

6 May 2019

# Treasury yield curve flattens as the Fed remains steady

*Shorter U.S. Treasury yields rose while the 30-year yield fell slightly last week, causing the yield curve to flatten. The Federal Reserve (Fed) made no changes to monetary policy last week, and Chair Jerome Powell's comments seemed to support the view that the Fed has no clear bias toward a cut or hike as its next move.*

## HIGHLIGHTS

- Preferred securities posted the best returns, followed by emerging markets and senior loans.
- Municipal bonds were range bound, but maintained a constructive tone.
- Non-U.S. markets outperformed the U.S. market, buoyed by strong returns in the European region.



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## FED OUTLOOK PUSHES SHORT TREASURY YIELDS HIGHER

**Shorter-maturity U.S. Treasury yields finished the week higher**, while the 30-year yield fell slightly.<sup>1</sup> The Treasury yield curve flattened as a result, as generally stronger economic data put upward pressure on the short end. After Wednesday's Fed meeting, the 2-year Treasury yield led a move higher and continued climbing on Thursday.<sup>1</sup> The increase in rates was partly offset on Friday when strong headline readings on the April jobs report were overshadowed by disappointing wage inflation. The 5-year Treasury led a slight decline in yields.<sup>1</sup>

**Most non-Treasury sectors outperformed U.S. Treasuries last week.**<sup>1</sup> Preferred securities posted the best returns, followed by emerging markets and senior loans.<sup>1</sup> These sectors were the top performers in April as well, when all domestic non-Treasury sectors posted positive total returns and only mortgage-backed securities lagged similar-duration Treasuries.<sup>1</sup> Last week, only the investment grade corporate sector suffered a lower total return than Treasuries.<sup>1</sup> Longer-maturity high grade corporates underperformed and dragged down overall sector performance.<sup>1</sup> Non-U.S. markets outperformed the U.S. market, buoyed by strong returns in Europe.<sup>1</sup>

**Markets have struggled in recent months to interpret Fed Chair Powell's communications.** Last week was no exception, as the Fed's policy statement and Powell's post-meeting comments sent mixed messages about the persistence of weak U.S. inflation. This caused market-based probabilities of a policy rate cut to decline and market yields to increase. Interestingly, although the market's Fed policy outlook reflects a stronger economic forecast, market-based inflation indicators fell last week.

*Over the next three months, municipal money available for reinvestment is expected to total \$117 billion.*

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## MUNICIPAL SUPPLY REMAINS SCARCE

**Municipal bonds and Treasuries were range bound last week, yet both ended with constructive tones.**<sup>1</sup> New issue supply was \$5.1 billion and was readily absorbed.<sup>2</sup> Weekly fund flows continued to be positive for the 17th consecutive week at \$1.2 billion.<sup>3</sup> This week's upcoming supply is expected to increase to \$6.5 billion and should be readily absorbed.<sup>2</sup>

**The fixed income market was slightly disappointed** by the Fed's lukewarm support last week for low rates. But the fact remains: There is no inflation in the economy, even with yet another stellar jobs report on Friday. Many continue to suggest that municipal bonds are "too rich" compared to Treasuries. However, municipals don't have a reason to get cheaper until proposed new issue supply increases dramatically, which will not likely happen soon. New issue supply is expected to average \$26 billion for the next few months.<sup>2</sup> Yet we expect strong municipal demand will continue. Over the next three months alone, municipal money available for reinvestment is expected to total \$117 billion from June 1 through August 1.<sup>2</sup> It's hard to make a case for tax-exempt yields to cheapen given this supply/demand imbalance.

**The City of Philadelphia** issued \$190 million general obligation bonds last week (rated A2/A).<sup>4</sup> Bonds started out priced aggressively, and strong demand allowed underwriters to lower yields upon final pricing. The city's fiscal management continues to improve, and Pennsylvania has high state income taxes and lower deductions due to reduced state and local taxes (SALT).

