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Weekly Fixed Income Commentary

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Treasury yields decline on stalling growth momentum

U.S. Treasury yields fell last week, supporting core fixed income returns, though recession fears also drove price action. Futures prices dialed back expectations for U.S. Federal Reserve rate hikes in 2022.

HIGHLIGHTS

- **Total returns were positive for Treasuries, agencies, MBS, CMBS, taxable munis, investment grade and high yield corporates, convertibles, preferreds and emerging markets.**
- **Loans were the sole major asset class with negative total returns.**
- **Municipal bond yields also declined. New issue supply was only $5.6B, with outflows of -$1.6B. This week's new issue supply increases to $8.8B.**

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Watchlist

- *10-year Treasury yields declined. We expect them to remain volatile, but move modestly higher this year.*
- *Spread assets benefited from the Treasury rally.*
- *Net-negative supply should provide some support to municipal bonds.*

INVESTMENT VIEWS

Accommodative interest rate policy remains a key market support. While investors continue to focus on more hawkish Fed policy, overall rates are likely to remain relatively low even after several rate hikes.

The underlying growth outlook remains healthy, as consumers have strong balance sheets, businesses are reinvesting and Covid recedes. This should keep defaults low.

Treasury yields are likely to rise this year, but we don't expect the 10-year Treasury yield to rise much above 3.5%.

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 bonds also look compelling.

KEY RISKS

- The Russia/Ukraine conflict continues to escalate.
- Inflation fails to decline as expected, negatively affecting asset values.
- Policymakers remove accommodation too rapidly, undermining the global economic expansion.
- COVID-19 cases increase, or new variants emerge.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

INVESTMENT GRADE CORPORATES FACE TECHNICAL HEADWINDS

U.S. Treasury yields declined last week, after three consecutive weeks of increases. The 10-year yield fell -9 basis points (bps), while the 2-year declined -12 bps. Flash PMIs for June disappointed, with the composite readings for the U.S. and euro area dropping to 51.9 and 51.2 points, respectively. Those were the lowest levels in more than a year, signaling stalling growth momentum and sparking markets to reduce expectations for Fed rate hikes. Futures prices removed around 16 bps of hikes for 2022, though they still signal another 180 bps of hikes over the four Fed remaining meetings this year.

Investment grade corporates benefited from the rally in Treasuries, returning 0.34%. However, the asset class underperformed similar-duration Treasuries by -24 bps. Spreads widened 4 bps, as the drop in Treasury yields outstripped the moves in corporates. Under the surface, decompression dynamics continued to dominate, with BBBs underperforming. The spread between single A and BBB rated corporates is now at 72 bps, the widest level since October 2020. Technical dynamics continued to be a headwind, with outflows of -$9.0 billion, the fourth largest ever. After seven sessions with no primary issuance, the longest such drought since immediately after Lehman's collapse in 2008, the market reopened with around $9.5 billion priced on the week. Concessions remained wide at 7.7 bps on average.

High yield corporates performed slightly better, returning 0.55% for the week, performing in-line with Treasuries. The asset class displayed similar dynamics as investment grade, with continued outflows (-$2.6 billion) and further decompression. BBs gained 0.55% for the week, while CCCs fell -0.29%. Loans, which are lower-rated than high yield overall, returned -0.25% for the week, reaching the lowest price level since November 2020. The moves have become more broad-based, now with 55% of the market trading at prices below $95.

Emerging markets lagged slightly, though total returns remained positive at 0.15%. The asset class lagged similar-duration Treasuries by -49 bps. Outflows remained a headwind at -$2.2 billion. Investment grade sovereign spreads tightened -1 bps, while high yield widened 14 bps. Recession fears dominated attention, sparking a rally in core European bond yields that outpaced the moves in Treasuries and dragged down global yields. 10-year German bund yields fell -22 bps.

MUNICIPAL BONDS SHOULD REMAIN WELL BID

Municipal bond yields declined last week, but ended Friday well bid.

Investors appear to like what they heard when Fed Chair Powell testified before Congress last week. Of note, Powell stated that his commitment to fighting inflation is “unconditional.” This, along with the Fed’s outsized rate increase of 75 bps at the June meeting, makes investors believe the Fed is ahead of the curve in its effort to curb inflation. That being said, the Fed plans to continue raising rates until inflation is under control. At least a 50 bps increase is expected in July.

