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Weekly Fixed Income Commentary

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Treasury yields rise as inflation surprises continue

U.S. Treasury yields rose further last week. Inflation surprised to the upside again, driving interest rates higher and pressuring fixed income returns. Spread assets weakened amid elevated volatility.

HIGHLIGHTS

- **Core fixed income broadly had negative returns amid the rise in rates, including Treasuries, agencies, MBS, investment grade and high yield corporates, taxable munis, convertibles and leveraged loans.**

- **Municipal bond yields remained essentially unchanged. New issue supply remained light at $4.1B, with outflows of -$2.2B. This week's new issue supply ticks up to $8.2B.**

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Watchlist

- *10-year Treasury yields moved higher last week.*
- *Spread assets weakened amid elevated volatility.*
- *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.

INVESTMENT GRADE CORPORATE SPREADS REACH THE WIDEST OF 2022

U.S. Treasury yields rose again last week, after the September CPI report showed another surprisingly high inflation rate. That should almost guarantee another 75 basis points (bps) rate hike at the U.S. Federal Reserve's policy meeting next month and increases the odds for additional outsized rate hikes over the next few quarters. Two-year Treasury yields rose 19 bps, while 10-year yields rose a more modest, but still significant, 14 bps.

Investment grade corporates weakened as well, returning -1.62% for the week and lagging similar-duration Treasuries by -72 bps. Spreads touched 165 bps mid-week, their widest levels of the year. Meanwhile, yields on the IG market overall ended the week at 5.97%, a new 13-year high. Market technicals remain unsupportive, with another -$6.7 billion leaving the asset class. On the supply side, only one deal priced, and it was met with tepid demand at only 2.0x oversubscribed. That likely signals elevated concessions for this week, when $15 billion to $20 billion of new supply is expected to price.

High yield corporates also sold off, returning -1.11% for the week and underperforming similar-duration Treasuries by -61 bps. Loans outperformed on a relative basis, returning -0.26%. Both markets saw further outflows, of -$713 million and -$1.1 billion for bonds and loans, respectively. The new issue market was slightly more active than in investment grade markets, but demand was similarly muted. Only four deals priced in high yield and one in loans, and they generally struggled to price and ultimately widened.

Emerging markets suffered from another large outflow and returned -1.69% for the week, underperforming Treasuries by -94 bps. Higher U.S. inflation, additional rate hikes and a stronger dollar have been a major drag on the asset class this year and that trend continued last week. Emerging markets funds saw another large outflow of -$2.3 billion, though that was the second consecutive weekly deceleration. The primary market was completely silent across both sovereigns and corporates, and overall issuance is now running -50% year-over-year.

INDIVIDUAL INVESTORS SUPPORT THE MUNICIPAL BOND MARKET

Municipal bond yields decoupled from the Treasury market last week, ending basically unchanged. The municipal new issue calendar remained light and negative fund flows continued for the tenth consecutive week. This week's new issue supply will need to be priced to sell to pique investor interest.

Fed rate increases should persist (for now). The 10-year Treasury yield reached 4% last week, which is still inverted relative to short-term yields. This suggests that investors believe the Fed will continue to raise short-term rates. Many expect the Fed will be successful by the second quarter of 2023, when long-term rates should rally.

Muni bonds also remain resilient. While mutual funds have seen redemptions, individual investors have supported the market with heavy interest, as they can buy bonds with a tax-exempt 4% yield. Institutional investors also continue to rework their portfolios. We expect continued volatility through the rest of 2022, but we believe trends are suggesting a better year in 2023.

The New Jersey Turnpike Authority issued $700 million turnpike revenue bonds (rated A1/AA-). The deal was well received, and some bonds traded at a premium in the secondary market. For example, 5.25% bonds due in 2052 came at a yield of 4.44%. and later traded 4 basis points richer at 4.40%.

High yield municipal bond yields rose last week, but outperformed on a relative basis. Yields are finding resistance higher as investors are attracted by the highest levels in years. Secondary trade volume is robust, as mutual fund selling is being met by strong demand from other buyers. Fund outflows persist but appear to be slowing. New issue volume remains constrained.

Investment grade corporate yields ended last week at 5.97% overall, which was a new 13-year high.

In focus

Inflation surprises to the upside

The U.S. September CPI report showed another big monthly price increase, with the headline measure rising 0.4% and the core measure up 0.6% from August. Overall, inflation is proving to be more durable than most analysts and policymakers expected, with negative implications for fixed income markets.

Under the surface, shelter inflation continues to accelerate. That component makes up almost one-third of the CPI basket, and is running at an annualized rate of more than 9%. Other services sectors are also seeing elevated pressures, as the tight labor market feeds through to higher prices. On the other hand, goods prices are moderating as supply chains normalize, and commodity prices are broadly off their peaks of earlier this year. We remain concerned about the near-term trajectory, but still think that inflation will moderate back to the 3% range by the end of next year.

Unfortunately for fixed income markets, that may be too late to give the Fed much comfort at the next few meetings. We expect another 75 bps hike in early November, followed by another 50bps hike in December and two 25 bps hikes in early 2023. Higher policy rates should weigh on fixed income returns and begin to drag more materially on economic growth. As a result, we favor an up-in-quality bias within asset classes.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	4.50	0.19	0.22	3.76
5-year	4.27	0.13	0.18	3.01
10-year	4.02	0.14	0.19	2.51
30-year	4.00	0.15	0.22	2.09

Source: Bloomberg L.P., 14 Oct 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	2.97	0.00	-0.12	2.73
5-year	3.00	-0.02	-0.12	2.41
10-year	3.15	-0.03	-0.15	2.12
30-year	3.76	0.00	-0.14	2.27

Source: Bloomberg L.P., 14 Oct 2022. **Past performance does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	79
30-year AAA Municipal vs Treasury	94
High Yield Municipal vs High Yield Corporate	62

Source: Bloomberg L.P., Thompson Reuters, 14 Oct 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	3.94	–	7.07	0.03	0.86	-11.37
High yield municipal	6.01	243[1]	10.59	-0.75	0.25	-15.82
Short duration high yield municipal[2]	5.96	292	4.38	-0.51	-0.18	-7.77
Taxable municipal	5.40	121[3]	9.01	-0.98	-1.42	-20.43
U.S. aggregate bond	5.03	68[3]	6.18	-1.19	-1.44	-15.84
U.S. Treasury	4.37	–	6.05	-0.77	-1.20	-14.14
U.S. government related	5.00	63[3]	5.12	-0.80	-1.04	-13.62
U.S. corporate investment grade	5.97	164[3]	7.00	-1.62	-1.48	-19.91
U.S. mortgage-backed securities	5.16	84[3]	6.01	-1.54	-1.86	-15.26
U.S. commercial mortgage-backed securities	5.52	117[3]	4.64	-0.76	-1.27	-12.94
U.S. asset-backed securities	5.27	71[3]	2.15	-0.43	-0.69	-5.71
Preferred securities	7.57	278[3]	5.12	-1.87	-2.09	-16.65
High yield 2% issuer capped	9.71	523[3]	4.07	-1.11	0.29	-14.48
Senior loans[4]	11.17	659	0.25	-0.26	0.47	-2.85
Global emerging markets	8.49	415[3]	5.86	-1.69	-1.37	-21.59
Global aggregate (unhedged)	3.91	65[3]	6.69	-1.42	-1.81	-21.34

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, 14 Oct 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, 14 Oct 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 12 Oct 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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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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