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Weekly Fixed Income Commentary

21 June 2021

Treasury yields decline on Fed's hawkish surprise

U.S. Treasury yields were volatile around the Federal Reserve's policy meeting, which proved to be more hawkish than expected. Ultimately, nominal yields ended the week lower and the curve flattened, to the benefit of most fixed income segments. However, those that depend more on monetary accommodation lagged.

HIGHLIGHTS

- **Investment grade corporates led gains, with preferred securities and senior loans rallying, and high yield corporates trading close to flat.**
- **Emerging markets and mortgage-backed securities lagged.**
- **Municipal bond yields rose across the curve. New issue supply was $12.2 billion, with flows of $1.9 billion. This week's new issue supply is $10.2 billion ($3.4 billion taxable).**

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Watchlist

- *Treasury yields fell last week, but we continue to anticipate further increases in the months ahead*
- *Spread assets were well-supported versus Treasuries, and strong growth should continue to support fundamentals moving forward*
- *Municipal bonds are unlikely to remain so rich*

INVESTMENT VIEWS

Zero/negative global interest rate policy remains a key market support. Investors remain focused on the eventual tapering of purchases, but we do not expect that to happen any time soon.

Unprecedented global fiscal stimulus should boost consumption and growth this year. First quarter GDP rose at a robust 6.4% pace.

Record supply of investment grade corporates has been followed by high levels of issuance from high yield, middle market loans and the broadly syndicated loan market. Taxable municipal supply continues to grow.

We favor a risk-on stance, focused on credits with durable free cash flow and solid balance sheets across a wide range of sectors. Mid-quality rating segments appear particularly attractive. Essential service municipal credits also look compelling.

KEY RISKS

- Policymakers become cautious and remove accommodation too early.
- Inflation rising in a disorderly way, forcing premature policy tightening.
- Further complications with the COVID-19 vaccine rollout.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.

INVESTMENT GRADE CORPORATES LEAD THE WAY

U.S. Treasury yields were volatile last week. The 10-year yield rose as much as 14 basis points (bps) before falling to end the week -2 bps lower at 1.44%. The initial spike higher came after the Fed sent a surprisingly hawkish signal at its policy meeting, with median forecasts now showing two rate increases in 2023 versus earlier expectations for zero. While headline Treasuries ultimately retraced to end the week near flat, real yields rose 9 bps, driven entirely by lower breakeven inflation rates. The curve flattened sharply, as short-end yields rose to reflect the higher policy rate implications of the Fed's signal, and long-end yields declined due to the weaker outlook for longer-term growth and inflation. The 5- to 30-year portion of the curve flattened -26 bps, the sharpest weekly move since 2011.

Investment grade corporates led the way, returning +0.58% for the week and generating 21 bps of outperformance versus similar-duration Treasuries. Spreads for the asset class as a whole touched their lowest levels since 2005 at 81 bps, while the BBB-rated section rallied to 100 bps, the tightest since 1998. Mortgage-backed securities notably underperformed, as the Fed's tapering signal generated some concern over the end of asset purchases. Mortgage-backed securities returned -0.34% and underperformed similar-duration Treasuries by -30 bps.

High yield corporates were mostly steady, returning -0.07% but generating 12 bps of outperformance versus similar-duration Treasuries. As in the high grade market, lower-rated segments outperformed, with CCCs gaining marginally for the week. Though there was some volatility around the Fed meeting on Wednesday, prices normalized on Thursday to end the week roughly flat. The dynamic in the loan market was similar, with prices ultimately ending slightly higher. Supply was high, with 29 deals launched totaling just under $15 billion, and inflows continued for the 23rd consecutive week.

Emerging markets lagged somewhat, as yields failed to keep pace with the rally in Treasuries. Investors offloaded some recent outperformers, leaving sovereign yields 6 bps and 9 bps higher in U.S. dollar and local currency markets, respectively. Part of the force behind the moves was a robust rally in the dollar, which lowers the attractiveness of emerging markets as an asset class. The dollar index gained 2.0%, and emerging markets currencies underperformed.

HIGH YIELD MUNICIPALS CONTINUE TO STRENGTHEN

Municipal bond yields rose across the curve last week. In contrast, U.S. Treasury yields rose on the short end of the curve and decreased on the long end.

The Fed stated it sees signs of an improving economy. As improvement continues, the Fed will become increasingly vigilant about fighting inflation, resulting in a rally in long Treasury bonds. The fact that the Fed will become vigilant on inflation suggests that government bonds are undervalued. As a result, investors increased Treasury purchases.

Municipal bonds may benefit from the Fed signaling it will be tough on inflation. We expect tax-exempt municipal bonds to remain well bid, and an outsized $180 billion of reinvestment money is returning to the tax-exempt market this summer.

Port of Seattle, Washington, issued $810 million revenue bonds, both non AMT and AMT (rated A1/A+). The deal was priced to sell and was well received. Bonds traded at slight premiums in the secondary market as the tax-exempt market firmed on Friday.

High yield municipal credit quality is improving and technical factors are strengthening. Strong deals are routinely oversubscribed as a result, making market access highly valuable. Despite the imbalance of supply and demand, investors can choose from a high number of new deals coming to market. Regardless, credit spreads on existing holdings have clear downward pressure and offer high scarcity value.

