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Treasury yields fall as the Fed hikes once more

U.S. Treasury yields fell last week. The November U.S. CPI report showed a smaller-than-expected monthly increase. The U.S. Federal Reserve delivered a 50 bps hike as expected, but also included hawkish economic projections that called into question the future of monetary policy.

HIGHLIGHTS

- **Total returns were positive for Treasuries, agencies, taxable munis, MBS, ABS, preferreds, investment grade and high yield corporates, loans and emerging markets.**
- **Convertibles, in contrast, had a slightly negative return.**
- **Municipal bond yields generally declined. New issue supply was \$3.9B, with outflows of -\$1.2B. This week's new issuance should be virtually zero due to the Christmas holiday.**



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OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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Watchlist

- *U.S. Treasury yields fell across the curve.*
- *Spread assets were generally positive.*
- *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.

INVESTMENT GRADE AND HIGH YIELD CORPORATES SEE INFLOWS

U.S. Treasury yields fell last week, with 10-year yields declining -10 basis points (bps) to 3.48%. Two-year yields fell even more, down -17 bps, though the curve remains heavily inverted. Two events dominated attention: the November CPI report on Tuesday and the Fed meeting on Wednesday. The former showed a smaller-than-expected increase in prices for the month, though measures of shelter inflation continue to run hot. The Fed delivered a 50 bps hike as expected, but also included hawkish economic projections, causing the Treasury market to give back some of its rally.

Investment grade bonds gained 0.55% for the week, but lagged similar-duration Treasuries by -13 bps. The asset class saw a \$2.4 billion inflow into ETFs and mutual funds, while the primary market is now likely closed for the rest of 2022. Overall, new supply totaled \$1.2 trillion this year, down -15% from 2021 levels. Preferreds also gained, up 0.57% for the week, with U.S. dollar AT1 CoCo securities notching a 1.16% rally, one of the best performing asset classes across all of fixed income.

High yield corporates lagged, returning 0.03% and underperforming similar-duration Treasuries by -52 bps. The high yield asset class saw inflows of \$313 million, and the primary market is also likely finished for the year. Leveraged loans gained 0.07% for the week, despite an outflow of -\$1.2 billion.

Emerging markets gained 0.47%, though they underperformed similar-duration Treasuries by -18 bps. Spreads tightened across sovereign and corporate markets. High yield continued its recent trend of outperforming investment grade. Inflows continued as well, with \$1.1 billion entering hard currency funds for the week, the largest weekly inflow since April.

MUNICIPAL BONDS SHOULD BEGIN 2023 WITH A SOLID TONE

Municipal bond yields fell last week, except on the short end. The 10- and 30-year bond yields each ended -4 bps lower. Weekly fund outflows continued at -\$ 1.2 billion, despite exchange-traded inflows of \$758 million.

After the Wednesday Fed meeting, Chair Powell reiterated that the Fed has more work to do to bring inflation down to its target of 2%. This may mean more rate increases in 2023 than previously expected. Investors remain divided into two camps. One thinks the Fed is essentially done raising rates as inflation is declining. The other believes the Fed should continue raising rates since inflation remains at about 7%.

Municipals have a solid tone as we close the year. Rates are substantially higher than the beginning of the year, attracting new investors. Also, managers continue to execute tax swaps through year end. Munis should begin 2023 with a good tone, as there will be billions of dollars to reinvest with a sparse new issue calendar.

The Port Authority of New York and New Jersey issued \$500 million revenue bonds, both AMT and non-AMT (rated Aa3/AA-). The non-AMT portion had long bonds priced at 5% due in 2052 at a yield of 4.05%.

The high yield municipal market is returning to more solid footing. Last week, the Pennsylvania Department of Transportation issued a \$1.8 billion deal, the largest of the year, which was heavily oversubscribed. New issuance should be negligible for the remainder of the year. Net outflows were modest last week due to latent tax loss selling. The market was bolstered by 15 December reinvestment cash flows and will be supported even more by January cash flows. In a sign that liquidity continues strengthen, high yield muni exchange-traded funds are receiving heavy inflows and becoming a larger market presence in the market.

