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Weekly Fixed Income Commentary

19 July 2021

Treasury yields decline due to concerns over early Fed action

U.S. Treasury yields declined last week despite stronger-than-expected inflation data, as the market moves to price in higher odds of earlier Federal Reserve tightening and somewhat lower longer-term growth and inflation.

HIGHLIGHTS

- **Most fixed income sectors performed well, with taxable municipals, emerging markets, investment grade corporates, MBS, and CMBS all generating positive returns.**
- **Convertibles notably lagged, experiencing negative total returns, and high yield corporates also weakened.**
- **Municipal bond yields remained unchanged. New issue supply was outsized at $10B, with flows of $2.2B. This week's new issue supply should be outsized at $11B ($1.9B taxable).**

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Watchlist

- *Treasury yields declined last week, but we continue to anticipate increases in the months ahead*
- *Spread assets were well-supported versus Treasuries, and strong growth should continue to support fundamentals moving forward*
- *Municipal bonds are unlikely to remain so rich*

INVESTMENT VIEWS

Zero/negative global interest rate policy remains a key market support. Investors remain focused on the eventual tapering of purchases, but we do not expect that to happen any time soon.

Unprecedented global fiscal stimulus should boost consumption and growth this year, with second quarter GDP growth reaching close to 10%.

Record supply of investment grade corporates has been followed by high levels of issuance from high yield, middle market loans and the broadly syndicated loan market. Taxable municipal supply also continues to grow.

We favor a risk-on stance, focused on credits with durable free cash flow and solid balance sheets across a wide range of sectors. Mid-quality rating segments appear particularly attractive. Essential service municipal credits also look compelling.

KEY RISKS

- Policymakers become cautious and remove accommodation too early.
- Inflation rising in a disorderly way, forcing premature policy tightening.
- Further complications with the COVID-19 vaccine rollout.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.

EMERGING MARKETS PERFORM WELL AFTER PREVIOUSLY LAGGING

Long-dated U.S. Treasury yields declined again last week, despite another upside inflation surprise. Headline CPI inflation came in at 0.9% month-over-month, taking the year-over-year rate to 5.4%. This data partially reflect significant base effects by comparing to last summer's depressed levels, and most of the price increases remain concentrated in a few idiosyncratic categories like motor vehicles. Somewhat perversely, higher inflation today increases the odds that the Fed will raise rates earlier than otherwise expected. This puts upward pressure on the short end of the yield curve, while also lowering longer-term expectations for growth and inflation, since tighter policy in the near-term is more likely to choke off growth.

Investment grade corporates rallied, with the index's yield-to-worst ending the week less than 2.00% for the first time since February. The asset class generated total returns of 0.31% for the week, though it underperformed similar-duration Treasuries by 12 bps. Attention was centered on a few money center banks that launched new issuance after their quarterly earnings reports, with Goldman Sachs, Morgan Stanley and Bank of America issuing a total of $21.75 billion in new bonds. Their spreads widened 5 bps on average, while the overall index's spread widened 1 bp.

High yield corporates lagged, with total returns of -0.15% and underperforming similar-duration Treasuries by -26 bps. The asset class saw outflows of -$1.4 billion, almost completely retracing the prior three weeks of inflows. Supply was strong with just short of $10 billion priced, a large amount for the summer. Under the surface, CCCs continued their recent trend of underperformance, with total returns of -0.23%, after outperforming strongly in the first half of the year. Loans performed somewhat better, with total returns of 0.06%, as individual investor demand was positive and CLOs provided a positive tailwind.

Emerging markets performed well after lagging somewhat recently, with total returns of 0.32% and outperformance versus similar-duration Treasuries of 2 bps. Flows were positive and supply eased after a busy two weeks, providing a positive technical backdrop. Chinese government bonds continued their recent bull steepening after the central bank eased policy earlier this month, while other EMs continued the broader recent theme of policy tightening. Chile's central bank hiked rates, but local yields rallied around -40 bps on lack of a hawkish follow-through.

OUTSIZED MUNICIPAL SUPPLY IS PRICED TO SELL

Municipal bond yields remained essentially unchanged last week, while Treasury bond yields of 10 years and longer declined. Both markets finished the week with firm tones. Underwriters had trouble selling some municipal deals due to outsized new issue supply. In response, they raised yields to levels necessary to pique buyer interest and complete the deals. We expect underwriters will continue to sell deals at the yields necessary to clear the market.

Fed Chairman Powell testified in front of Congress last week, stating that he does not see inflation – which would cause interest rates to rise – as a problem. He conceded that the economy is improving, but not quickly enough. He reiterated that any tapering of the Fed's low interest rate policy is *a ways off*. The market has confidence in Chair Powell, which is why Treasury rates moved lower on the long end of the yield curve last week. Municipal yields were basically unchanged, which makes sense since municipals still remain rich to Treasuries. We expect both Treasuries and municipals to remain well bid for the foreseeable future, as investors believe that interest rates will remain lower for longer.

The Dormitory Authority State of New York issued $250 million revenue bonds for New York University (rated Aa2/AA-). The deal included a 20-year bond with a 3% coupon issued with a yield of 1.72%. Those bonds traded in the secondary market at 1.65%.

