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# Fed chatter boosts Treasury yields further

*Long U.S. Treasury yields continued to rise, though the short end rallied on less hawkish signals from the U.S. Federal Reserve. Following an almost certain 75 basis point hike in November, the magnitude of future hikes is less assured.*

## HIGHLIGHTS

- **Convertibles, high yield corporates and senior loans all had positive total returns. Investment grade corporates also had positive excess returns.**
- **Agencies, MBS, ABS, preferreds and emerging markets all had negative returns.**
- **Municipal bond yields rose dramatically. New issue supply was \$8.2B, with outflows of -\$2.6B. This week's new issue supply rose to \$10.5B.**



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# Watchlist

- 10-year Treasury yields moved higher last week.
- Spread assets gained amid dovish Fed signals.
- 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.

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## INVESTMENT GRADE CORPORATE YIELDS HIT ANOTHER FRESH 13- YEAR HIGH

**Long U.S. Treasury yields rose again last week**, with the 10-year yield rising 20 basis points (bps) to 4.22%, the highest level in almost 15 years. In contrast, 2-year yields fell -2 bps, after media reports suggested that Fed officials are already debating the size of the December hike. A 75 bps rate hike is already almost fully priced in for the November 2 meeting. While another hike in December is also almost a certainty, its magnitude is not. We currently expect a 50 bps hike, though markets currently forecast around a 39% chance that the Fed hikes by 75 bps again instead. That is down from around a 66% chance of a larger hike before the latest reports about internal Fed debate.

**Investment grade corporates weakened alongside the move higher in yields**, returning -1.22%. However, they outperformed similar-duration Treasuries by 19 bps. Yield levels for the investment grade asset class hit another fresh 13-year high of 6.10%, though spreads remained flat at 164 bps. Technicals remained unresponsive, with another large outflow totaling -\$7.2 billion. The primary market restarted, with 12 issuers pricing almost \$20 billion of new supply.

**High yield corporates gained 0.29% for the week**, beating similar-duration Treasuries by 61 bps. Spreads tightened by -15 bps to 507 bps, around the middle of their range from the last few months. Senior loans returned 0.16% for the week, also benefiting from the improved risk sentiment. Outflows moderated somewhat, with -\$144 million exiting the high yield market, though -\$995 million exited loan funds. Carnival Cruise Line issued a \$2 billion bond deal, which priced at a discount at 98.5 and yield of 10.75%. Though not the best levels for a B rated issuer, it was a positive sign that the primary market is reopening. This was only the fifth deal of the month and the first of more than \$1 billion in size.

**Emerging markets continued to lag**, returning -1.20% for the week and underperforming similar-duration Treasuries by -19 bps. Most of the weakness was concentrated in the high yield corporate space, where spreads widened 13 bps. In the sovereign space, spreads tightened by around -4 bps. Liquidity remains thin in the secondary market, with trading volumes running around -50% year-over-year. As in other markets, the new issue calendar picked up, with \$10.5 billion pricing across emerging markets.

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## HIGH YIELD MUNIS OUTPERFORM HIGH GRADES

**Municipal bond yields rose dramatically last week.** Short-term yields rose 16 bps while long-term yields increased 23 bps. New issue deals were priced to sell, yet some had balances remaining by week's end. Fund flows were negative for the eleventh week in a row. This week's new issue calendar will need to be priced cheaply to pique investor interest.

**Fed members last week suggested** short-term rates may have to be increased to 5% for the Fed to get inflation completely under control. Treasury yields sold off accordingly, with the 10-year yield reaching 4.24%. This closing yield has not been seen since October 2008. Munis sold off also. Many investors believe the Fed is being overly vigilant on inflation, but also that the Fed was too cavalier earlier this year. We see signs of a cooling economy, believe rates will crest in early 2023 and anticipate volatility will continue.

**The state of Connecticut** issued \$1.1 billion tax exempt special tax obligation bonds (rated Aa3/AA-). It was priced to sell and well received. However, bonds traded cheaper than where the deal came as the week progressed. For example, 5% coupon bonds due in 2038 came at a yield of 3.96% and traded later at 4.11%, reflecting how fixed income in general sold off.