Muni bonds should begin 2023 with a good tone, as there will be billions of dollars to reinvest with a sparse new issue calendar.

In focus

The Fed hikes by a little less, but more is in store

After increasing its policy rate by 75 bps at each of its last four meetings, the Fed raised rates by 50 bps (to a range of 4.25% to 4.50%) last week. While inflation concerns remain despite softer data in October and November, risks between higher prices and slower growth now appear more balanced than they have for several years.

The Fed also issued updated growth and employment outlooks, which were less optimistic than those released in September. Meanwhile, according to the dot plots, the median expectation for the level of interest rates moved higher for the end of 2023 (from 4.625% to 5.125%), more than traders had anticipated. The Fed's 2024 policy forecast remains dispersed among individual members, but rate cuts totaling about 100 bps appear to be on tap.

In his post-meeting press conference, Fed Chair Jerome Powell pointed out that inflation is still elevated, and the labor market continues to be out of balance. This means demand for workers far exceeds supply, thereby putting upward pressure on wages — which the central bank would like to reverse.

Much to investors' disappointment, Powell didn't provide signs the Fed is looking to end its tightening cycle. U.S. equities fell in the immediate wake of the Fed's decision, while the yield on the bellwether U.S. 10-year Treasury declined, reflecting a reduced possibility of an economic soft landing next year.

U.S. Treasury market

Maturity	Change (%)			
	Yield	Week	Month-to-date	Year-to-date
2-year	4.18	-0.17	-0.13	3.45
5-year	3.63	-0.14	-0.11	2.36
10-year	3.49	-0.09	-0.12	1.98
30-year	3.55	-0.02	-0.19	1.64

Source: Bloomberg L.P., 16 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	2.49	0.05	-0.04	2.25
5-year	2.43	-0.04	-0.20	1.84
10-year	2.47	-0.04	-0.24	1.44
30-year	3.42	-0.04	-0.10	1.93

Source: Bloomberg L.P., 16 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	71
30-year AAA Municipal vs Treasury	97
High Yield Municipal vs High Yield Corporate	66

Source: Bloomberg L.P., Thompson Reuters, 16 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.

For more information, please visit nuveen.com.

Performance: Bloomberg L.P. **Issuance:** The Bond Buyer, 16 Dec 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 14 Dec 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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Characteristics and returns

Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Returns (%)		
				Week	Month-to-date	Year-to-date
Municipal	3.40	–	6.16	0.24	1.07	-7.81
High yield municipal	5.62	241 ¹	7.73	0.31	2.07	-11.15
Short duration high yield municipal ²	5.32	287	4.16	0.17	1.23	-4.67
Taxable municipal	4.88	119 ³	8.37	0.88	2.56	-15.65
U.S. aggregate bond	4.35	50 ³	6.29	0.80	1.70	-11.13
U.S. Treasury	3.86	–	6.32	0.68	1.47	-10.71
U.S. government related	4.48	60 ³	5.37	0.45	1.15	-9.79
U.S. corporate investment grade	5.11	132 ³	7.34	0.55	1.96	-13.73
U.S. mortgage-backed securities	4.33	43 ³	5.65	1.28	1.96	-9.69
U.S. commercial mortgage-backed securities	5.00	121 ³	4.64	0.86	1.35	-9.75
U.S. asset-backed securities	5.03	89 ³	2.92	0.49	1.02	-3.96
Preferred securities	7.17	274 ³	4.99	0.57	0.76	-13.22
High yield 2% issuer capped	8.58	459 ³	3.88	0.03	0.75	-9.96
Senior loans ⁴	10.46	648	0.25	0.07	0.15	-1.26
Global emerging markets	7.31	351 ³	6.21	0.47	1.81	-14.46
Global aggregate (unhedged)	3.49	52 ³	6.82	-0.09	1.72	-15.27

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, 16 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.

by way of example. Performance data shown represents past performance and does not predict or guarantee future results. Investing involves risk; principal loss is possible.

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Important information on risk

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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