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Weekly Fixed Income Commentary

28 August 2023

Treasury yields rise as the Fed leans hawkish

U.S. Treasury yields rose again as U.S. economic growth remains strong and U.S. Federal Reserve Chair Powell delivered hawkish comments at the Jackson Hole conference. He emphasized that if economic growth remains strong, rates may need to increase further.

HIGHLIGHTS

- **Treasuries, agencies, investment grade and high yield corporates, taxable munis, senior loans and emerging markets all had positive total returns.**
- **Municipal bond yields rose across the curve. New issue supply was $8.1B with outflows of -$534M. This week's new issuance should be $3.5B.**

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OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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Watchlist

- *10-year U.S. Treasury yields were flat, but we anticipate modest declines over the course of 2023.*
- *Spread assets outperformed 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.

EMERGING MARKETS RALLY

U.S. Treasury yields rose last week, led by the front end. 10-year yields were essentially flat for the week, while 2-year yields rose 14 bps. Economic data were slightly weaker than expected, as the composite U.S. Purchasing Managers' Index fell -1.6 pts in the preliminary August release. The move marked the third straight monthly decrease and the sharpest drop since last November. Nevertheless, a popular estimate of real-time economic growth from the Federal Reserve Bank of Atlanta moved even higher, to 5.9% quarter-over-quarter annualized growth for the third quarter. Separately, Fed Chair Powell leaned hawkish in his remarks at the Jackson Hole conference. He emphasized that if economic growth remains strong, rates may need to increase further. The market went from pricing around a 37% chance of another rate hike at the start of the week to a 62% chance on Friday after Powell spoke.

Investment grade corporates gained, rallying 0.61% for the week after four straight weeks of losses. The asset class outperformed similar-duration Treasuries by 41 bps. Issuance was very soft, at around $3.5 billion for the week, and this week's calendar is expected to be equally light. However, activity is likely to pick up in September. Roughly $130 billion of new deals are expected to come to market, which would be about in-line with historical averages. Outflows from investment grade funds totaled -$984 million last week.

High yield corporates also advanced, returning 0.41% for the week and beating similar-duration Treasuries by 51 bps. Senior loans returned 0.27%. High yield funds saw elevated outflows of -$1.2 billion, while loan funds saw a marginal outflow of only -$42 million. The backdrop of strong economic growth and higher rates is supportive for both high yield and loans, thanks to their lower duration and elevated credit risk compared to core fixed income asset classes.

Emerging markets improved after recent underperformance, gaining 0.49% for the week and outpacing similar-duration Treasuries by 37 bps. The rally came despite continued sluggish growth data from China, where corporate profits were reported down -6.7% year-over-year in July. A survey of economists showed that consensus expectations for China's full-year GDP growth have been marked down from 5.5% to 5.2% for this year.

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MUNICIPAL BONDS REPRESENT VALUE

Municipal bond yields rose across the curve last week. Short-term rates ended the week 4 bps higher, while long-term yields rose 9 bps. Weekly new issuance was priced to sell and well received. Weekly fund flows were negative. This week's new issue calendar is undersized heading into the U.S. Labor Day holiday.

Muni rates sold off because they are slightly rich to Treasuries. What's driving that relationship? Not much municipal bond reinvestment money is left to put to work. Also, the new issue calendar is expected to heat up after Labor Day and should be outsized through the end of the year.

Muni yields may be challenged for the next few months, but we believe muni bonds still represent value. We would consider any outsized selloff a buying opportunity.

New York City Transitional Finance Authority (TFA) issued $1 billion in bonds (rated Aa1/AAA). The deal was priced to sell and so well received that underwriters lowered yields upon final pricing. For example, the 5% coupon 10-year bond was priced with a tax-exempt yield of 3.39%.

High yield municipal bond yields increased only 5 bps on average last week, continuing to cushion investors from more pronounced volatility in high grade munis and U.S. Treasuries. Even with the relative outperformance, investors remain attracted to higher yields. High yield munis saw inflows again last week. While the average yield of the Bloomberg High Yield Municipal Index stands at 5.93%, large inflows remain elusive for the asset class. As a result, total returns rely on excess yield premium and idiosyncratic credit selection. Deals are expected this week in sectors such as land-secured, charter schools, sales tax districts, higher education and health care.

Strong U.S. economic growth and higher rates supports high yield corporates and senior loans.

In focus

Post-Covid municipal budgets remain resilient

As the summer wraps up and fall begins, many municipal governments will focus on budget and capital plans that will consider higher costs from inflation, waning federal funds and a slower U.S. economy.

Many state and local governments are planning for budget deficits, which means budgets will reflect lower revenues. For fiscal year 2024, state governments are expecting a 0.7% decline in stand-alone revenues, following double digit annual growth in collections in 2021 and 2022. Short-term Covid related federal funds will also be expiring.

Governments continue to have extraordinary financial flexibility, and fundamentals remain strong. They are prepared to balance budget deficits by reducing targeted expenditures. Average spending by states increased by an elevated 16.8% in 2022 due mostly to one-time Covid-related spending. States are estimating just a 2.5% increase in expenditures in FY24. Governments also have the flexibility to reduce other expenditures and increase revenues.

In addition, municipal governments' rainy day funds, or savings/reserves, sit at historical highs. State governments are entering FY24 with $159 billion in rainy day funds, or more than double pre-pandemic levels, which offers significant budgetary flexibility.

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U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	5.08	0.14	0.20	0.65
5-year	4.44	0.05	0.26	0.44
10-year	4.24	-0.02	0.28	0.36
30-year	4.29	-0.09	0.28	0.32

Source: Bloomberg L.P., 25 Aug 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	3.19	0.04	0.19	0.59
5-year	2.93	0.09	0.27	0.41
10-year	2.95	0.11	0.38	0.32
30-year	3.91	0.09	0.40	0.33

Source: Bloomberg L.P., 25 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	69
30-year AAA Municipal vs Treasury	91
High Yield Municipal vs High Yield Corporate	69

Source: Bloomberg L.P., Thompson Reuters, 25 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

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	3.84	–	6.20	-0.40	-1.81	1.21
High yield municipal	5.94	226[1]	7.74	-0.58	-2.25	2.75
Short duration high yield municipal[2]	5.53	263	4.10	-0.07	-0.48	3.47
Taxable municipal	5.36	91[3]	8.03	0.41	-1.57	2.65
U.S. aggregate bond	5.13	50[3]	6.24	0.28	-1.58	0.41
U.S. Treasury	4.66	–	6.04	0.17	-1.34	-0.13
U.S. government related	5.18	48[3]	5.16	0.19	-1.11	1.35
U.S. corporate investment grade	5.77	119[3]	6.92	0.61	-1.78	1.72
U.S. mortgage-backed securities	5.18	57[3]	6.32	0.19	-1.90	-0.15
U.S. commercial mortgage-backed securities	5.98	134[3]	4.39	-0.13	-0.92	0.49
U.S. asset-backed securities	5.63	61[3]	2.66	-0.01	-0.15	2.02
Preferred securities	7.59	245[3]	4.71	-0.01	-1.63	2.81
High yield 2% issuer capped	8.67	382[3]	3.48	0.41	-0.65	6.15
Senior loans[4]	10.23	566	0.25	0.27	0.81	8.58
Global emerging markets	7.76	315[3]	6.04	0.49	-1.93	2.50
Global aggregate (unhedged)	4.01	49[3]	6.65	-0.08	-2.34	-0.26

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, 25 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, 25 Aug 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 23 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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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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