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Economic data continue boosting Treasury yields

10-year U.S. Treasury yields continue to rise as economic data remain very strong. The closely watched U.S. GDP forecast from the Federal Reserve Bank of Atlanta has risen to 5.8% annualized quarter-over-quarter growth.

HIGHLIGHTS

- **Senior loans enjoyed positive total returns.**
- **Treasuries, agencies, investment grade and high yield corporates, MBS, preferreds and emerging markets all weakened.**
- **Municipal bond yields rose across the curve. New issue supply was \$6.2B with outflows of -\$264M. This week's new issuance should be \$7.0B.**



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OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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Watchlist

- 10-year U.S. Treasury yields rose, but we anticipate modest declines over the course of 2023.
- Spread assets underperformed relative to Treasuries.
- Increased seasonal supply should provide an attractive entry point for municipal bonds.

INVESTMENT VIEWS

“Higher for longer” rates 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 business investment. This combination should keep corporate defaults low.

Treasury yields are likely to fall slightly this year, and we expect the 10-year Treasury yield to end 2023 around 3.35%.

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.

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SENIOR LOANS ARE BOOSTED BY THE RISE IN INTEREST RATES

U.S. Treasury yields rose again last week, with the 10-year yield ending 10 basis points (bps) higher at 4.26%. 2-year yields were more muted, rising 5 bps. Continued strong economic data drove the increase, with U.S. retail sales expanding 0.7% month-over-month in July, almost double the expected pace. The data for June were revised up as well. Industrial production beat expectations, and U.S. GDP growth estimates for the third quarter are being revised up across the board. The closely watched forecast from the Federal Reserve Bank of Atlanta has risen to 5.8% annualized quarter-over-quarter growth. That would be the strongest quarterly growth since 2003, excluding the post-Covid surge.

Investment grade corporates weakened, returning -0.71% for the week and lagging similar-duration Treasuries by -21 bps. That marks the fourth consecutive weekly selloff, as interest rates have steadily moved higher in August. Although a few issuers shelved plans to issue new bonds last week amid the weaker price action, overall supply still totaled around \$14 billion as expected. This week, that pace is expected to decelerate further, with around \$5 to \$10 billion of new deals. The investment grade asset class reverted to outflows again, with -\$575 million exiting from IG funds for the week.

High yield corporates also weakened, returning -0.81% for the week and underperforming similar-duration Treasuries by -69 bps. Senior loans gained 0.24% for the week, boosted by the rise in interest rates thanks to their floating-rate nature. High yield funds had sizeable outflows of -\$1.1 billion, while loan funds experienced inflows of \$274 million. As in high grade markets, leveraged finance asset classes should see slower activity this week amid the summer lull.

Emerging markets lagged materially, returning -1.45% for the week and underperforming similar-duration Treasuries by -104 bps. Economic data from China continued to soften, with retail sales, industrial production and fixed asset investment disappointing versus expectations in July. The official unemployment rate also ticked higher to 5.3%. Though the People's Bank of China cut interest rates by -15 bps, more than expected, the weakness in the data outweighed the support from policy. Looking forward, we continue to anticipate additional fiscal and monetary easing, though we have also revised lower our China GDP forecast for this year to around 5%, from 5.5%.

MUNI BONDS ARE RICH RELATIVE TO TAXABLE BONDS

Municipal bond yields rose last week, with short-term yields rising 5 bps and long-term rates increasing 13 bps. New issue supply was priced to sell, yet underwriters struggled to complete deals. Weekly fund flows were negative. This week's new issue supply will need to be priced to sell to pique investor interest.

We are relatively optimistic about fixed income. Yields have returned to levels last seen in October 2022, yet inflation is lower. However, yields should remain elevated until inflation declines closer to the U.S. Federal Reserve's 2% target.

We are also constructive on municipal bonds, but choppiness may extend through the end of 2023. Tax-exempt bonds are rich relative to taxable bonds due to low tax-exempt new issuance during the summer and more than \$100 billion of reinvestment money returning to the market. This trend should reverse this fall, when we expect supply to pick up and reinvestment money will be comparatively lower. In this orderly muni market, institutional investors should be rearranging portfolios back to mandates. There may be pockets of illiquidity through the end of the year, which we would see as buying opportunities.

