

06 February 2023

# Treasury yields rise as the Fed hikes again

*U.S. Treasury yields rose and spread assets outperformed, amid a dovish U.S. Federal Reserve meeting and positive economic data. The Fed hiked rates by an-expected 25 basis points, while the January jobs report beat expectations by a wide margin.*

## HIGHLIGHTS

- **Taxable munis, investment grade and high yield corporates, preferreds, convertibles, senior loans and emerging markets all enjoyed positive total returns.**
- **U.S. Treasuries and MBS both saw modest negative total returns.**
- **Municipal bond yields again remained essentially unchanged. New issue supply was only \$1.6B with outflows of -\$362M. This week's new issuance should tick up to \$4.9B.**



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OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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# Watchlist

- U.S. Treasury yields rose across most of the curve.
- Spread assets appreciated.
- Net-negative supply should provide some support to municipal bonds.

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## INVESTMENT VIEWS

**The end to U.S. central bank tightening appears near**, as we expect Fed rate hikes to cease early this year. The overall level of rates is likely to remain historically low.

**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 fall this year**, and we expect the 10-year Treasury yield to end the year around 3.25%.

**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.

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## KEY RISKS

- Inflation fails to moderate as expected, negatively affecting asset values.
- Policymakers remove accommodation too rapidly, undermining the global economic expansion.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.
- Covid cases increase, or new variants emerge.

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## INVESTMENT GRADE CORPORATES START THE YEAR HISTORICALLY STRONG

**U.S. Treasuries experienced volatility last week**, after a dovish Fed meeting and an impressively strong jobs report. The Fed hiked rates by 25 basis points (bps) as expected. Though Chair Powell continued to caution against premature loosening in policy, the market responded by accelerating expectations for a pause in the hiking cycle and rate cuts later this year. Yields across the Treasury curve rallied in response, with 10-year yields falling as much as -17 bps. However, they fully retraced that move to end the week up 2 bps after the January jobs report beat expectations by a wide margin. The report showed that the U.S. economy added 517,000 jobs last month, more than double expectations, and the unemployment rate fell to a new 50-year low of 3.4%. Other data painted a more complex picture, with job openings also picking up while the ISM manufacturing survey fell deeper into contractionary territory.

**Investment grade corporates rallied**, gaining 0.30% for the week and beating similar-duration Treasuries by 33 bps. That capped a 4.01% return in January, the best start to a year since 1975. Preferreds have also started 2023 strong, returning 0.85% for the week and 8.64% in January. Investment grade funds saw inflows of \$4.8 billion, helping the market to easily digest around \$21 billion of new supply. Overall issuance was 5.1x oversubscribed, leading to negative concessions in many cases.

**High yield corporates also gained**, returning 1.01% for the week and outpacing similar-duration Treasuries by 110 bps. The asset class rallied along with other risk assets after the dovish Fed meeting, but gave back some of that performance after the jobs report on Friday. Still, CCCs returned 1.91% for the week, compared to 0.80% for BBs. The asset class saw \$6 billion of new issuance as the primary market continues to reactivate. Outflows picked up, with -\$1.5 billion leaving the asset class, while -\$786 million exited from loan funds. Senior loans returned 0.43% for the week.

**Emerging markets also rallied**, returning 0.43% and beating similar-duration Treasuries by 48 bps. As in other asset classes, lower-rated segments outperformed. Within sovereign space, high yield spreads compressed -14 bps, versus -6 bps for investment grade names. Local currency bonds gained 1.23%, despite an outflow of -\$462 million. Hard currency funds saw inflows of \$1.1 billion, a slowdown from the recent strong pace, but still a solid pace.

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## MUNICIPAL BONDS REMAIN WELL BID

**The municipal bond market, and most of fixed income, was listless again last week** as investors waited for Wednesday's Fed meeting. Weekly new issue supply was scant, as many issuers also stayed on the sidelines. Fund flows turned negative last week, and this week's new issue supply should tick up slightly.

### **Last week was chock full of government data.**

On Wednesday, Fed Chair Powell's commitment to "ongoing" rate increases until inflation is under control was well received by the bond market. Friday's strong jobs report caused fixed income in general to sell off as some investors fear that high employment will lead to more inflation. With rates currently just under 5%, it would be hard for an economy to grow dramatically with such a high cost of capital.

**Municipal bonds continue to be well bid and look rich** relative to taxable bonds on a historical basis, and we expect this trend to continue. Municipal new issue supply is anticipated to be constrained for the foreseeable future while demand remains strong. We would interpret any selloffs as a buying opportunity.

