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Weekly Fixed Income Commentary

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Treasury yields continue to climb on escalating Fed rhetoric

U.S. Treasury yields rose yet again as the U.S. Federal Reserve (Fed) continued to ratchet up its hawkish tone. We believe Chair Powell will remain focused on inflation until the rate of price increases slows to 2% — the Fed's target — or close to it.

HIGHLIGHTS

- **Core fixed income asset classes suffered negative returns amid the rise in rates, including Treasuries, agencies, MBS, investment grade and high yield corporates, taxable munis, convertibles and leveraged loans.**
- **ABS was the only major asset class to see a positive excess return.**
- **Municipal bond yields increased significantly. New issue supply was muted at $1.1B, with outflows of -$2B. This week's new issue supply should be light again at $5.5B.**

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Watchlist

- *10-year Treasury yields moved higher last week.*
- *Spread assets weakened amid macro uncertainty.*
- *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 the pace of long-term increases should remain relatively modest.

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.

HIGH YIELD CORPORATE NEW ISSUE MARKET OPENS UP SUBSTANTIALLY

U.S. Treasury yields moved higher again last week, with the 10-year yield rising 24 basis points (bps) to 3.69% – a new 12-year high. Yields have now increased for eight consecutive weeks, the longest such streak since 1994. The moves were driven by escalating hawkish rhetoric from the U.S. Federal Reserve, as it raised interest rates by another 75 bps and signaled additional outsized hikes are likely later this year. More policy-sensitive 2-year Treasury yields ended the week 33 bps higher.

Investment grade corporates continued to weaken alongside the selloff in Treasuries. The asset class returned -1.61% for the week, underperforming similar-duration Treasuries by -29 bps. Yields touched a fresh 13-year high at 5.43%, but spreads were relatively well-contained and only widened by 4 bps to 146 bps. The primary market was muted, with only around $6 billion of new issuance for the week, versus expectations of around $20 billion. Those new deals came with relatively attractive concessions of around 11 bps.

High yield corporates underperformed amid fundamental and technical headwinds. The asset class returned -1.74% for the week, underperforming similar-duration Treasuries by -63 bps. On the fundamental side, the Fed's escalating hawkishness raised fresh concerns around rates and the growth outlook. On the technical side, outflows continued at -$1.7 billion. The new issue market opened back up substantially, headlined by the $8 billion Citrix issuance, split roughly evenly between bonds and loans. Leveraged loans also sold off for the week, returning -0.91%.

Emerging markets bonds weakened, returning -1.76% for the week. The strengthening dollar continued to act as a headwind, especially for local currency markets, which underperformed versus hard currency. Separately, the new government in the United Kingdom announced new budget measures that entail substantially more borrowing than previously anticipated. The policies are likely to be inflationary and lead to even higher policy rates from the Bank of England. Two- and 10-year gilt yields rose 82 and 69 bps, the largest weekly increases on record going back to 1989.

MUNICIPAL BOND NEW ISSUANCE REMAINS MUTED

Municipal bond yields rose across the board last week. Short-term yields rose 43 bps and long-term rates increased 12 bps. Fund flows were negative for the seventh consecutive week. New issue supply was muted and is expected to be undersized again this week.

The Treasury yield curve is flat and inverted in some areas, suggesting that many investors believe the Fed will show it has inflation contained sooner rather than later. They are betting longer-term bonds – which currently yield *less* than short-term bonds – will rally once inflation is controlled.

The municipal bond curve is also very flat, suggesting the same thought process. Although munis continue to sell off, they are bid constructively. New issue supply has been muted, easing market pressure. Institutions continue to trade daily to rework portfolios, and individual investors remain interested. We expect heightened volatility through year end, but anticipate a constructive year for fixed income in 2023.

The Board of Water Works of the Louisville/ Jefferson Co. Metro Government (Kentucky) issued $125 million water system revenue bonds (rated Aaa/AAA). The deal included a 5% bond due in 2032 coming at a yield of 3.16%. The 10-year Treasury bond closed Friday at 3.68 %. These bonds yield 86% of the 10-year, which is considered fair value.

