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Weekly Fixed Income Commentary

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Covid optimism and a hawkish Fed boost Treasury yields

U.S. Treasury yields rose as concerns over Covid eased, with the Omicron variant seemingly less deadly than prior strains. The U.S. Federal Reserve signaled another hawkish shift in policy, suggesting a more aggressive pace of reducing its balance sheet.

HIGHLIGHTS

- **Total returns were negative in Treasuries, MBS, CMBS, ABS, taxable municipals, investment grade and high yield corporates, preferreds and emerging markets.**
- **Emerging markets and preferreds had positive excess returns, and senior loans rallied strongly.**
- **Municipal bond yields ended the week higher. Fund flows were $841M. The new issue calendar begins in earnest this week at $8.2B.**

Anders Persson
CIO of Global Fixed Income

John Miller
Head of Municipals

Watchlist

- *10-year Treasury yields rose last week, and we anticipate increases in the quarters ahead.*
- *Spread assets weakened slightly after recent strong gains.*
- *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 tapering and an eventual increase in interest rates.

Unprecedented global fiscal stimulus should continue to boost consumption and growth.

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 bonds also look compelling.

KEY RISKS

- Inflation rises in a disorderly way, negatively affecting asset values.
- Policymakers remove accommodation too rapidly, undermining the global economic expansion.
- Further complications with the Covid vaccine rollout, as well as new variants.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.

INVESTMENT GRADE CORPORATE ISSUANCE SHATTERS EXPECTATIONS

U.S. Treasury yields rose sharply last week, with the 10-year yield ending 25 basis points (bps) higher at 1.76%. The curve steepened, as the two-year yield rose only 13 bps. The moves were initially driven by optimism around Covid. Despite high case growth, the Omicron variant increasingly seems to be less deadly than prior strains. The curve steepening accelerated on Wednesday with the release of the minutes from December's Fed meeting. The minutes were surprisingly hawkish, showing that officials discussed reducing the Fed's balance sheet as soon as this year. For context, in the last tightening cycle, the Fed waited two years between the first rate hike and beginning to run off its balance sheet.

Investment grade corporates traded weaker alongside the move in rates, returning -1.93% and underperforming similar-duration Treasuries by -3 bps. Though demand from Asia-based accounts was strong, that dynamic was offset by a very heavy primary issuance calendar. Thirty-seven issuers brought $59 billion of new supply, shattering expectations for around $35-40 billion. The more hawkish Fed rhetoric and expectations for higher rates are already encouraging corporations to accelerate their issuance plans.

High yield corporates also sold off, returning -0.94% and underperforming similar-duration Treasuries by -13 bps. In contrast to the investment grade market, high yield saw relatively modest new issuance activity, with only $7 billion of supply for the week. Loans performed well, gaining 0.27% and benefiting from a strong inflow of $840 million to start the year. Loan prices are now up to $98.82 at the index level, the highest in seven years, as the asset class benefits from strong demand for floating-rate paper amid the rise in rates.

Emerging markets also experienced negative total returns, at -1.52% for the week, but outperformed similar-duration Treasuries by 16 bps. There was more pressure in the China property sector after Simao defaulted on a trust loan, though there was no contagion beyond that sector. Local markets were weaker, rising 14 bps in yield overall, as they were pressured by the twin shocks of higher developed market rates and positive economic/inflation data in several EM countries, including Hungary, Poland, Czech Republic, Brazil and Turkey.

MUNICIPAL INVESTORS REMAIN CONCERNED ABOUT INFLATION

Municipal bond yields rose last week in response to heightened inflation fears.

Investors are worried that inflation may continue to increase, and interest rates are rising as a result. The 10-year Treasury bond yield reached 1.80% last week, the highest since January 2020. The Fed must now show it is ahead of the curve on fighting inflation. Easy money policies are over. In fact, the Fed is signaling it will likely raise short-term rates in March 2022 to continue the battle against inflation. Rates may remain range bound as investors give the Fed a chance to show it has inflation under control.

Municipal bond prices have sold off in sympathy to Treasuries, although municipals have outperformed the Treasury selloff. This is primarily because of the outsized January 1 municipal reinvestment income waiting to be deployed, as well as anticipation over new issue supply.