**High yield municipal yields increased 18 bps on average last week**, outperforming both high grade munis and Treasuries. The market felt promising with a large \$500 million deal for Common Spirit being strongly oversubscribed, but an acute surge in Treasury yields halted this stronger footing. Outflows accelerated at -\$682 million. This week's new issuance is very light, except for two \$200 million deals for Palmor Health and Enloe Med Center, both California BBB-rated hospitals.

*High yield corporate spreads tightened to around the middle of their range from the last few months.*

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## In focus

# Loan outflows continue despite attractive valuations

*Senior loan funds saw more than \$15 billion of outflows in the third quarter, following strong inflows in 2021 and the first quarter of 2022. Yet we believe that valuations in senior loans today are more attractive than in the recent past.*

Many senior loans funds are currently paying dividends between 6% and 7%. Those dividends may increase further if the Fed continues raising short-term interest rates. Senior loans also trade at a material discount to par, offering longer-term investors total return potential in addition to current income.

Loans are credit-sensitive assets whose performance is correlated with the U.S. economy, similar to equities. However, given their senior secured risk profile and short-dated maturity, senior loans have historically had less volatility than stocks.

Given that, we believe senior loans offer an interesting relative value opportunity for investors: possible equity-like returns, higher current income, and significantly lower volatility if the U.S. economy faces continued headwinds from higher rates and inflation.

## U.S. Treasury market

Maturity	Change (%)			
	Yield	Week	Month-to-date	Year-to-date
2-year	4.48	-0.02	0.19	3.74
5-year	4.34	0.07	0.25	3.08
10-year	4.22	0.20	0.39	2.71
30-year	4.34	0.34	0.56	2.44

Source: Bloomberg L.P., 21 Oct 2022. Past performance does not predict or guarantee future results.

## Municipal market

Maturity	Yield to Worst	Change (%)		
		Week	Month-to-date	Year-to-date
2-year	3.13	0.16	0.04	2.89
5-year	3.19	0.19	0.07	2.60
10-year	3.34	0.19	0.04	2.31
30-year	3.99	0.23	0.09	2.50

Source: Bloomberg L.P., 21 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	92
High Yield Municipal vs High Yield Corporate	64

Source: Bloomberg L.P., Thompson Reuters, 21 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

Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Returns (%)		
				Week	Month-to-date	Year-to-date
Municipal	4.13	–	7.24	-1.20	-0.35	-12.44
High yield municipal	6.19	238 <sup>1</sup>	10.63	-1.89	-1.64	-17.40
Short duration high yield municipal <sup>2</sup>	6.10	287	4.42	-0.51	-0.69	-8.24
Taxable municipal	5.59	121 <sup>3</sup>	8.89	-1.88	-3.27	-21.92
U.S. aggregate bond	5.15	67 <sup>3</sup>	6.09	-1.07	-2.49	-16.74
U.S. Treasury	4.47	–	5.89	-1.06	-2.25	-15.05
U.S. government related	5.10	63 <sup>3</sup>	5.03	-0.80	-1.84	-14.32
U.S. corporate investment grade	6.10	164 <sup>3</sup>	6.87	-1.22	-2.67	-20.89
U.S. mortgage-backed securities	5.32	81 <sup>3</sup>	6.06	-1.04	-2.88	-16.15
U.S. commercial mortgage-backed securities	5.64	122 <sup>3</sup>	4.63	-0.59	-1.86	-13.45
U.S. asset-backed securities	5.35	81 <sup>3</sup>	2.75	-0.03	-0.72	-5.74
Preferred securities	7.82	288 <sup>3</sup>	5.15	-1.40	-3.46	-17.82
High yield 2% issuer capped	9.63	508 <sup>3</sup>	4.05	0.29	0.58	-14.24
Senior loans <sup>4</sup>	11.17	656	0.25	0.16	0.63	-2.70
Global emerging markets	8.70	424 <sup>3</sup>	5.77	-1.20	-2.55	-22.53
Global aggregate (unhedged)	3.99	63 <sup>3</sup>	6.64	-0.69	-2.48	-21.88

**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, 21 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. **Issuer:** The Bond Buyer, 21 Oct 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 19 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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