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# Treasury yields continue marching higher

*U.S. Treasury yields rose further, after another round of unfavorable inflation data. The bond market selloff was catalyzed by strong economic data, with PMIs beating expectations and PCE inflation coming in higher than anticipated.*

## HIGHLIGHTS

- **Total returns were negative across all major fixed income asset classes.**
- **Agencies, ABS, preferreds, high yield corporates and emerging markets outperformed Treasuries.**
- **Municipal bond yields rose as well. New issue supply was only \$3.4B with outflows of -\$1.7B. This week's new issuance should be \$4.8B.**



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OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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# Watchlist

- *U.S. Treasury yields rose across the curve.*
- *Spread assets weakened after a strong start to the year.*
- *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 relatively low by historical standards.

**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 2023 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 SEE RARE INFLOWS

**U.S. Treasury yields rose again last week**, with the 10-year yield rising 13 basis points (bps) to 3.95%. 2-year yields moved more sharply, up 20 bps, as the market anticipated additional Fed rate hikes and removed pricing for rate cuts later this year. The selloff was catalyzed by strong economic data, with PMIs beating expectations and PCE inflation coming in higher than expected. In addition, the 5-year and 7-year Treasury auctions tailed more than usual, reflecting weak demand and putting further upward pressure on yields.

**Investment grade corporate spreads widened** for the third consecutive week, the longest such streak since September. The asset class returned -0.99% for the week, lagging similar-duration Treasuries by -10 bps. Yields moved higher, with the index now trading at 5.53%. That is up 70 bps from the lows earlier this month. Investment grade funds had large inflows of \$4.5 billion, in contrast to other asset classes, but the new issue market remained active as well. February issuance has already totaled \$122 billion, the most for February on record with two days remaining. We expect this trend to continue in March, with another \$150 billion of supply expected.

**High yield corporates outperformed**, but still had negative returns at -0.18% for the week. The asset class outperformed similar-duration Treasuries by 41 bps. The relative outperformance came despite the third biggest outflow on record, at -\$6.1 billion. Loan funds experienced outflows of -\$618 million, with the asset class returning -0.11%. The new issue calendar for both markets was much quieter than investment grade, with only one high yield deal coming to market.

**Emerging markets returned -0.36%**, but beat similar-duration Treasuries by 46 bps. Spreads widened across sovereigns and corporates, and high yield names lagged in both markets. Hard currency funds had their biggest outflows since October at -\$921 million. Local funds also saw accelerating outflows totaling -\$402 million, though the local market asset class returned a more-healthy -0.04%. As in the high yield market, issuance was light, with less than \$5 billion coming to market across emerging markets.

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## MUNICIPAL BONDS SELL OFF ALONG WITH TREASURIES

**The municipal bond market sold off dramatically last week**, along with Treasuries. Fund flows were negative, and dealers struggled to sell the muted amount of new issue supply. We expect supply will be modest again this week, yet deals will have to be priced cheaply to sell.

**It appears interest rates will remain higher for longer**, as inflation pressures persist through much of the U.S. economy. Fed members have reiterated their commitment to raise rates continually until inflation is under control. We now expect three more rate increases in 2023, with little hope for the Fed to begin lowering rates by the end of this year. However, the Fed commitment is more important. Interest rates are substantially cheaper than at the beginning of 2022. Further major swings in rates seem unlikely over the foreseeable future, thus we expect fixed income to remain range-bound for some time.

**Las Vegas, Nevada**, issued \$69 million general obligation bonds (rated Aa2/AA+). The deal included 5% coupon bonds that came at a yield of 3.57%. Those bonds later traded in the secondary market at 3.60%. In this skittish market, dealers will sell bonds at slight losses to keep inventory moving.

**High yield municipals remain well bid**, despite a short burst of outflows mainly from short-duration bonds. Inflows year-to-date, lower new issue supply and higher absolute yields have kept technical support firmly positive, as high yield munis have outperformed high grade munis and Treasuries. While performance remains positive year-to-date, continued short-term spikes in rate volatility are not uncommon within a longer trend of normalization. These shifts can distract from the municipal bonds' healthy fundamentals and stronger technical factors that support market demand.

