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Weekly Fixed Income Commentary

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Treasury yields rise on the Fed's last hike

U.S. Treasury yields rose after the U.S. Federal Reserve hiked interest rates for what should be the final time of this tightening cycle. U.S. economic data were mostly positive, including a strong employment report and improving manufacturing data.

HIGHLIGHTS

- **Treasuries, MBS and ABS had positive total returns.**
- **Investment grade and high yield corporates, preferreds, senior loans and emerging markets all weakened.**
- **Municipal bond yields remained essentially unchanged. New issue supply was $6.3B with outflows of -$846M. This week's new issuance is expected to be $7.9B.**

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Watchlist

- *U.S. Treasury yields rose slightly.*
- *Spread assets weakened on continued banking sector stress.*
- *Increased seasonal supply should provide an attractive entry point for municipal bonds.*

INVESTMENT VIEWS

"Higher for longer" remains as a theme, as the Fed battles to control inflation. Higher interest rates are likely to cause additional volatility.

The underlying growth outlook remains healthy, thanks to strong consumer balance sheets and solid levels of businesses investment. This combination should keep corporate 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 selectively taking on risk in this environment of attractive prices and yields. Credit selection is key as we search for bonds with favorable income and solid fundamentals.

KEY RISKS

- Inflation fails to moderate as expected, weighing on asset prices.
- Policymakers tighten too rapidly, undermining the global economic expansion.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.

HIGH YIELD CORPORATES HIT A TECHNICAL HEAD WIND

U.S. Treasury yields rose last week and the curve steepened. The 10-year yield rose 2 basis points (bps), while the 2-year yield fell -9 bps. The Fed raised interest rates by 25 bps as expected and signaled that it is likely finished hiking for now. U.S. economic data were mostly positive, with the unemployment rate falling back to 3.4% in the latest jobs report. The ISM manufacturing survey rose 0.8 pts as well, though it remained in contractionary territory at 47.1.

Investment grade corporates weakened, returning -0.59% for the week and lagging similar-duration Treasuries by -58 bps. Spreads widened 10 bps, their worst performance since mid-March at the peak of the banking stress. Spread levels for the index reached 146 bps, also the highest since they peaked in mid-March around 163 bps. Financials led the weakness, with small regional bank bonds falling -10 to -30 points in price. Larger regional spreads were 30 to 50 bps wider, and money center banks were 20 bps wider. Given the banking weakness, preferred securities sold off, returning -3.29% for the weak and underperforming similar-duration Treasuries by -346 bps. Despite the negative price action, investment grade funds had inflows of $3.4 billion.

High yield corporates declined, returning -0.38% for the week and lagging similar-duration Treasuries by -69 bps. Unlike the investment grade market, high yield was affected by a technical headwind of -$1.6 billion in outflows for the week. Loan funds saw outflows of -$374 million, with the asset class returning -0.11%. Both markets had relatively large issuance, with $5.7 billion in the high yield market and $4.9 billion in loans. Both were largely dominated by refinancing deals.

Emerging markets outperformed other risk assets but still ended lower, returning -0.02% for the week to underperform similar-duration Treasuries by -12 bps. Hard currency sovereign spreads widened 3 bps, with high yield outperforming slightly as Tunisia and Argentina both rallied 1.5 pts in price. Outflows eased, but continued, with -$146 million exiting hard currency funds.

MUNICIPALS LOOK TO BENEFIT FROM POSITIVE TECHNICALS

Municipal bond yields were essentially unchanged last week. This is positive news in the face of another Fed rate hike and a strong U.S. employment report. New issuance was priced to sell and well received. Municipal bond mutual funds have shown outflows for 12 consecutive weeks, but it should be noted that exchange-traded funds have experienced positive flows for the year. This week's new issue supply should be well received.

Many investors are concerned that the strength of U.S. employment will lead to continued inflation. However, the Fed maintains its resolve to continue fighting until inflation declines to the Fed's target rate of 2%.

Fixed income in general remains well bid as investors believe the Fed will bring inflation under control. Municipal bonds also remain well bid. Heavy reinvestment money is coming due throughout the summer and new issuance is expected to remain muted throughout 2023.

