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Weekly Fixed Income Commentary

2 August 2021

Treasury yields fall on weaker economic data and Fed signals

U.S. Treasury yields fell further last week, after slightly disappointing economic data and accommodative signals from the Federal Reserve. Most U.S. fixed income segments generated positive total returns as a result.

HIGHLIGHTS

- **U.S. fixed income generated mainly positive total returns, including investment grade and high yield corporates, mortgage- and asset-backed securities, taxable munis and preferred securities.**
- **Emerging markets, convertibles and senior loans lagged, with negative total returns.**
- **Municipal bond yields remained unchanged. New issue supply was $7.4B, with flows of $1.4B. This week's new issue supply should be $8.2B ($2.1B taxable).**

Anders Persson
CIO of Global Fixed Income

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Head of Municipals

Watchlist

- *Treasury yields declined slightly last week, but we continue to anticipate 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 continue to focus 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, with second quarter GDP growth reaching close to 10%.

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 also 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 PERFORM WELL

U.S. Treasury yields fell last week, amid weaker-than-expected economic data and continued accommodative signals from the Federal Reserve. Consumer spending and business investment remained strong, with some drag from residential investment. The housing sector remains historically strong, but it inevitably weighed on second quarter growth after a strong first quarter. Separately, Wednesday's Fed meeting was relatively quiet, with the Fed adding a reference to "coming meetings" to their characterization of tapering. That is consistent with our expectations for a Nov or Dec announcement for tapering. With the next meeting in September likely off the table for a formal announcement, real yields fell and inflation breakevens rose.

Investment grade corporates performed well, generating 5 bps outperformance versus similar-duration Treasuries. Attention centered on second quarter earnings reports; 88% of companies so far have reported higher profits than expected. Spreads narrowed -1 bp and all-in yields fell -2 bps. Supply was slow in the first half of the week, but picked up on Thursday. Demand remains strong, with $294 million entering the asset class after last week's outflow.

High yield corporates again traded near-flat last week, underperforming similar-duration Treasuries by -9 bps. Under the surface, higher-quality companies continued outperforming lower-rated names. Retail demand picked up at $996 million. In loans, retail demand has softened with the move lower in rates, but a large number of CLO warehouses remain open and seem primed to continue buying.

Emerging markets lagged again amid a string of negative headlines, underperforming similar-duration Treasuries by -51 bps. Several adverse developments in China included the government announcing new restrictions on for-profit education firms, unsubstantiated rumors circulating that U.S. investors would be barred from Hong Kong markets, and policy makers reiterating that "housing is for living, not speculation." As a result, a broad range of Chinese corporate names weakened in the affected sectors and more broadly. Outside of China, conditions were less affected, though there were also idiosyncratic headwinds in Tunisia, where the President froze parliament and sacked the Prime Minister, with levels trading down before stabilizing.

HIGH YIELD MUNICIPAL YIELD SPREADS CONTINUE TO CONTRACT

Municipal bond prices remained basically unchanged last week, and the market ended the week with a good tone.

Investors were happy with what they heard from the Fed after its July meeting. Chair Powell stated that the Fed believes the economy still needs rates to remain low so the economy can recover. However, the Fed indicated that the economy is improving and it may begin to taper its easy-money policy by the end of the year. Both the bulls and the bears appear happy with the Fed's stance, as interest rates are little changed since the Fed announcement. We expect interest rates to remain range bound, with the Fed looking for economic improvement before beginning to raise rates.

The city of Philadelphia issued $298 million general obligation bonds (rated A2/A). The bonds were priced to sell and the deal was well received. The deal included 5% bonds due in 2036 yielding 1.41%. Those bonds traded in the secondary market at a premium of 1.37% by week's end.