The state of Tennessee issued \$449 million general obligation bonds (rated Aaa/AAA). A substantial balance was left on the deal when the bonds were purchased. 5% coupon bonds due in 2041 came at a yield of 3.70% and traded in the secondary market at 3.81%.

High yield munis saw modest outflows last week, but demand remained supportive as high beta bonds like Buckeye 5s traded near year-high yields before getting stronger bids. The high yield muni market remains cushioned by limited secondary trading volume, low new issuance and strong revenue growth.

Investment grade corporate new supply is expected to decline further this week.

In focus

Why CMBS now?

Commercial mortgage-backed securities (CMBS) have sold off broadly in recent months, due to uncertain U.S. return-to-office participation and very publicized imminent maturity walls.

Building valuations could come under pressure if corporations fail to renew their long-term office space leases in markets like San Francisco, New York and Los Angeles. And a good deal of the CMBS market is approaching the time when owners must refinance at significantly higher costs of capital, spiking concerns around commercial defaults.

As a result, prices have declined for much of the CMBS market as of the end of June. Short-seasoned bonds with diversified exposure saw yields skyrocket to 11% to 16% for AA-/A-, while more defensive AAA bonds with exposure primarily to industrial, self-storage or multifamily real estate properties are yielding 7.5% (8% to 9% with leverage). Opportunistic office AAA/AA bonds are yielding 9% to 15%.

We believe this sector is oversold and expect spreads to tighten over the next 6 to 10 months. Prices may appreciate significantly as public sentiment recovers and rigorously structured office CMBS continue to weather turbulent markets.

U.S. Treasury market

Maturity	Change (%)			
	Yield	Week	Month-to-date	Year-to-date
2-year	4.95	0.05	0.07	0.52
5-year	4.39	0.08	0.21	0.38
10-year	4.26	0.10	0.29	0.38
30-year	4.38	0.11	0.37	0.41

Source: Bloomberg L.P., 18 Aug 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	3.15	0.05	0.15	0.55
5-year	2.84	0.07	0.18	0.32
10-year	2.84	0.14	0.27	0.21
30-year	3.82	0.13	0.31	0.24

Source: Bloomberg L.P., 18 Aug 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	87
High Yield Municipal vs High Yield Corporate	67

Source: Bloomberg L.P., Thompson Reuters, 18 Aug 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

Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Returns (%)		
				Week	Month-to-date	Year-to-date
Municipal	3.76	–	6.16	-0.58	-1.41	1.62
High yield municipal	5.87	228 ¹	7.62	-0.72	-1.68	3.35
Short duration high yield municipal ²	5.48	269	4.09	-0.24	-0.40	3.55
Taxable municipal	5.37	91 ³	8.02	-0.50	-1.97	2.23
U.S. aggregate bond	5.12	51 ³	6.26	-0.50	-1.85	0.13
U.S. Treasury	4.62	–	6.06	-0.41	-1.50	-0.29
U.S. government related	5.14	49 ³	5.16	-0.50	-1.30	1.16
U.S. corporate investment grade	5.80	124 ³	6.89	-0.71	-2.38	1.10
U.S. mortgage-backed securities	5.18	56 ³	6.37	-0.47	-2.09	-0.34
U.S. commercial mortgage-backed securities	5.91	133 ³	4.40	-0.35	-0.79	0.62
U.S. asset-backed securities	5.53	61 ³	2.66	-0.07	-0.13	2.03
Preferred securities	7.55	243 ³	4.74	-0.97	-1.62	2.82
High yield 2% issuer capped	8.72	393 ³	3.50	-0.81	-1.05	5.71
Senior loans ⁴	10.13	570	0.25	0.24	0.54	8.29
Global emerging markets	7.79	321 ³	6.04	-1.45	-2.41	2.00
Global aggregate (unhedged)	4.01	50 ³	6.66	-0.77	-2.26	-0.17

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, 18 Aug 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, 18 Aug 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 16 Aug 2023.

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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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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