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Weekly Fixed Income Commentary

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Treasury yields rise on economic optimism

Positive risk sentiment boosted U.S. Treasury yields last week, led by longer maturities. Investors appear optimistic over an expected rebound in growth as the economy reopens. The Federal Reserve (Fed) meets this week, leading to considerable speculation about the potential for any additional measures to be announced.

HIGHLIGHTS

- **High yield corporates led total returns, closely followed by high yield municipals, senior loans and emerging markets debt.**
- **High yield municipals outperformed high grades, as both markets continue to recover.**
- **The global aggregate index posted a positive return, as strong performance in Europe was offset by soft returns in Asia.**

Bill Martin
Head of Global Fixed Income

John Miller
Head of Municipals

OPTIMISM LIFTS TREASURY YIELDS DESPITE SOCIAL UNREST

A risk-friendly market tone propelled Treasury yields higher and steepened the yield curve last week.[1] Investors appeared optimistic over an expected rebound in growth as the economy reopens. However, the yield increase, including the biggest jump in rates for most maturities, occurred before the strong May employment report was released on Friday. Longer-maturity rates are increasing more than short maturities under the weight of ever-increasing Treasury and corporate bond issuance, while the Fed dials back its daily Treasury purchases to $4 billion per day.

Non-Treasury sectors continued their recent recovery, with all sectors outperforming Treasuries.[1] Once again, the higher-risk sectors enjoyed the strongest returns. High yield corporates led all sectors, significantly outpacing the Treasury sector.[1] Senior loans, emerging markets debt and preferred securities followed high yield, posting solidly positive total returns.[1] The sectors closest to government-type debt experienced the lowest returns. Commercial mortgage-backed, agency debt and agency mortgage-backed securities endured negative returns, although all outperformed similar-duration Treasuries.[1] The global aggregate index posted a slightly positive return, as strong performance in the European region was offset by soft returns in Asia.

The Fed is meeting this week, but it is not expected to change interest rate policy. However, there is speculation over the potential for additional measures to be announced, such as regular monthly purchases of Treasuries and agency mortgage-backed securities, or extending the maturity of its purchases.

Municipal market demand is expected to outpace supply by approximately $52 billion over the next three months.

MUNICIPAL MARKET REMAINS FUNDAMENTALLY SOUND

Municipal yields closed slightly higher last week, along with U.S. Treasuries.[1] The new issue calendar of $6.8 billion was priced to sell and well received.[2] Fund flows were positive again at $1.2 billion.[3] This week's new issue supply is expected to be $11.6 billion ($4.3 billion taxable).[2] Demand is expected to outpace supply by approximately $52 billion over the next three months.[4]

The high grade municipal yield curve held steady last week, after improving for the last 16 consecutive trading days.[1] Nevertheless, we believe this market remains fundamentally sound. High yield performance lags high grades year to date, but both markets continue to recover.

The municipal market owes its resurgence to an aggressive Fed committing to keep short-term rates near zero. Congress has pledged billions of dollars in aid directly to municipalities, airports, hospitals and other municipal entities. Finally, the Fed pledged $500 billion for municipalities to borrow through its Municipal Liquidity Facility (MLF) initiative. Some municipalities have already borrowed through this program.

The New York City Municipal Water Finance Authority issued $780 million revenue bonds (rated Aa1/AA+).[5] A 30-year term bond with a 4% coupon came at a yield of 2.15% and traded slightly cheaper in the secondary at 2.16%. These levels reflect the selloff in the government market and the fact that municipal yields have held steady.

High yield municipal bond performance momentum is picking up steam. Credit spreads contracted another 21 basis points (bps) last week, as the asset class outperformed not just high grade municipals but also U.S. Treasuries.[1] High yield municipal fund flows were positive for the third consecutive week.[3] SIFMA (short-term yields) continues to decline, resetting last week at 0.11%. We believe high yield municipals are well positioned to enter the historically strong summer months ahead.

HIGH YIELD CORPORATES HAVE RETURNED 7.6% OVER THE PAST THREE WEEKS

High yield corporate bonds outperformed all fixed income categories for the third consecutive week.[1] Spreads tightened by more than 100 bps last week, bringing them down to roughly their 20-year average.[1] Lower-rated (CCC) credits again led their higher-quality (BB and B) counterparts.[1] Recent familiar themes continued to support the high yield market: the reopening of economies, a dramatic rebound in oil prices, a rising stock market, the Fed's buying of corporate bond ETFs and record-setting inflows into the asset class. Notably, six of high yield's largest weekly inflows on record have occurred in the past 10 weeks.[3]

Investment grade corporates extended their streak of positive results to four weeks, although returns have been progressively lower over the past three.[1] Spreads narrowed by 28 bps last week, led by the energy sector (-43 bps) as oil prices jumped 10%.[1] The pace of new investment grade issuance (+$45 billion) eased a bit, but still beat street estimates.[1] With nearly $10 billion of inflows into the asset class, investor demand remained strong.[3]

Recent familiar themes continued to support the high yield market.