High yield municipals are supported by strong summer technical trends. We are seeing a healthy deal flow in this space, but the need for research and careful credit selection is ever present. Investor appetite remains robust, and strong demand keeps pushing down the already tight credit spreads.

Investment grade corporates rallied, with yield-to-worst less than 2.00% for the first time since February.

In focus

Infrastructure spending could boost munis

In June, a bipartisan group of senators reached an agreement with the Biden administration to provide $600 billion in new funding for traditional, physical infrastructure projects. The current proposal funds surface transportation, airports, ports, public transit, water, power and broadband infrastructure.

Many Democrats favor a broader spending package, but compromise seems unlikely on funding for a larger plan. A single bill advanced through the budget reconciliation process, supported by only Democrats, may be an alternative path forward.

Current proposals have meaningful implications for municipal issuers and investors. Tax rate increases are possible for multinational corporations, individual personal income taxes and capital gains. Higher tax rates would support demand for tax-exempt issuance. Any roll back of state and local tax (SALT) deduction caps could lower some individuals' effective tax rates, but we expect other factors to offset the impact of any changes to SALT deductions.

A new Build America Bonds program with a federal tax subsidy could generate new taxable municipal bond supply, depending on the magnitude of the subsidy. There is strong support for restoring tax-exempt advance refundings, which would increase tax-exempt new issue supply while boosting bond calls and pre-refundings.

Congressional action is not expected until the fourth quarter, but there is hope that a package could pass before year end.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	0.22	0.01	-0.03	0.10
5-year	0.78	-0.01	-0.12	0.41
10-year	1.29	-0.07	-0.18	0.38
30-year	1.92	-0.07	-0.17	0.27

Source: Bloomberg L.P., 16 Jul 2021. **Past performance is no guarantee of future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	0.11	-0.01	0.01	-0.03
5-year	0.40	-0.01	-0.03	0.18
10-year	0.84	0.00	-0.15	0.13
30-year	1.35	0.02	-0.24	-0.04

Source: Bloomberg L.P., 16 Jul 2021. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	64
30-year AAA Municipal vs Treasury	73
High Yield Municipal vs High Yield Corporate	81

Source: Bloomberg L.P., Thompson Reuters, 16 Jul 2021. 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	0.90	–	5.01	0.04	0.70	1.77
High Yield Municipal	2.97	182[1]	5.60	0.10	0.89	7.07
Short Duration High Yield Municipal[2]	2.43	182	3.35	0.14	0.60	5.27
Taxable Municipal	2.08	74[3]	9.66	0.48	1.17	1.47
U.S. Aggregate Bond	1.43	36[3]	6.61	0.24	0.68	-0.94
U.S. Treasury	0.88	–	7.16	0.29	0.90	-1.71
U.S. Government Related	1.25	40[3]	6.10	0.23	0.65	-0.55
U.S. Corporate Investment Grade	1.99	86[3]	8.79	0.31	0.76	-0.51
U.S. Mortgage-Backed Securities	1.70	34[3]	4.00	0.11	0.30	-0.47
U.S. Commercial Mortgage-Backed Securities	1.41	60[3]	5.19	0.19	0.60	0.10
U.S. Asset-Backed Securities	0.47	24[3]	2.07	0.03	0.10	0.29
Preferred Securities	2.56	155[3]	4.64	-0.02	0.20	3.03
High Yield 2% Issuer Capped	3.82	283[3]	3.83	-0.15	0.25	3.87
Senior Loans[4]	4.76	441	0.25	0.06	0.15	3.63
Global Emerging Markets	3.81	279[3]	6.99	0.32	0.46	-0.14
Global Aggregate (unhedged)	1.05	34[3]	7.57	0.16	0.63	-2.60

1 Yield difference between the Bloomberg Barclays 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, 16 Jul 2021. **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.

For more information, please visit nuveen.com.

Performance: Bloomberg, L.P. **Issuance:** The Bond Buyer, 16 Jul 2021. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 14 Jul 2021.

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 Barclays Municipal Index; **high yield municipal:** Bloomberg Barclays High Yield Municipal Index; **short duration high yield municipal:** S&P Short Duration Municipal Yield Index; **taxable municipal:** Bloomberg Barclays Taxable Municipal Bond Index; **U.S. aggregate bond:** Bloomberg Barclays U.S. Aggregate Bond Index; **U.S. Treasury:** Bloomberg Barclays U.S. Treasury Index; **U.S. government related:** Bloomberg Barclays U.S. Government-Related Index; **U.S. corporate investment grade:** Bloomberg Barclays U.S. Corporate Index; **U.S. mortgage-backed securities;** Bloomberg Barclays U.S. Mortgage-Backed Securities Index; **U.S. commercial mortgage-backed securities:** Bloomberg Barclays CMBS ERISA-Eligible Index; **U.S. asset-backed securities:** Bloomberg Barclays Asset-Backed Securities Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **high yield 2% issuer capped:** Bloomberg Barclays High Yield 2% Issuer Capped Index; **senior loans:** Credit Suisse Leveraged Loan Index; **global emerging markets:** Bloomberg Barclays Emerging Market USD Aggregate Index; **global aggregate:** Bloomberg Barclays Global Aggregate Unhedged Index.

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 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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