High yield municipal spreads widened 8 bps last week, driven largely by tobacco and Puerto Rico, with the market anticipating additional liquidity pressure. Strong secondary market trade volume shows that yields are attracting firm demand. High yield municipal credit spreads are inverted by 43 bps between 7- and 20-year maturities. The new issue calendar remains light, and deals are successful to the extent they satisfy buyer demands in what is firmly a buyers' market.

Strong high yield muni secondary market trade volume shows that yields are attracting firm demand.

In focus

The Fed's upward march continues

As expected, last week the Fed raised its target policy range by 75 bps for the third consecutive meeting, to 3.00% – 3.25%.

Coming into the meeting, markets had priced in about a 20% chance of a 100 bps hike, driven by August's hotter-than-expected core inflation data. But the Fed opted to keep the pace of hiking constant, perhaps aware of markets' sensitivity to hawkish policy surprises.

Looking ahead, the Fed's dot plot shows a slim majority of voting members anticipating at least one more 75 bps move (probably in November), followed by a 50 bps raise in December. Officials also signaled that they do not intend to cut rates materially in 2023, and Chair Jerome Powell used his press conference to caution against premature policy easing.

The potential impact of the Fed's systematic hawkishness is evident based on its latest set of 2023 forecasts and the first since June. The median projection for GDP growth fell to 1.2% compared to 1.7%, while the unemployment rate is anticipated to rise to 4.4% from 3.9%.

Since Powell has staked a claim as an inflation fighter regardless of the pain raising rates inflict on the economy, we expect he will remain focused on this mission until the rate of price increases slows to 2% — the Fed's target — or close to it.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	4.21	0.34	0.71	3.47
5-year	3.98	0.35	0.63	2.72
10-year	3.69	0.24	0.49	2.18
30-year	3.61	0.09	0.31	1.70

Source: Bloomberg L.P., 23 Sep 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	2.92	0.43	0.64	2.68
5-year	2.95	0.37	0.63	2.36
10-year	3.11	0.26	0.52	2.08
30-year	3.73	0.12	0.44	2.24

Source: Bloomberg L.P., 23 Sep 2022. **Past performance does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	84
30-year AAA Municipal vs Treasury	103
High Yield Municipal vs High Yield Corporate	63

Source: Bloomberg L.P., Thompson Reuters, 23 Sep 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	3.87	–	7.07	-1.35	-2.91	-11.28
High yield municipal	5.84	226[1]	10.52	-1.98	-4.73	-14.75
Short duration high yield municipal[2]	5.66	270	4.22	-1.12	-2.38	-6.93
Taxable municipal	5.04	117[3]	9.16	-1.67	-3.73	-18.02
U.S. aggregate bond	4.62	60[3]	6.27	-1.56	-3.36	-13.75
U.S. Treasury	4.04	–	6.19	-1.16	-2.76	-12.47
U.S. government related	4.63	58[3]	5.25	-1.23	-2.66	-11.97
U.S. corporate investment grade	5.43	146[3]	7.24	-1.61	-3.43	-17.15
U.S. mortgage-backed securities	4.72	70[3]	5.90	-2.21	-4.39	-13.05
U.S. commercial mortgage-backed securities	5.06	103[3]	4.70	-1.31	-2.57	-11.32
U.S. asset-backed securities	4.77	53[3]	2.18	-0.57	-1.10	-5.00
Preferred securities	6.91	248[3]	5.04	-1.84	-2.71	-13.82
High yield 2% issuer capped	9.26	513[3]	4.09	-1.74	-2.64	-13.56
Senior loans[4]	10.60	624	0.25	-0.91	-1.12	-2.28
Global emerging markets	7.71	372[3]	6.07	-1.76	-3.16	-18.51
Global aggregate (unhedged)	3.59	58[3]	6.81	-2.44	-4.45	-19.31

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, 23 Sep 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, 23 Sep 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 21 Sep 2022.

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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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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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