**Fort Worth Independent School District, Texas,** issued \$275 million bonds (rated Aa1/NR, but rated AAA factoring in the guarantee by the Permanent School Fund). The deal included 4% coupon bonds due in 2042 that came at a yield of 3.03%.

**High yield municipal bond performance remained strong last week,** as credit spreads continued to compress with building demand from mutual funds. Exchange-traded funds are seeing outflows, as investors rotate back into active funds. ETF redemptions are providing secondary supply where new issue supply remains exceptionally light. February reinvestment cash flows are expected to be large and should further bolster demand.

***Investment grade corporate bonds returned 4.01% in January, the best start to a year since 1975.***

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## *In focus*

# *The Fed eases up a bit more*

*After raising rates by 75 bps in November and 50 bps in December, the Fed continued to slow its pace of rate hikes last week, lifting its fed funds rate target range by 25 bps, to 4.50% - 4.75% — the highest level since 2007.*

With new Fed economic forecasts and an updated interest rate outlook not due until March, markets homed in on changes to the Fed's policy statement. While acknowledging the recent slowing in several measures of inflation, the statement also kept the phrase "ongoing increases" to set expectations for future Fed action. Last December, the Fed published a median 2023 interest rate forecast of 5.125%, signaling that additional tightening is still on tap.

During his post-meeting press conference, Chair Jerome Powell continued to emphasize the labor market's supply/demand imbalance and its ability to fuel wage growth. In the Fed's view, ongoing firmness in wage gains is a key driver of rising inflation. So Powell and his colleagues seemingly are in no rush to pivot from lifting borrowing costs to lowering them "for quite some time."

The Fed now faces a difficult balancing act: wind down its rate hikes without the further easing of financial conditions, which could rekindle inflation later this year. To guard against this, we expect repeated, firm commitments from Fed officials that they won't begin to change course until 2024, after interest rates have peaked.

## U.S. Treasury market

Maturity	Change (%)			
	Yield	Week	January 2023	Year-to-date
2-year	4.29	0.09	-0.23	-0.14
5-year	3.66	0.05	-0.39	-0.35
10-year	3.53	0.02	-0.37	-0.35
30-year	3.62	-0.01	-0.33	-0.35

Source: Bloomberg L.P., 03 Feb 2023. Performance data shown represents past performance and does not predict or guarantee future results.

## Municipal market

Maturity	Change (%)			
	Yield to Worst	Week	January 2023	Year-to-date
2-year	2.19	0.02	-0.43	-0.41
5-year	2.04	-0.01	-0.47	-0.48
10-year	2.18	-0.01	-0.44	-0.45
30-year	3.17	-0.03	-0.38	-0.41

Source: Bloomberg L.P., 03 Feb 2023. Performance data shown represents past performance and does not predict or guarantee future results.

## Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	62
30-year AAA Municipal vs Treasury	87
High Yield Municipal vs High Yield Corporate	68

Source: Bloomberg L.P., Thompson Reuters, 03 Feb 2023. 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, 03 Feb 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 01 Feb 2023.

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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	Characteristics			Returns (%)		
	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	January 2023	Year-to-date
Municipal	3.09	–	6.11	0.15	2.87	2.99
High yield municipal	5.39	242 <sup>1</sup>	7.62	0.66	4.44	5.10
Short duration high yield municipal <sup>2</sup>	5.05	297	4.04	0.32	2.45	2.72
Taxable municipal	4.73	103 <sup>3</sup>	8.43	0.38	5.04	5.26
U.S. aggregate bond	4.32	44 <sup>3</sup>	6.39	0.03	3.08	3.02
U.S. Treasury	3.91	–	6.36	-0.05	2.51	2.28
U.S. government related	4.48	55 <sup>3</sup>	5.46	0.12	2.36	2.45
U.S. corporate investment grade	4.97	115 <sup>3</sup>	7.34	0.30	4.01	4.08
U.S. mortgage-backed securities	4.28	38 <sup>3</sup>	5.95	-0.09	3.29	3.36
U.S. commercial mortgage-backed securities	4.88	104 <sup>3</sup>	4.60	0.03	2.63	2.56
U.S. asset-backed securities	4.88	64 <sup>3</sup>	2.88	0.03	1.42	1.35
Preferred securities	6.36	194 <sup>3</sup>	4.89	0.85	8.64	8.91
High yield 2% issuer capped	7.90	387 <sup>3</sup>	3.73	1.01	3.81	4.96
Senior loans <sup>4</sup>	9.76	573	0.25	0.43	2.57	2.91
Global emerging markets	6.97	314 <sup>3</sup>	6.31	0.43	3.20	3.78
Global aggregate (unhedged)	3.43	45 <sup>3</sup>	6.86	0.18	3.28	3.49

**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, 03 Feb 2023. 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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