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Weekly Fixed Income Commentary

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Treasury yields rise, anticipating another Fed rate hike

U.S. Treasury yields rose and the curve continued to flatten on higher inflation data. Investors anticipate additional moderation in the pace of inflation, but another significant U.S. Federal Reserve rate hike this week.

HIGHLIGHTS

- **Total returns were positive for ABS and emerging markets.**
- **Investment grade and high yield corporates had negative total returns, but positive excess returns. Treasuries, agencies, MBS and preferreds had negative returns.**
- **Municipal bond yields generally declined. New issue supply was higher at $7.4B, with inflows of $47M. This week's new issuance should be $3.9B.**

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OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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Watchlist

- *U.S. Treasury yields rose and the curve flattened further.*
- *Spread assets were mixed.*
- *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 have risen 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 tighten too aggressively, undermining the global economic expansion.
- The Russia/Ukraine conflict continues to escalate.
- Covid-19 cases increase, or new variants emerge.

CROSS-ASSET INVESTORS RETURN TO INVESTMENT GRADE CORPORATES

U.S. Treasury yields rose last week, and the curve continued to flatten. 10-year yields rose 9 basis points (bps), while 2-year yields increased 7 bps. That took the 2-year-10-year curve to -84 bps, its most inverted level since 1981. Producer prices surprised to the upside for November, sparking the selloff and focusing attention on this Tuesday's release of consumer price inflation data. On Wednesday, the Fed's policy meeting will dominate attention, where a 50 bps rate hike is expected.

Investment grade bonds weakened after their recent rally, returning -0.26% for the week but beating similar-duration Treasuries by 6 bps. The asset class saw an inflow of $993 million, largely into exchange-traded funds, as reports suggested that cross-asset investors returned to buying. Only five issuers brought new deals, totaling $4.75 billion, well below expectations. Amid the thin supply, new issue concessions were only around 3 bps.

High yield corporates performed similarly, returning -0.19% but outperforming similar-duration Treasuries by 6 bps. The asset class saw a small inflow of $66 million, while loan funds had outflows of -$408 million. Nevertheless, the senior loan asset class returned -0.04% to modestly outperform bonds. Two new deals came to market, totaling $2.3 billion.

Emerging markets eked out a gain, returning 0.04% for the week and beating similar-duration Treasuries by 37 bps. Most of the outperformance came from the corporate space, especially in China, where several credits rallied strongly on further easing of the Covid zero policy. Sovereigns were closer to flat for the week, with high yield spreads widening 6 bps and investment grade spreads tightening -2 bps. Hard currency funds saw inflows of $932 million, the fourth consecutive weekly inflow. That's the first such stretch of inflows in more than a year.

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MUNI BONDS BEGIN RETRACING SELLOFF

Municipal bond yields declined in the mid to long portions of the curve last week. The 10-year yield ended -10 bps lower while the long end finished down -2 bps. Weekly inflows were positive overall at $47 million, a combination of outsized flows into the long-term category ($445 million) and substantial outflows from short-term tax-exempt bonds.

Investors are divided as to how many more Fed rate hikes we'll see in this cycle. Although the Fed has made progress this year in cooling inflation, the Consumer Price Index still stands at 7.7%. Many believe the Fed will have to raise rates a few more times in 2023 to reach its goal of 2% inflation.

While 2022 will be a down year for fixed income performance, municipal bonds have begun retracing their selloff. The 4.6% return for November was the highest monthly return since 2008. We expect munis to end the year strong. Supply should be muted, while demand is robust for yields that are much higher than where the year began. And January reinvestment money is estimated to be $28 billion.

The state of Ohio issued $377 million general obligation bonds (rated Aa1/AA+). The deal was well received, and underwriters were able to lower yields across the curve upon final pricing.