Mortgage-backed securities notably underperformed, as the Fed's tapering signal generated some concern over the end of asset purchases.

In focus

Hotter inflation puts Fed in an awkward spot

Last week's Fed meeting garnered more attention than most because of the events leading up to it. Since the Fed last gathered in April, U.S. inflation data have quickly accelerated and job creation has disappointed. Still, no imminent policy changes seem likely.

While the Fed will remain accommodative, it's in a bit of a bind: Should it keep policy extremely easy until the unemployment rate falls further from its current 5.8%? Or tighten policy to keep inflation in check? For now, the Fed has decided on the first option, believing (as we do) that April's spike in inflation is transitory.

Even with this dovish tilt, 13 of the 18 voting members now expect the Fed to increase rates in 2023, and the majority of them believe the Fed will hike at least twice that year. Moreover, seven think the Fed could begin raising rates as early as 2022. These are significant shifts forward in the anticipated timing of rate "lift-off" versus the last set of forecasts in March.

In its policy statement, the Fed did not mention any change in thinking regarding its quantitative easing asset purchase program. But in his post-meeting Q&A, Chair Jerome Powell said that the "substantial further progress" in the economy the Fed would need to see before reducing its pace of bond-buying hasn't been achieved. We expect a Fed announcement on tapering those purchases sometime this fall, with actual reductions beginning in the first quarter of 2022.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	0.26	0.11	0.11	0.13
5-year	0.88	0.14	0.08	0.51
10-year	1.44	-0.01	-0.16	0.52
30-year	2.02	-0.13	-0.27	0.37

Source: Bloomberg L.P., 18 Jun 2021. **Past performance is no guarantee of future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	0.16	0.08	0.06	0.02
5-year	0.50	0.10	0.07	0.28
10-year	0.96	0.07	-0.03	0.25
30-year	1.45	0.06	-0.14	0.06

Source: Bloomberg L.P., 18 Jun 2021. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	66
30-year AAA Municipal vs Treasury	72
High Yield Municipal vs High Yield Corporate	79

Source: Bloomberg L.P., Thompson Reuters, 18 Jun 2021. 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	1.00	–	5.02	-0.35	0.31	1.10
High Yield Municipal	3.14	187[1]	5.82	-0.04	0.95	5.79
Short Duration High Yield Municipal[2]	2.59	190	3.59	0.06	0.66	4.37
Taxable Municipal	2.17	72[3]	9.67	0.57	1.75	0.37
U.S. Aggregate Bond	1.51	34[3]	6.63	0.11	0.71	-1.60
U.S. Treasury	0.95	–	7.07	0.16	0.77	-2.46
U.S. Government Related	1.39	45[3]	6.14	-0.01	0.61	-1.18
U.S. Corporate Investment Grade	2.05	82[3]	8.76	0.58	1.68	-1.22
U.S. Mortgage-Backed Securities	1.81	31[3]	4.19	-0.34	-0.25	-0.97
U.S. Commercial Mortgage-Backed Securities	1.46	55[3]	5.19	-0.13	0.34	-0.37
U.S. Asset-Backed Securities	0.48	22[3]	2.03	-0.11	-0.05	0.15
Preferred Securities	2.55	144[3]	4.55	0.20	0.92	2.38
High Yield 2% Issuer Capped	3.98	287[3]	3.84	-0.07	0.70	2.96
Senior Loans[4]	4.80	443	0.25	0.01	0.26	3.33
Global Emerging Markets	3.77	266[3]	6.94	-0.09	0.85	-0.47
Global Aggregate (unhedged)	1.13	34[3]	7.53	-0.99	-0.64	-3.16

1 Yield difference between the Bloomberg Barclays 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, 18 Jun 2021. **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.

For more information, please visit nuveen.com.

Performance: Bloomberg, L.P. **Issuance:** The Bond Buyer, 18 Jun 2021. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 16 Jun 2021. **Municipal reinvestment:** Bank of America.

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 Barclays Municipal Index; **high yield municipal:** Bloomberg Barclays High Yield Municipal Index; **short duration high yield municipal:** S&P Short Duration Municipal Yield Index; **taxable municipal:** Bloomberg Barclays Taxable Municipal Bond Index; **U.S. aggregate bond:** Bloomberg Barclays U.S. Aggregate Bond Index; **U.S. Treasury:** Bloomberg Barclays U.S. Treasury Index; **U.S. government related:** Bloomberg Barclays U.S. Government-Related Index; **U.S. corporate investment grade:** Bloomberg Barclays U.S. Corporate Index; **U.S. mortgage-backed securities;** Bloomberg Barclays U.S. Mortgage-Backed Securities Index; **U.S. commercial mortgage-backed securities:** Bloomberg Barclays CMBS ERISA-Eligible Index; **U.S. asset-backed securities:** Bloomberg Barclays Asset-Backed Securities Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **high yield 2% issuer capped:** Bloomberg Barclays High Yield 2% Issuer Capped Index; **senior loans:** Credit Suisse Leveraged Loan Index; **global emerging markets:** Bloomberg Barclays Emerging Market USD Aggregate Index; **global aggregate:** Bloomberg Barclays Global Aggregate Unhedged Index.

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A word 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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