The trend in high yield municipals remains firmly intact, with yields and spreads continuing to contract. High yield municipal yields declined 2 bps on average last week and AAA-rated yields increased 3 bps, driving spreads lower by another 5 bps. Investors added $578 million in new flows in what would typically be a slower and lighter period of activity. We are tracking at least 13 new deals coming this week, many of good size, across 7 sectors from 10 different dealers. The restructuring of Puerto Rico general obligation bonds appears to continue on an accelerated timeline and bond prices are responding favorably. We are also watching for any developments in the federal infrastructure plan.

Investment grade corporate demand remains strong, with $294 million entering the asset class after last week's outflow.

In focus

The Fed tries to recalibrate

The "dot plots" from June's Federal Reserve meeting showed a growing number of members willing to raise interest rates earlier and faster in response to hotter inflation, which the Fed has insisted is "transitory." At the time, markets interpreted the Fed's tone and upgraded forecasts as hawkish.

Since then, the Treasury yield curve has flattened. The yield on the 2-year note (which is sensitive to Fed policy) has risen, while the 10-year rate (which gauges the market's view on future growth and inflation) has fallen.

We think higher inflation has flattened the curve because the bond market is more worried about the Fed's reaction to inflation than about inflation itself. In fact, inflation expectations — which normally rise in the face of accelerating economic growth — have actually declined on fears the Fed will tighten policy too soon, causing a recession.

At last week's press conference following the Fed's July meeting, Chair Jerome Powell sought to assuage those fears, reasserting his pledge that the Fed would remain patient. The question is whether he and his colleagues can ultimately convince markets that they will stick to their guns, acting only when full employment has been reached and inflation durably exceeds the 2% target.

In our view, the Fed will need to sound a more consistently dovish tone — and be proven right about inflation being transitory — to fully regain its credibility.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	July 2021	Year-to-date
2-year	0.19	-0.01	-0.06	0.06
5-year	0.69	-0.02	-0.20	0.33
10-year	1.22	-0.05	-0.25	0.31
30-year	1.89	-0.02	-0.19	0.25

Source: Bloomberg L.P., 30 Jul 2021. **Past performance is no guarantee of future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	July 2021	Year-to-date
2-year	0.06	-0.02	-0.10	-0.08
5-year	0.36	-0.01	-0.13	0.14
10-year	0.82	-0.01	-0.17	0.11
30-year	1.39	0.03	-0.11	0.00

Source: Bloomberg L.P., 30 Jul 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	74
High Yield Municipal vs High Yield Corporate	75

Source: Bloomberg L.P., Thompson Reuters, 30 Jul 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	July 2021	Year-to-date
Municipal	0.87	–	5.03	0.04	0.83	1.90
High Yield Municipal	2.91	172[1]	5.59	0.09	1.20	7.40
Short Duration High Yield Municipal[2]	2.40	183	3.32	0.10	1.82	1.95
Taxable Municipal	2.03	75[3]	9.69	0.36	1.65	1.95
U.S. Aggregate Bond	1.36	35[3]	6.57	0.25	1.12	-0.50
U.S. Treasury	0.81	–	7.13	0.27	1.36	-1.25
U.S. Government Related	1.20	41[3]	6.09	0.13	0.85	-0.35
U.S. Corporate Investment Grade	1.93	86[3]	8.80	0.36	1.37	0.08
U.S. Mortgage-Backed Securities	1.62	31[3]	3.86	0.14	0.63	-0.15
U.S. Commercial Mortgage-Backed Securities	1.36	62[3]	5.19	0.19	0.93	0.43
U.S. Asset-Backed Securities	0.46	26[3]	2.11	0.06	0.21	0.39
Preferred Securities	2.49	156[3]	4.59	0.33	0.43	3.26
High Yield 2% Issuer Capped	3.89	296[3]	3.85	0.06	0.38	4.00
Senior Loans[4]	4.83	453	0.25	-0.09	0.00	3.48
Global Emerging Markets	3.94	297[3]	7.02	-0.22	0.16	-0.44
Global Aggregate (unhedged)	0.99	34[3]	7.56	0.61	1.33	-1.92

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, 30 Jul 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, 30 Jul 2021. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 28 Jul 2021.

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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