Fixed income in general should remain range bound. We expect munis to remain well bid. They represent fair value versus Treasuries, and muni bond calls remain outsized for July and August.

The state of Georgia issued $226 million general obligation bonds (rated Aaa/AAA). The deal included 5% bonds due in 2031 yielding 2.83%. Those bonds traded in the secondary market at 2.74%. This reflects how market strength increased as the week progressed.

The high yield municipal market showed early signs of stabilization and recovery last week, and fund outflows slowed. New issuance should remain light this week. The market continues to be bolstered by heavy seasonal reinvestment cash flows, even if fund flows remain negative in the near term. Further, muni credit quality is currently robust, and demand could be strengthened for risk assets most likely to weather any increasing probability of a recession.

The high yield muni market continues to be bolstered by heavy seasonal reinvestment cash flows.

In focus

Muni after-tax yields grow more attractive

With the increase in municipal yields in 2022, taxable-equivalent yields have grown more attractive for investors subject to U.S. federal income tax.

Municipal bonds offer income that is exempt from U.S. federal income tax, and often also state and local income taxes. The tax-equivalent yield (TEY) accounts for money saved in taxes, reflecting the yield one would have to earn on a similar taxable investment.

Municipal yields have increased 170 bps to 210 bps since the beginning of the year, with the 10-year AAA MMD municipal tax-exempt bond currently yielding 2.79%. Municipal TEY has also increased, as shown below by rating.

10-year taxable equivalent yields, 2022 (%)

Rating	03 Jan	24 Jun
AAA	1.65	4.43
AA	1.84	4.86
A	2.00	5.17
BBB	2.56	5.84

Short 2-year muni bonds offer a TEY of more than 3% across all rating categories. Longer bonds offer double the TEY, with the 30-year single A at 6.05%.

These strong yields offer an attractive entry point. In addition, municipal bonds remain cheaper that U.S. Treasuries, credit spreads are narrow versus corporate bonds, and muni market volatility is relatively low.

TEY is based on the highest individual marginal federal tax rate of 37%. Individual tax rates may vary.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	3.07	-0.12	0.51	2.33
5-year	3.19	-0.16	0.37	1.92
10-year	3.14	-0.09	0.29	1.62
30-year	3.26	-0.02	0.21	1.36

Source: Bloomberg L.P., 24 Jun 2022. **Past performance does not predict or guarantee future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	1.97	-0.09	0.14	1.73
5-year	2.26	-0.10	0.17	1.67
10-year	2.79	-0.12	0.20	1.76
30-year	3.25	-0.13	0.17	1.76

Source: Bloomberg L.P., 24 Jun 2022. **Past performance does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	89
30-year AAA Municipal vs Treasury	100
High Yield Municipal vs High Yield Corporate	63

Source: Bloomberg L.P., Thompson Reuters, 24 Jun 2022. 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. **Past performance 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	3.25	–	6.82	0.83	-1.99	-9.31
High yield municipal	5.32	221[1]	10.44	1.25	-3.63	-12.17
Short duration high yield municipal[2]	4.96	243	4.37	0.70	-1.72	-5.88
Taxable municipal	4.41	114[3]	9.26	0.58	-1.33	-14.94
U.S. aggregate bond	3.81	55[3]	6.43	0.61	-2.21	-10.94
U.S. Treasury	3.19	–	6.36	0.57	-1.63	-9.83
U.S. government related	3.74	56[3]	5.47	0.60	-1.66	-9.53
U.S. corporate investment grade	4.73	148[3]	7.57	0.34	-3.03	-14.59
U.S. mortgage-backed securities	3.90	49[3]	5.90	0.91	-2.50	-9.61
U.S. commercial mortgage-backed securities	4.21	104[3]	4.84	0.71	-1.51	-8.97
U.S. asset-backed securities	3.85	76[3]	2.26	0.45	-0.74	-4.04
Preferred securities	6.42	273[3]	4.94	0.61	-4.05	-13.73
High yield 2% issuer capped	8.44	509[3]	4.25	0.55	-5.01	-12.60
Senior loans[4]	9.47	620	0.25	-0.25	-1.15	-3.56
Global emerging markets	7.04	383[3]	6.32	0.15	-3.81	-16.48
Global aggregate (unhedged)	2.95	55[3]	7.00	1.01	-3.23	-13.94

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, 24 Jun 2022. **Past performance 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, 24 Jun 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 22 Jun 2022.

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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