**The average yield for the Bloomberg Barclays High Yield Municipal Index increased last week**, due to higher yields on the weaker tobacco securitization sector and the addition of Virgin Trains USA bonds into the index.<sup>1</sup> Virgin Trains bonds, even after contracting 50 basis points, still yield substantially more than the index average and are a large enough issue to skew the index higher.<sup>1</sup> Yields for other sectors continue to grind tighter.<sup>1</sup> Inflows remained strong at \$297 million net positive flows last week.<sup>3</sup>

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## HIGH YIELD ADDS TO GAINS AS SUPPLY REMAIN TIGHT

**High yield corporates gained for the eighth week in a row.**<sup>1</sup> The asset class has now delivered positive results in all but two weeks of 2019.<sup>1</sup> Factors contributing to last week's performance included spread tightening, muted new-issue volume, fund inflows and support from the equity market. Among the detractors were volatile oil prices, which caused high yield energy names to move lower, as well as uncertainty around inflation and Fed rate policy. In terms of quality, higher-rated (BB) bonds outperformed B and CCC issues.<sup>1</sup>

**Investment grade corporate bonds posted a small loss.**<sup>1</sup> Spread widening hurt autos and energy the most, while financials held up better. With Japan observing its Golden Week holidays, the investment grade market lacked a strong component of overseas demand. On the supply side, primary market activity picked up, with 20 issuers pricing a combined \$21.1 billion in new deals.<sup>2</sup> Year to date, new issuance is down 11% compared to 2018, a decline driven largely by substantially lower volume in the financials sector.<sup>2</sup>

### *High yield corporates have delivered positive results in all but two weeks of 2019.*

**Emerging markets (EM) debt improved after the previous week's listless showing.** Narrower spreads, stronger fund flows and a sense that the U.S./China trade talks are reaching their end game helped EM bonds outpace most other taxable fixed income sectors last week. The Argentine peso rebounded from recent weakness, rising 3.2% to lead all other EM currencies.

## *In focus*

# *Fed: "solid" growth but no rate hikes—or cuts—for now*

*As expected, the Fed left the target federal funds rate unchanged at its May meeting. The Fed made few substantive alterations to the language in its policy statement, painting a relatively bullish picture of the U.S. economy.*

In his post-meeting press conference, Chair Jerome Powell downplayed concerns that stubbornly low inflation reflected broader economic weakness. Instead, he argued that "transitory" factors may be keeping inflation subdued. This statement supports the view of a patient Fed content with waiting for clear signs to guide its next rate move.

Markets, on the other hand, were looking for clues that the Fed was considering lowering rates. Indeed, coming into the meeting, fed funds futures—used by traders to bet on the direction of interest rates—showed a 67% chance of a rate cut by the end of the year. After Powell's comments, that probability began to decline and stood at 53% (still high) immediately following the meeting.

We're not convinced a rate cut is where the Fed is headed. Yes, the Fed's first quarter dovishness and moderating policy forecasts almost certainly suggest rates will stay put for now. In fact, we don't expect the Fed to make any changes to rates in 2019. But given the U.S. economy's solid performance and diminishing slack in the job market, we think there's a better chance of a hike than a cut before the end of the year.

## U.S. Treasury market

Maturity	Change (%)			
	Yield	Week	April 2019	Year-to-date
2-year	2.33	0.05	0.00	-0.16
5-year	2.32	0.03	0.04	-0.19
10-year	2.53	0.03	0.10	-0.16
30-year	2.92	0.00	0.11	-0.10

Source: Bloomberg L.P. As of 3 May 2019. Past performance is no guarantee of future results.

## Municipal market

Maturity	Change (%)			
	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	1.57	0.01	0.08	-0.21
5-year	1.64	-0.03	0.07	-0.30
10-year	1.87	-0.08	0.01	-0.41
30-year	2.55	-0.15	-0.05	-0.47

Source: Bloomberg L.P. As of 3 May 2019. Past performance is no guarantee of future results.

## Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	75
30-year AAA Municipal vs Treasury	87
High Yield Municipal vs High Yield Corporate	76

Source: Bloomberg L.P., Thompson Reuters. As of 3 May 2019. AAA municipals represented by the MMD scale. The high yield ratio equals the yield-to-worst for the Bloomberg Barclays High Yield Municipal Index divided by the yield-to-worst for the Bloomberg Barclays High Yield Corporate Index. Past performance is no guarantee of future results.