Energy Northwest (state of Washington) issued $509 million electric revenue bonds (rated Aa2/AA-). The deal included 5% coupon bonds due in 2038 that came at a yield of 3.23%. Those bonds traded in the secondary market at 3.10%.

High yield municipal bond yields declined on average last week, and credit spreads tightened slightly as a result. The inversion of the high yield municipal credit spread curve is slowly normalizing. The pace of outflows continues to taper, and soon the market will be fed with large reinvestment cash flows in June, July and August. Rate volatility has been stabilizing, and this is allowing high yield munis to produce positive total returns with greater consistency. Performance should be supported with the Fed seemingly on pause and a summer of technical strength.

Municipal bond reinvestment money is soon coming due, and new issuance should remain muted throughout 2023.

In focus

Will the Fed shelve its hiking boots?

As expected, the U.S. Federal Reserve raised interest rates by 25 bps last week, taking the target range for its policy rate to 5.00%-5.25%.

In its policy statement, the Fed signaled an imminent end to this aggressive tightening cycle that began in March 2022. It no longer "anticipates that some additional policy firming may be appropriate," instead saying that it will "closely monitor incoming information."

During his post-meeting press conference, however, Chair Jerome Powell leaned slightly hawkish. While noting that the Fed is "prepared to do more" if needed and will assess incoming data on a meeting-by-meeting basis, Powell also implied that more rate hikes may be warranted if inflation remains persistently high and banks don't tighten lending standards as anticipated.

Markets ignored Powell's message, continuing to price in nearly three full rate cuts over the balance of 2023, with zero additional hikes from current levels. When asked about the disconnect between Fed rhetoric and market pricing, Powell stated that, based on the Fed's projections, rate cuts aren't appropriate.

In our view, the Fed is done tightening for now. We expect the central bank to keep policy rates unchanged for the next several meetings, with a small chance of cuts in the fourth quarter.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	3.92	-0.09	-0.09	-0.51
5-year	3.41	-0.07	-0.07	-0.59
10-year	3.44	0.02	0.02	-0.44
30-year	3.75	0.08	0.08	-0.21

Source: Bloomberg L.P., 05 May 2023. **Performance data shown represents past performance and does not predict or guarantee future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	2.66	-0.03	-0.03	0.06
5-year	2.31	-0.07	-0.07	-0.21
10-year	2.31	-0.04	-0.04	-0.32
30-year	3.36	-0.03	-0.03	-0.22

Source: Bloomberg L.P., 05 May 2023. **Performance data shown represents past performance and does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	67
30-year AAA Municipal vs Treasury	89
High Yield Municipal vs High Yield Corporate	66

Source: Bloomberg L.P., Thompson Reuters, 05 May 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.**

Characteristics and returns

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	3.34	–	6.07	0.35	0.35	2.90
High yield municipal	5.69	257[1]	7.61	0.16	0.16	3.49
Short duration high yield municipal[2]	5.31	308	3.91	0.22	0.22	2.88
Taxable municipal	4.69	104[3]	8.27	-0.13	-0.13	6.36
U.S. aggregate bond	4.31	58[3]	6.42	-0.05	-0.05	3.53
U.S. Treasury	3.71	–	6.36	0.06	0.06	3.62
U.S. government related	4.31	57[3]	5.41	0.08	0.08	3.79
U.S. corporate investment grade	5.15	146[3]	7.24	-0.59	-0.59	3.68
U.S. mortgage-backed securities	4.42	60[3]	6.16	0.20	0.20	3.27
U.S. commercial mortgage-backed securities	5.05	141[3]	4.53	0.30	0.30	3.00
U.S. asset-backed securities	4.81	83[3]	2.86	0.24	0.24	2.61
Preferred securities	7.73	311[3]	4.60	-3.29	-3.29	-0.35
High yield 2% issuer capped	8.59	472[3]	3.64	-0.38	-0.38	4.21
Senior loans[4]	9.69	607	0.25	-0.11	-0.11	3.98
Global emerging markets	7.31	363[3]	6.26	-0.02	-0.02	2.53
Global aggregate (unhedged)	3.49	55[3]	6.86	0.15	0.15	3.62

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, 05 May 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.

For more information, please visit nuveen.com.

Performance: Bloomberg, L.P. **Issuance:** The Bond Buyer, 05 May 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 03 May 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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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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