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Weekly Fixed Income Commentary

22 August 2022

Fed rhetoric leads to higher Treasury yields

U.S. Treasury yields rose as the U.S. Federal Reserve leaned hawkish and economic data were slightly worse. Spread assets weakened as a result.

HIGHLIGHTS

- **All major fixed income sectors suffered negative total returns.**
- **ABS and preferred securities experienced positive excess returns versus Treasuries.**
- **Municipal bond yields rose substantially. New issue supply was $8B, with outflows of -$229M. This week's new issue supply should be $6.8B.**

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Watchlist

- *10-year Treasury yields rose to close to our forecast for year end.*
- *Spread assets weakened amid worsening economic data.*
- *Net-negative supply should provide some support to municipal bonds.*

INVESTMENT VIEWS

Accommodative interest rate policy remains a key market support. While investors continue to focus on more hawkish Fed policy, overall rates are likely to remain relatively low even after several rate hikes.

The underlying growth outlook remains healthy, as consumers have strong balance sheets, businesses are reinvesting and Covid recedes. This should keep defaults low.

Treasury yields are likely to rise this year, but we don't expect the 10-year Treasury yield to rise much above 3.00%.

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 fails to moderate as expected, negatively affecting asset values.
- Policymakers remove accommodation too rapidly, undermining the global economic expansion.
- The Russia/Ukraine conflict continues to escalate.
- COVID-19 cases increase, or new variants emerge.

INVESTMENT GRADE CORPORATE DEMAND REMAINS STRONG

U.S. Treasury yields rose as rhetoric from Fed officials leaned hawkish, despite generally weaker economic data. Housing starts contracted almost -10% in July, taking the level of housing activity to the lowest in one and a half years. Building permits and existing home sales also contracted. On the other hand, retail sales continued to expand at a healthy pace. Fed officials nevertheless suggested that they may hike rates by more than currently priced next month and keep rates higher for longer. Markets currently imply a roughly 50% chance of another 75 bps hike next month, and a 50% chance of a smaller, 50 bps hike.

Investment grade corporates weakened, returning -1.23% for the week and lagging similar-duration Treasuries by -34 bps. The market digested another week of elevated supply, with $22 billion of new issuance pricing, the fifth consecutive week where actual supply met or exceeded expectations. That dynamic is likely to moderate next week, as late August is typically relatively quiet for issuance. Demand remained strong, with another weekly inflow of $3.5 billion.

High yield corporates weakened after the robust recent rally. The asset class returned -1.21% for the week, ending six straight weekly gains, and underperformed similar-duration Treasuries by -81 bps. Yields moved higher in tandem with Treasuries, and spreads widened. Leveraged loans returned -0.12%, though both high yield and loan funds saw inflows of $1.5 billion and $123 million, respectively.

Emerging markets sold off alongside U.S. corporates, returning -1.11% for the week and underperforming similar-duration Treasuries by -39 bps. Concerns about global growth weighed on commodity prices and strengthened the dollar, which appreciated 2.4% for the week for its best weekly performance since March 2020. That dynamic weighed on the riskiest segments of emerging markets, as high yield sovereign spreads widened 28 bps, versus only a 1 bps widening in investment grade sovereigns.

MUNICIPAL BOND YIELD CURVE FLATTENS

Municipal bond yields rose substantially across the curve last week. Short-term rates ended 41 bps cheaper and long-term rates were 18 bps cheaper, causing flattening in the muni yield curve. Both the Treasury and municipal bond markets ended the week with weak tones.

Fixed income is in the summer doldrums, and market depth is very thin. However, all eyes remain on the Fed. No Fed meeting is scheduled in August, but Fed members will meet at a conference in Jackson Hole, Wyoming, later this month. We will probably hear the Fed reiterate its commitment to fighting inflation, which should be well received by the market. Also, data will continue to be released throughout August to show whether the economy is continuing to cool. We expect fixed income in general to be range bound through the end of August.

Mecklenburg Co., North Carolina, issued $451 million general obligation (GO) school bonds (rated Aaa/AAA). Balances remain in the deal, so underwriters will likely need to sell bonds cheaper from where the deal came, as the fixed income market in general has sold off.

