rose slightly last week, led by the short end of the yield curve. Yields were pushed higher over optimism about the containment of the coronavirus in China. Market expectations for Federal Reserve (Fed) rate cuts in 2020 continue to hover around 1.5 cuts, with the first rate reduction anticipated in September.

HIGHLIGHTS

- **The high yield corporate, emerging markets and preferred sectors led total returns and outperformed U.S. Treasuries.**
- **Municipal bond prices remained essentially unchanged, as positive fund flows continued.**
- **Emerging markets debt recorded a gain for the tenth consecutive week.**

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TREASURY YIELDS DRIFT HIGHER

Most U.S. Treasury yields drifted marginally higher last week, led by the short end of the yield curve.[1] Yields rose on optimism about the containment of the coronavirus in China. Optimism waned as the week progressed as a new approach to diagnosing the virus resulted in a surge of new cases. CPI data released later in the week showed some increase in inflation. But market reaction was muted, as the recent decline in commodity prices will likely counter the CPI data, putting downward pressure on inflation.

All U.S. fixed income sectors posted positive total returns last week and outperformed Treasuries, led by the high yield and preferred sectors.[1] All sectors outperformed similar-duration Treasuries, with spreads tightening as part of a broader risk-on move.[1] The global aggregate and emerging markets sectors outperformed similar-duration Treasuries, but emerging markets posted a strong positive total return while the global aggregate return was negative.[1] Midway through the first quarter, the investment grade corporate sector has delivered the strongest total return but underperformed similar-duration Treasuries, as heavy new issuance has limited spread compression.[1] The preferred securities sector has delivered the strongest relative performance this year, as strong investor demand resulted in spread tightening.[1]

Expectations for Fed rate cuts continue to hover around 1.5 cuts, with the first rate reduction anticipated in September. Given the strength of U.S. economic growth and a muted inflation outlook, Fed rate cut expectations appear to be driven by the expected impact of the coronavirus on the global economy.

The preferred securities sector has delivered the strongest relative performance so far in the first quarter.

MUNICIPAL MARKET REMAINS STEADY

The municipal bond market remained basically unchanged last week, along with U.S. Treasuries.[1] However, both markets closed Friday with strong bids. New municipal issuance of $9.6 billion was well received.[2] Weekly fund flows were positive at $2.1 billion, marking the 58th straight week of positive flows.[3] This week's new issue municipal supply is expected to be $6.8 billion ($1.4 billion taxable) and should be well received.[2]

Interest rates may be in a holding pattern for the foreseeable future. At a government auction last week, 30-year Treasury bonds sold at a record low yield of 2.06%.[1] Fed Chairman Powell also spoke last week, suggesting there was no fear of inflation and thus no need to raise interest rates. Meanwhile, the impact of the coronavirus remains. We hope steps by the Chinese government to contain the virus will be successful, but the Chinese economy will likely be depressed for some time. Investors appear to believe China's struggles will affect the broader global economy, continuing to suppress interest rates. Municipal bonds are expensive by all measurements, but low supply and high demand for tax-exempt municipal bonds should keep prices well bid for the foreseeable future.

The City of New York issued $1 billion of general obligation (GO) bonds (rated Aa1/AA).[4] The deal was not fully underwritten at its initially rich prices, and yields were adjusted upon final sale. However some bonds offered in the secondary market traded at a premium. This once again shows the strong demand for tax-exempt bonds, especially when institutional investors can buy large blocks.

High yield municipal bond yields continue to grind lower, on average, due to record levels of inflows.[1,3] The State of Ohio plans to refund $5.2 billion in Buckeye Tobacco Settlement Securitization bonds.[4] The proceeds being returned to investors and the corresponding reinvestment needs it will create will likely put further downward pressure on credit spreads.

HIGH YIELD CORPORATES LEAD ALL SECTORS MONTH TO DATE

High yield corporate bonds extended the prior week's rally.[1] The asset class recovered from the initial shock of coronavirus-driven volatility to be the top-performing fixed income sector in February. Last week's strong results were due primarily to well-received new supply and some issuer-specific headlines related to earnings and mergers and acquisitions. New issuance totals $62 billion year to date, $50 billion of which is refinancings.[2]

Investment grade corporates eked out a marginally positive total return last week.[1] The week began with credit spreads tightening amid optimism that the coronavirus outbreak was slowing.[1] Later in the week, the market tone shifted as the headlines about the disease became less encouraging, and spreads widened to end the week flat.[1] Demand for the asset class remained intact, with $5.5 billion flowing into investment grade funds.[3] In the primary market, investors snapped up $30 billion of new supply.[2]

Demand for investment grade funds remained intact last week, with $5.5 billion in inflows.