High yield municipal credit spread compression brought excess returns across the asset class in 2021. Credit spread risk and idiosyncratic risk correlations to U.S. Treasury yields have been powerful, as the 10-year U.S. Treasury yield rose 60 bps in 2021. Despite the continued rapid ascent of yields to begin 2022, high yield municipal yields have exhibited only 50% of the volatility, and much less in lower correlation sectors and credits. Likely recognizing the low sensitivity to rate risk, investors added $389 million to high yield municipal funds in the first week of 2022.

Loan prices are now up to $98.82 at the index level, the highest in seven years.

In focus

We favor spread sectors and credit risk in '22

In 2022, we expect the U.S. and global economies to continue expanding at an above-trend pace, although growth is likely to slow in most major regions.

The U.S. labor market will likely reach full employment, which should help drive strong growth in consumer spending. Supply chain challenges will remain in the near term, but should eventually unwind, slowing inflation by year-end. That said, we still anticipate prices to be rising by about +3% year-over-year by the end of the year.

We maintain our view that the first Fed rate hike will come this summer, but we think the market has fully priced this in after the recent rise in front-end rates. After providing substantial support in 2021, fiscal policy will become a major headwind to headline growth in 2022, a direct result of lower spending.

Given the still-positive growth backdrop and our expectation for a measured pace of policy tightening, we continue to favor spread sectors and credit risk in fixed income markets. As the global economy heals and policy accommodation is steadily pared back, interest rates should gradually rise. This should benefit floating-rate products like senior loans, as well as shorter-duration markets like high yield credit and some emerging markets.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	0.86	0.13	0.13	0.13
5-year	1.50	0.24	0.24	0.24
10-year	1.76	0.25	0.25	0.25
30-year	2.12	0.21	0.21	0.21

Source: Bloomberg L.P., 07 Jan 2022. **Past performance is no guarantee of future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	0.40	0.16	0.16	0.16
5-year	0.73	0.14	0.14	0.14
10-year	1.17	0.14	0.14	0.14
30-year	1.63	0.14	0.14	0.14

Source: Bloomberg L.P., 07 Jan 2022. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	67
30-year AAA Municipal vs Treasury	77
High Yield Municipal vs High Yield Corporate	70

Source: Bloomberg L.P., Thompson Reuters, 07 Jan 2022. AAA municipals represented by the MMD scale. The high yield ratio equals the yield-to-worst for the Bloomberg High Yield Municipal Index divided by the yield-to-worst for the Bloomberg 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	1.26	–	5.09	-0.70	-0.70	-0.70
High Yield Municipal	3.23	177[1]	6.67	-0.65	-0.65	-0.65
Short Duration High Yield Municipal[2]	2.70	170	3.63	-0.20	-0.20	-0.20
Taxable Municipal	2.55	75[3]	9.61	-1.95	-1.95	-1.95
U.S. Aggregate Bond	1.98	36[3]	6.85	-1.53	-1.53	-1.53
U.S. Treasury	1.45	–	7.04	-1.61	-1.61	-1.61
U.S. Government Related	1.86	44[3]	6.10	-1.37	-1.37	-1.37
U.S. Corporate Investment Grade	2.55	92[3]	8.58	-1.93	-1.93	-1.93
U.S. Mortgage-Backed Securities	2.21	31[3]	5.32	-1.13	-1.13	-1.13
U.S. Commercial Mortgage-Backed Securities	2.10	67[3]	5.06	-1.16	-1.16	-1.16
U.S. Asset-Backed Securities	1.26	36[3]	2.31	-0.34	-0.34	-0.34
Preferred Securities	3.39	159[3]	4.71	-0.70	-0.70	-0.70
High Yield 2% Issuer Capped	4.61	299[3]	3.95	-0.94	-0.94	-0.94
Senior Loans[4]	5.40	431	0.25	0.27	0.27	0.27
Global Emerging Markets	4.51	294[3]	7.01	-1.52	-1.52	-1.52
Global Aggregate (unhedged)	1.45	35[3]	7.57	-1.17	-1.17	-1.17

1 Yield difference between the Bloomberg 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, 07 Jan 2022. **Past performance is no guarantee of future results.** Unless otherwise noted, the index is Bloomberg. 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, 07 Jan 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 05 Jan 2022.

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

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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