The high yield municipal market is back on more solid footing. The market saw another week of strong inflows, as investors are being attracted by attractive after-tax yields. New issue deals are receiving stronger subscriptions. U.S. Steel and the week's largest charter school deals were multiple times oversubscribed. Brightline cleared $785 million of completion financing, met with $375 million of equity, for its phase two Orlando corridor. Bonds are first backed by future appropriations from Broward and Miami-Dade counties. This week should see new supply contracting heading closer to Labor Day in the U.S.

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In focus

Two yields: SEC vs distribution

With the dramatic increase in market yields this year, bond fund SEC yields have risen sharply and deviated from distribution yields. We often receive questions about the difference between the two yields.

SEC yield is considered forward looking, since it is based on the yield to maturity using current market prices. It represents the amount of theoretical income generated by a fund's portfolio, measured over 30 days and net of expenses. It is a rate of return on the current maximum public offering price on the last day of the 30-day period. The calculation looks at theoretical income and excludes income that is not predictable or repeatable.

Distribution yield is considered backward looking, as it is calculated on past distributions. It is the annualized dividend divided by the share price. It may vary from fund to fund and could be based on a 30-day or 12-month period.

Factors that may create a difference between the two yield calculations include quickly changing market yields, the market yields on portfolio purchases, fund turnover, and fund inflows or outflows. When analyzing a fund, a significant difference between the SEC yield and distribution yield may indicate that income is being generated from a source that is not predictable or repeatable, or that the distribution yield could be susceptible to change.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	3.24	-0.01	0.35	2.50
5-year	3.09	0.14	0.42	1.83
10-year	2.98	0.14	0.32	1.46
30-year	3.22	0.10	0.20	1.31

Source: Bloomberg L.P., 19 Aug 2022. **Past performance does not predict or guarantee future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	2.16	0.41	0.56	1.92
5-year	2.20	0.38	0.40	1.61
10-year	2.48	0.24	0.27	1.45
30-year	3.11	0.18	0.22	1.62

Source: Bloomberg L.P., 19 Aug 2022. **Past performance does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	87
30-year AAA Municipal vs Treasury	100
High Yield Municipal vs High Yield Corporate	67

Source: Bloomberg L.P., Thompson Reuters, 19 Aug 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 does not predict or guarantee future results.**

Characteristics and returns

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	3.14	–	6.66	-1.21	-1.40	-7.89
High yield municipal	5.16	217[1]	10.03	-0.88	-0.99	-9.38
Short duration high yield municipal[2]	4.72	243	4.19	-0.08	-0.57	-4.08
Taxable municipal	4.39	120[3]	9.29	-0.71	-2.01	-14.08
U.S. aggregate bond	3.74	48[3]	6.41	-0.89	-1.68	-9.70
U.S. Treasury	3.23	–	6.44	-0.70	-1.68	-9.24
U.S. government related	3.81	60[3]	5.45	-0.66	-1.27	-8.84
U.S. corporate investment grade	4.58	136[3]	7.58	-1.23	-1.52	-12.96
U.S. mortgage-backed securities	3.70	33[3]	5.69	-0.95	-1.92	-7.65
U.S. commercial mortgage-backed securities	4.15	100[3]	4.80	-0.50	-1.45	-7.96
U.S. asset-backed securities	4.01	75[3]	2.21	0.01	-0.52	-3.81
Preferred securities	5.95	219[3]	4.87	-1.06	0.02	-9.32
High yield 2% issuer capped	7.74	433[3]	4.02	-1.21	0.39	-8.77
Senior loans[4]	8.88	547	0.25	-0.12	1.81	-0.90
Global emerging markets	6.88	368[3]	6.39	-1.11	0.31	-15.13
Global aggregate (unhedged)	2.88	52[3]	7.00	-1.92	-2.37	-14.17

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, 19 Aug 2022. **Past performance does not predict or guarantee 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, 19 Aug 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 17 Aug 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.

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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 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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