Emerging markets (EM) debt recorded a sixth consecutive week of gains.[1] Among taxable sectors, EM finished behind only high yield corporates and senior loans. Spreads tightened by 47 bps for the week, and flows into EM funds totaled nearly $2 billion.[1,3] All segments – sovereign, corporate and local-currency – participated in the strong showing. Broad U.S. dollar weakness buoyed EM currencies, particularly in Latin America.

In focus

ECB puts more PEPP in its step

Federal Reserve and European Central Bank (ECB) meetings have garnered more scrutiny than usual over the past few months, as markets focused on each central bank's policy responses and economic outlooks amid the coronavirus pandemic. With the Fed on tap to meet on 10 June, last week all eyes were on the ECB's 4 June meeting.

Following weeks of abysmal economic data, ECB President Christine Lagarde's downbeat assessment of the eurozone economy wasn't surprising. She emphasized that the region "is experiencing an unprecedented contraction" and "exceptionally elevated uncertainty." Against that backdrop, the ECB lowered its 2020 GDP growth outlook to -8.7% from +0.8% just three months ago.

The ECB also announced further measures to try to halt this unprecedented slide. Chief among them was a pledge to buy €600 billion ($680 billion) of eurozone sovereign and corporate debt under the Pandemic Emergency Purchase Program (PEPP), a quantitative easing effort launched in March. The PEPP's planned purchases now total €1.35 trillion. Lastly, the ECB promised to keep buying bonds until it deems the coronavirus crisis phase is over – at least through June 2021.

Beyond the ECB, last week Germany said it will provide €130 billion of fiscal support through tax cuts and rebates on electric cars. More financial aid for Europe may be coming, as the European Union will soon negotiate a €750 billion recovery fund.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	0.21	0.05	0.05	-1.36
5-year	0.47	0.16	0.16	-1.23
10-year	0.90	0.24	0.24	-1.02
30-year	1.67	0.26	0.26	-0.72

Source: Bloomberg L.P. As of 5 Jun 2020. **Past performance is no guarantee of future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	0.19	0.03	0.03	-0.85
5-year	0.38	0.00	0.00	-0.71
10-year	0.89	0.05	0.05	-0.55
30-year	1.70	0.05	0.05	-0.39

Source: Bloomberg L.P. As of 5 Jun 2020. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	98
30-year AAA Municipal vs Treasury	101
High Yield Municipal vs High Yield Corporate	84

Source: Bloomberg L.P., Thompson Reuters. As of 5 Jun 2020. 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

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	1.63	–	5.71	0.00	0.00	1.25
High Yield Municipal	5.11	362[6]	10.23	2.12	2.12	-4.37
Short Duration High Yield Municipal[7]	4.47	383	4.22	1.21	1.21	-2.28
Taxable Municipal	2.85	181[8]	9.97	-1.26	-1.26	2.73
U.S. Aggregate Bond	1.43	65	6.06	-0.49	-0.49	4.95
U.S. Treasury	0.66	–	7.02	-1.52	-1.52	6.96
U.S. Government Related	1.42	80[8]	5.97	-0.46	-0.46	2.51
U.S. Corporate Investment Grade	2.31	146[8]	8.49	0.51	0.51	3.53
U.S. Mortgage-Backed Securities	1.53	61[8]	2.44	-0.08	-0.08	3.51
U.S. Commercial Mortgage-Backed Securities	2.06	148[8]	5.31	-0.52	-0.52	2.98
U.S. Asset-Backed Securities	1.18	92[8]	2.11	0.20	0.20	2.44
Preferred Securities	3.67	256[8]	4.48	1.20	1.20	-1.65
High Yield 2% Issuer Capped	6.07	536[8]	3.61	3.09	3.09	-1.80
Senior Loans[9]	6.96	663	0.25	1.97	1.97	-4.17
Global Emerging Markets	4.78	401[8]	6.52	1.58	1.58	-1.31
Global Aggregate (unhedged)	1.08	56[8]	7.30	0.02	0.02	2.10

6 Yield difference between the Bloomberg Barclays High Yield Municipal Index and the 20-year AAA MMD scale. **7** 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. **8** Option-adjusted spread to Treasuries. **9** 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 5 Jun 2020. **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 indexes are unmanaged and unavailable for direct investment.

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1 Bloomberg L.P. **2** The Bond Buyer, 5 Jun 2020. **3** Lipper Fund Flows. **4** Citigroup. **5** Market Insight, MMA Research, 3 Jun 2020.

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 Taxable Municipal Bond Index** is a rules-based, market-value-weighted index engineered for the long-term taxable bond market. **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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A word on risk

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 advisor regarding the suitability 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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