Emerging markets (EM) debt recorded a gain for the tenth consecutive week.[1] Anticipation of monetary stimulus from EM central banks, if needed in the event global growth slows, overcame worries about the spread of the coronavirus. As in the prior week, higher-yielding risk assets were in demand. Inflows into EM funds totaled $1.7 billion, dominated by hard-currency strategies.[3]

In focus

Municipal-to-Treasury yield ratios: the new normal

A traditional method of assessing the value of municipal bonds is comparing their yields to U.S. Treasuries. A higher municipal-to-Treasury yield ratio means municipals appear more attractive relative to Treasuries.

The historical average yield ratios for 10- and 30-year maturities are 84% and 93%, respectively.[1] Ratios have trended lower in recent years, currently sitting at 74% and 89%.[1] Changing supply and demand dynamics have been the driving force behind this shift.

Since 2009, the municipal market has grown just 4%, while the U.S. Treasury market has expanded 175%.[5] Scarcity expectations are entrenched in the municipal market and were exacerbated when tax-exempt advance refundings were eliminated by the Tax Cuts and Jobs Act of 2017.

As supply has declined, demand for municipals has increased. The municipal market has seen 57 consecutive weeks of positive fund flows, mainly due to the limit on state and local tax deductions in the 2017 tax law changes.[3] Investors from high-tax states are looking to the municipal market in search of tax-exempt income.

Higher demand and below-normal new supply has boosted the price of municipal bonds relative to Treasuries. As a result, ratios have broken below previous floors and will likely remain there as this low-supply environment persists.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	1.43	0.03	0.11	-0.14
5-year	1.42	0.01	0.10	-0.28
10-year	1.59	0.00	0.08	-0.33
30-year	2.04	-0.01	0.04	-0.35

Source: Bloomberg L.P. As of 14 Feb 2020. **Past performance is no guarantee of future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	0.87	0.00	0.04	-0.17
5-year	0.88	0.00	0.04	-0.21
10-year	1.18	0.00	0.03	-0.26
30-year	1.82	-0.01	0.02	-0.27

Source: Bloomberg L.P. As of 14 Feb 2020. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	74
30-year AAA Municipal vs Treasury	89
High Yield Municipal vs High Yield Corporate	70

Source: Bloomberg L.P., Thompson Reuters. As of 14 Feb 2020. 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

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	1.50	–	5.17	0.10	-0.01	1.78
High Yield Municipal	3.58	195[6]	6.17	0.15	0.18	2.65
Short Duration High Yield Municipal[7]	2.83	186	3.44	0.24	0.35	1.88
Taxable Municipal	2.69	104[8]	9.65	0.12	-0.16	4.02
U.S. Aggregate Bond	2.06	41[8]	5.91	0.03	-0.04	1.88
U.S. Treasury	1.56	–	6.77	-0.01	-0.29	2.15
U.S. Government Related	2.17	59[8]	6.03	0.19	0.01	2.16
U.S. Corporate Investment Grade	2.59	96[8]	8.10	0.07	0.16	2.51
U.S. Mortgage-Backed Securities	2.28	43[8]	2.69	0.01	0.14	0.84
U.S. Commercial Mortgage-Backed Securities	2.13	64[8]	5.28	0.07	-0.22	2.27
U.S. Asset-Backed Securities	1.72	27[8]	2.14	0.04	-0.05	0.94
Preferred Securities	2.58	82[8]	4.66	0.31	0.96	2.18
High Yield 2% Issuer Capped	5.11	344[8]	3.02	0.46	1.09	1.11
Senior Loans[9]	5.97	454	0.25	0.09	0.05	0.58
Global Emerging Markets	4.69	309[8]	6.34	0.32	0.58	2.14
Global Aggregate (unhedged)	1.28	38[8]	7.21	-0.15	-0.85	0.42

6 Yield difference between the Bloomberg Barclays High Yield Municipal Index and the 20-year AAA MMD scale. **7** 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. **8** Option-adjusted spread to Treasuries. **9** 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 14 Feb 2020. **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, 14 Feb 2020. **3** Lipper Fund Flows. **4** Market Insight, MMA Research, 12 Feb 2020. **5** SIFMA, 30 Sep 2019.

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 Taxable Municipal Bond Index** is a rules-based, market-value-weighted index engineered for the long-term taxable bond market. **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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