***Investment grade corporate spreads widened for the third consecutive week, the longest such streak since September.***

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## *In focus*

# *More hikes in the Fed's future*

*The biggest driver of fixed income markets over the last year has been the steady, upward recalibration of expectations for the terminal level of the Fed's policy rate. The latest round of inflation data surprised to the upside, and contained trends that point to higher-for-longer policy.*

We now anticipate three additional 25 bps hikes, one at each of the March, May and June meetings.

Core inflation is still running too hot. Goods prices have softened, but services are running ahead of expectations. Partially, that reflects continued housing and rental price inflation, which is likely to slow in the coming months. But price pressures remain intense in the rest of core services due to the tight labor market and show no signs of decelerating.

As a result, the Fed will likely raise rates further than investors previously expected. We still think the Fed will pause later this year, though we do not anticipate rate cuts until next year. Leading indicators point to much slower growth ahead, which will impact inflation with a lag. By summer, we expect tighter financial conditions to weigh more materially on growth and inflation.

Our outlook for more rate hikes, a higher terminal rate and slower growth ahead still supports our forecast for a rally in 10-year Treasury yields this year. By later this year, we expect markets to look toward the likely economic slowdown and potential rate cuts that will follow. We continue to forecast the 10-year yield at 3.25% for year end.

## U.S. Treasury market

Maturity	Change (%)			
	Yield	Week	Month-to-date	Year-to-date
2-year	4.82	0.20	0.61	0.39
5-year	4.22	0.19	0.60	0.21
10-year	3.95	0.13	0.44	0.07
30-year	3.93	0.06	0.30	-0.03

Source: Bloomberg L.P., 24 Feb 2023. 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	2.95	0.16	0.78	0.35
5-year	2.61	0.14	0.56	0.09
10-year	2.59	0.10	0.40	-0.04
30-year	3.56	0.06	0.36	-0.02

Source: Bloomberg L.P., 24 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	66
30-year AAA Municipal vs Treasury	91
High Yield Municipal vs High Yield Corporate	67

Source: Bloomberg L.P., Thompson Reuters, 24 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, 24 Feb 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 22 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	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Returns (%)		
				Week	Month-to-date	Year-to-date
Municipal	3.62	–	6.15	-0.44	-2.29	0.51
High yield municipal	5.80	242 <sup>1</sup>	7.79	-0.61	-3.23	1.07
Short duration high yield municipal <sup>2</sup>	5.45	292	4.10	-0.32	-1.14	1.28
Taxable municipal	5.11	93 <sup>3</sup>	8.25	-0.89	-2.63	2.28
U.S. aggregate bond	4.83	47 <sup>3</sup>	6.27	-0.89	-2.82	0.16
U.S. Treasury	4.41	–	6.14	-0.77	-2.61	-0.17
U.S. government related	4.95	52 <sup>3</sup>	5.27	-0.60	-1.99	0.32
U.S. corporate investment grade	5.53	123 <sup>3</sup>	7.06	-0.99	-3.38	0.49
U.S. mortgage-backed securities	4.78	45 <sup>3</sup>	6.14	-1.06	-2.87	0.33
U.S. commercial mortgage-backed securities	5.38	102 <sup>3</sup>	4.53	-0.80	-2.05	0.53
U.S. asset-backed securities	5.28	56 <sup>3</sup>	2.84	-0.32	-0.94	0.46
Preferred securities	6.86	196 <sup>3</sup>	4.88	-0.54	-2.21	6.23
High yield 2% issuer capped	8.72	420 <sup>3</sup>	3.80	-0.18	-1.73	2.01
Senior loans <sup>4</sup>	10.54	587	0.25	-0.11	0.52	3.10
Global emerging markets	7.56	324 <sup>3</sup>	6.09	-0.36	-2.39	0.73
Global aggregate (unhedged)	3.83	47 <sup>3</sup>	6.72	-1.19	-3.54	-0.37

<sup>1</sup> Yield difference between the Bloomberg High Yield Municipal Index and the 20-year AAA MMD scale. <sup>2</sup> 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. <sup>3</sup> Option-adjusted spread to Treasuries. <sup>4</sup> 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, 24 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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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.

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