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Weekly Fixed Income Commentary

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Treasury yields end modestly lower amid mixed economic data

U.S. Treasury yields started the week higher after July inflation data showed moderation in price increases. But declining consumer confidence caused yields to retrace. Spread sectors performed well, especially longer-duration asset classes.

HIGHLIGHTS

- **Investment grade corporates, mortgage-backed securities and emerging markets led the way.**
- **High yield corporates, preferred securities and convertibles all registered positive total returns.**
- **Municipal bond yields gradually sold off. New issue supply was $8.0B, with flows of $1.8B. This week's new issue supply should be $9.3B ($2.5B taxable).**

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Watchlist

- *Treasury yields fell 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 approaching 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.

HIGH YIELD CORPORATES WEAKEN FURTHER

U.S. Treasury yields fell slightly last week, with the 10-year yield ending -2 bps lower at 1.28%. The front end of the yield curve was muted, with yields on 2- and 5-year Treasuries ending flat. To start the week, yields moved higher after July inflation data showed a moderation in the rate of price increases, consistent with our baseline expectations for inflation to normalize moving forward. Headline consumer prices rose 0.5% month-over-month in July, down from 0.9% in June. However, later in the week, yields retraced their moves after the University of Michigan's survey of consumer sentiment surprisingly fell -11 points to 70.2, an even lower level than in the depths of lockdowns last spring.

Investment grade markets gained, mirroring the move in the long end of the yield curve, with the asset class returning 0.18%, in line with similar-duration Treasuries. Trading volumes were slightly below average, and the primary market is likely to quiet down in the second half of August, as many investors take vacation. Expectations for supply activity next week are modest as well, with around $10 to $15 billion penciled in. On the demand side, the asset class saw an inflow of $3.9 billion last week, the largest in a month.

High yield corporates weakened for the second consecutive week, returning -0.16% and underperforming similar-duration Treasuries by 20 bps. The weakness partially reflects a robust primary market calendar, with elevated supply so far this month, but also indicates some concerns over the economic reopening amid the Delta variant. The energy and leisure sectors returned -0.56% and -0.51%, respectively, last week, reflecting those concerns. In the senior loan market, returns were healthy at 0.12%. Both asset classes saw solid inflows, of $510 million and $423 million, respectively.

Emerging markets outperformed again, gaining 0.20% in total return and outperforming similar-duration Treasuries by 8 bps. Most of the gains were in hard-currency corporate bonds, where yields fell -2 bps. Local sovereign bond yields rose 4 bps, though this was cushioned somewhat by a 0.3% rally for emerging market currencies. In developed markets, yields mostly mirrored the moves in Treasuries, with 10-year yields in sovereign markets down between -1 and -2 bps.

MUNICIPAL BONDS SHOULD REMAIN RANGE BOUND

Municipal bond yields sold off gradually last week, but should remain range bound for the foreseeable future. Treasury yields sold off sharply, but retraced all of their decline on Friday. Municipal bonds underperformed the Friday rally. Tax-exempt municipals currently lack a compelling story, as they are rich to Treasury bonds and offer low yields on an absolute basis. However, a large amount of tax-exempt cash sits on the sidelines to be reinvested should yields rise. Look for new issue supply to pick up after the U.S. Labor Day holiday.

The state of Maryland issued $281 million GO bonds (rated Aaa/AAA). The deal contained 5% coupon bonds issued in 2032 yielding 1%. Those bonds traded in the secondary market at a yield of 0.99% despite the fact that municipal yields in general were higher. Investors were willing to pay for large blocks of quality tax-exempt bonds even though yields were off.

High yield municipal bond yields held steady last week, despite softness in high grade yields. As a result, high yield municipal credit spreads contacted by another 6 bps on average. High yield municipal fund flows totaled $493 million. This week's new issue calendar is headlined by a long-anticipated refunding deal for PRASA, which further demonstrates the growing market access for select Puerto Rico credits. The deal could offer very little new issuance to the market if existing holders elect to exchange and retain investments in the new deal. All together, we are tracking at least 16 deals from 10 different dealers across 9 different sectors.

Investment grade corporates saw inflows of $3.9 billion last week, the largest in a month.

In focus

Treasury rally presents a puzzle

10-year U.S. Treasury yields have risen 11 bps so far in August, after touching fresh 6-month lows to start the month. Last week, yields briefly touched 1.38% before moderating on Friday. Ever since yields topped out at the start of April at 1.74%, investors have generally been puzzled by the strength and persistence of the subsequent rally.

The snapback higher in yields over the last two weeks was initially boosted by the strong July jobs report. Given that supply-side issues still constrain job creation (lack of child care, generous unemployment benefits, ongoing concerns over COVID-19), we believe the latest labor market data may substantially improve in the months ahead. Over the medium-term, we anticipate a return to full employment by next summer.

This rosy labor market outlook could clear the way for the Federal Reserve to begin withdrawing accommodation. The first substantive step would be tapering asset purchases from the current pace of $120 billion per month. Most likely, the pace of purchases would decline toward zero over 8 to 10 months, with an announcement likely later this year. That means Chair Powell could begin firmly signaling the taper this month at the Jackson Hole conference or at the September policy meeting.

Given our expectations for continued labor market strength and the end of ultra-accommodative monetary policy, we think it the recent trend of lower yields is likely ending. We continue to expect 10-year yields to rise from their current levels, to end the year around 1.80%.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	0.21	0.00	0.02	0.09
5-year	0.77	0.01	0.08	0.41
10-year	1.28	-0.02	0.05	0.36
30-year	1.93	-0.02	0.04	0.28

Source: Bloomberg L.P., 13 Aug 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	0.08	0.00	0.02	-0.06
5-year	0.38	0.01	0.02	0.16
10-year	0.88	0.01	0.06	0.17
30-year	1.50	0.07	0.11	0.11

Source: Bloomberg L.P., 13 Aug 2021. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	68
30-year AAA Municipal vs Treasury	77
High Yield Municipal vs High Yield Corporate	72

Source: Bloomberg L.P., Thompson Reuters, 13 Aug 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	0.94	–	5.11	-0.18	-0.31	1.58
High Yield Municipal	2.95	164[1]	5.80	-0.09	-0.15	7.24
Short Duration High Yield Municipal[2]	2.44	182	3.43	-0.03	0.16	1.70
Taxable Municipal	2.08	75[3]	9.74	0.16	-0.25	1.70
U.S. Aggregate Bond	1.43	36[3]	6.67	0.11	-0.31	-0.82
U.S. Treasury	0.88	–	7.23	0.10	-0.30	-1.55
U.S. Government Related	1.25	40[3]	6.12	0.08	-0.12	-0.47
U.S. Corporate Investment Grade	2.00	88[3]	8.78	0.18	-0.50	-0.42
U.S. Mortgage-Backed Securities	1.69	33[3]	4.11	0.05	-0.20	-0.35
U.S. Commercial Mortgage-Backed Securities	1.42	61[3]	5.17	0.10	-0.25	0.18
U.S. Asset-Backed Securities	0.51	26[3]	2.20	0.03	-0.05	0.34
Preferred Securities	2.66	158[3]	4.72	-0.18	0.10	3.36
High Yield 2% Issuer Capped	4.12	310[3]	3.91	-0.16	-0.35	3.64
Senior Loans[4]	4.86	453	0.25	0.12	0.15	3.63
Global Emerging Markets	3.91	289[3]	7.01	0.20	0.28	-0.16
Global Aggregate (unhedged)	1.02	34[3]	7.61	0.17	-0.31	-2.22

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, 13 Aug 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, 13 Aug 2021. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 11 Aug 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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