## Characteristics and returns

Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Returns (%)		
				Week	April 2019	Year-to-date
Municipal	2.29	–	5.59	0.20	0.38	3.41
High Yield Municipal	4.66	230 <sup>5</sup>	8.45	0.16	0.56	4.54
High Yield Municipal, ex Puerto Rico	4.60	224 <sup>5</sup>	7.74	0.08	0.50	4.10
Short Duration High Yield Municipal <sup>6</sup>	3.95	227	3.80	0.16	0.34	3.08
Short Duration High Yield Municipal, ex Puerto Rico <sup>6</sup>	3.90	222	3.68	0.14	0.31	2.84
U.S. Aggregate Bond	3.00	43 <sup>7</sup>	5.94	-0.06	0.03	2.90
U.S. Treasury	2.46	–	6.26	-0.08	-0.28	1.72
U.S. Government Related	3.06	60 <sup>7</sup>	5.57	-0.08	0.18	3.17
U.S. Corporate Investment Grade	3.64	112 <sup>7</sup>	7.43	-0.16	0.54	5.54
U.S. Mortgage-Backed Securities	3.17	37 <sup>7</sup>	4.36	0.05	-0.06	2.21
U.S. Commercial Mortgage-Backed Securities	3.06	65 <sup>7</sup>	5.25	-0.09	0.21	3.28
U.S. Asset-Backed Securities	2.73	37 <sup>7</sup>	2.19	-0.02	0.26	1.66
Preferred Securities	4.21	148 <sup>7</sup>	4.64	0.34	1.37	9.94
High Yield 2% Issuer Capped	6.12	354 <sup>7</sup>	3.38	0.13	1.42	8.80
Senior Loans <sup>8</sup>	6.66	427	0.25	0.19	1.59	5.51
Global Emerging Markets	5.33	285 <sup>7</sup>	5.89	0.29	0.40	5.95
Global Aggregate (unhedged)	1.83	45 <sup>7</sup>	7.07	0.10	-0.30	1.85

<sup>5</sup> Yield difference between the Bloomberg Barclays High Yield Municipal Index and the 20-year AAA MMD scale. <sup>6</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>7</sup> Option-adjusted spread to Treasuries. <sup>8</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. As of 3 May 2019. Past performance is no guarantee of future results. Unless otherwise noted, the index is Bloomberg Barclays. 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. All indices are unmanaged and unavailable for direct investment.

## For more information, please visit [nuveen.com](http://nuveen.com).

1 Bloomberg L.P. 2 The Bond Buyer, 3 May 2019. 3 Lipper Fund Flows. 4 Market Insight, MMA Research, 1 May 2019.

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.

**Bloomberg Barclays Municipal Index** covers the USD-denominated tax-exempt bond market. **Bloomberg Barclays High Yield Municipal Index** covers the USD-denominated, below investment grade tax-exempt bond market. **S&P Short Duration Municipal Yield Index** tracks the municipal bond market with maturities from 1 to 12 years. **Bloomberg Barclays U.S. Aggregate Bond Index** covers the U.S. investment grade fixed rate bond market. **Bloomberg Barclays U.S. Treasury Index** includes public obligations of the U.S. Treasury. **Bloomberg Barclays U.S. Government-Related Index** includes debt guaranteed, owned and sponsored by the U.S. government; it does not include debt directly issued by the U.S. government. **Bloomberg Barclays U.S. Corporate Index** is a broad-based benchmark that measures the investment grade, fixed-rate, taxable corporate bond market. **Bloomberg Barclays U.S. Mortgage-Backed Securities Index** is the MBS component of the U.S. Aggregate index and includes the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). **Bloomberg Barclays CMBS ERISA-Eligible Index** is the CMBS component of the U.S. Aggregate index and includes CMBS investment grade securities that are ERISA eligible under the underwriter's exemption. **Bloomberg Barclays Asset-Backed Securities Index** is the ABS component of the U.S. Aggregate index and includes credit and charge cards, autos and utilities. **ICE BofA Merrill Lynch U.S. All Capital Securities Index** is a subset of the BofA Merrill Lynch U.S. Corporate Index including all fixed-to-floating rate, perpetual callable and capital securities. **Bloomberg Barclays High Yield 2% Issuer Capped Index** measures the market of USD-denominated, non-investment grade bonds and limits each issue to 2% of the index. The **Credit Suisse Leveraged Loan Index** is designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market. Loans are added to the index if they qualify according to the following criteria: The highest Moody's/S&P ratings are Ba1/BBB+, only funded term loans are included, and the tenor must be at least one year. **Bloomberg Barclays Emerging Market USD Aggregate Index** is a flagship hard currency Emerging Markets debt benchmark that includes USD denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. **Bloomberg Barclays Global Aggregate Unhedged Index** measures the performance of global bonds. It includes government, securitized and corporate sectors and does not hedge currency. One basis point equals .01%, or 100 basis points equal 1%.

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