High yield municipal bonds are outperforming in December, following a strong November. Credit spreads have contracted 9 bps on average, in addition to lower base municipal yields. Last week, both Golden State Tobacco and Chicago general obligation new issue deals were heavily oversubscribed, strongly indicating that liquidity and demand are strengthening heading into year end. Flows were positive last week for the first since the summer. We are tracking at least 11 new issue deals this coming week, likely the last major trading week of the year.

Muni supply should be muted through the end of the year, while demand is robust for higher yields.

In focus

Assessing loan performance requires multiple lenses

In a difficult year for fixed income, senior loans have relatively outperformed. Their floating rate coupons helped reduce rate sensitivity, and, recently, increasing coupons offset principal volatility.

As with other bond market sectors, higher quality loans outperformed lower quality as managers positioned portfolios defensively ahead of a potential economic slowdown.

But another much less rational factor has been in play: liquidity. So far this year, for loans rated B and above (that is, excluding the lowest quality assets), smaller, often less liquid loan facilities have outperformed larger, more liquid names that have been more efficiently marked to market.

Fundamentally, one would expect the opposite relationship. All else equal, larger, more liquid loans are made to larger (in many cases public) companies that are generally better able to pass through rising input costs and weather an economic slowdown. For investors assessing how managers have performed year-to-date and forecasting future risks, it is critical to understand how much of that performance has come from fundamentals versus a lack of liquidity.

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U.S. Treasury market

Maturity	Yield	Change (%) Week	Month-to-date	Year-to-date
2-year	4.35	0.07	0.04	3.61
5-year	3.77	0.12	0.03	2.51
10-year	3.58	0.09	-0.03	2.07
30-year	3.56	0.01	-0.18	1.66

Source: Bloomberg L.P., 09 Dec 2022. **Performance data shown represents past performance and does not predict or guarantee future results.**

Municipal market

Maturity	Yield to Worst	Change (%) Week	Month-to-date	Year-to-date
2-year	2.44	0.01	-0.74	2.20
5-year	2.47	-0.06	-0.77	1.88
10-year	2.51	-0.10	-0.88	1.48
30-year	3.46	-0.02	-0.66	1.97

Source: Bloomberg L.P., 09 Dec 2022. **Performance data shown represents past performance and does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	70
30-year AAA Municipal vs Treasury	97
High Yield Municipal vs High Yield Corporate	66

Source: Bloomberg L.P., Thompson Reuters, 09 Dec 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. **Performance data shown represents past performance and 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	3.42	–	6.17	0.33	0.83	-8.03
High yield municipal	5.63	238[1]	7.70	0.80	1.76	-11.43
Short duration high yield municipal[2]	5.35	286	4.24	0.38	1.06	-4.83
Taxable municipal	4.99	120[3]	8.36	-0.24	1.67	-16.38
U.S. aggregate bond	4.49	52[3]	6.29	-0.44	0.89	-11.84
U.S. Treasury	3.99	–	6.27	-0.41	0.79	-11.31
U.S. government related	4.59	58[3]	5.38	-0.26	0.70	-10.19
U.S. corporate investment grade	5.20	130[3]	7.33	-0.26	1.41	-14.20
U.S. mortgage-backed securities	4.50	52[3]	5.74	-0.69	0.67	-10.83
U.S. commercial mortgage-backed securities	5.17	125[3]	4.64	-0.43	0.49	-10.52
U.S. asset-backed securities	5.24	96[3]	2.91	0.10	0.53	-4.42
Preferred securities	7.31	273[3]	5.01	-0.77	0.19	-13.71
High yield 2% issuer capped	8.54	439[3]	3.85	-0.19	0.72	-9.98
Senior loans[4]	10.57	646	0.25	-0.04	0.08	-1.33
Global emerging markets	7.41	350[3]	6.21	0.04	1.33	-14.86
Global aggregate (unhedged)	3.47	52[3]	6.87	-0.07	1.81	-15.19

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, 09 Dec 2022. **Performance data shown represents past performance and 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, 09 Dec 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 07 Dec 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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