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Weekly Fixed Income Commentary

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Inflation data rule, with Treasury yields mixed

U.S. Treasury yields were mixed last week, with the curve flattening, helping spread sectors to enjoy broad gains. Inflationary pressures beyond expectations are impacting the U.S. Federal Reserve's planned sequence of rate hikes and reverberating throughout fixed income markets.

HIGHLIGHTS

- **Total returns were positive for Treasuries, agencies, taxable munis, investment grade and high yield corporates, MBS, CMBS, ABS and loans.**
- **Emerging markets notably lagged, with negative total returns.**
- **Municipal bond yields declined. New issue supply was outsized at $11.2B, with inflows of $206M. This week's new issue supply should be only $6.8M.**

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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 improved growth outlook.*
- *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 3.25%.

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

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

INVESTMENT GRADE CORPORATE MARKET CONTINUES TO DECOMPRESS

The U.S. Treasury curve flattened further last week, with the 2-year to 10-year spread touching its lowest level since 2000 at -23 basis points (bps), before ending at -21 bps. The June inflation data showed another upside surprise, causing the market to further accelerate expectations for near-term Fed rate hikes. The 2-year yield rose 2 bps, as expectations solidified for a 75 bps rate hike at the July meeting, with the possibility of a 100 bps increase. Expectations for the September meeting also rose; a 50 bps rate hike was already expected, but there is now a better chance that the Fed goes with another 75 bps hike. Despite increases in the front-end, the 10-year yield fell -16 bps, as concerns about longer-term inflation moderated and near-term recession fears accelerated.

Investment grade corporates rallied, returning 1.06%, but underperforming similar-duration Treasuries by -10 bps. The asset class saw the 20th consecutive week of outflows, at $675 million. This year's outflows total almost 3% of AUM. Money center banks were in focus, as earnings reports were generally worse than expected. Under the surface, the market continues to decompress, with the spread between A and BBB rated corporates widening to 78 bps.

High yield corporates also gained, returning 0.26% while underperforming similar-duration Treasuries by -18 bps. Trading volumes were limited, especially in lower-rated names. As in investment grade, higher-quality continued to outperform, with BBs gaining 0.44% while CCCs overall traded flat. Loans benefited from the uptick in front-end rates and renewed CLO demand, with the asset class ultimately gaining 0.35%. This came despite another outflow totaling -$1.2 billion.

Emerging markets lagged substantially, returning -1.29% and underperforming similar-duration Treasuries by -213 bps, as the dollar continued to strengthen and weigh on the asset class. The dollar index gained 0.99% last week and is now 6.13% stronger since the end of May. In sovereign space, riskier names traded lower, e.g. Sub-Saharan Africa bonds traded down -5 to -7 points. Corporate bonds in China continue to reach new lows, with property names continuing to weaken amid concerns about the sectors ability to repay upcoming maturities. Tech, financial and gaming names all weakened as well, on a combination of government regulation and growth slowdown concerns.

MUNICIPAL-TO-TREASURY YIELD RATIOS LIKELY TO REMAIN ATTRACTIVE

Municipal bond yields declined last week, following the U.S. Treasury rally. Short-term municipal yields ended the week down -9 basis points, while long-term rates declined 3 bps. New issuance was outsized and was well received. Fund flows turned slightly positive.

Fixed income rallied last week, despite the Consumer Price Index (CPI) and the Producer Price Index (PPI) showing the highest readings in 40 years. The market believes the Fed will continue to raise short-term rates as much as it takes to curb inflation. Investors appear to be looking past the current high inflation readings and betting the Fed will be successful.

Muni bonds look historically rich to Treasuries, with the 10-year AAA MMD curve currently yielding 83% of the taxable 10-year Treasury bond. We believe yield ratios will likely remain rich due to an outsized amount of municipal bond reinvestment proceeds that has yet to be put to work.

Dallas Fort Worth International Airport issued $542 million revenue bonds (rated A1/A+). The deal was well received, and many maturities traded at premiums in the secondary market.

The high yield municipal market rally continues, due to a number of factors. U.S. Treasury rates remain stable, fund flows have turned positive and are growing, technical support from reinvestment cash flows continues to build, and credit quality remains robust. Nuveen is tracking at least 12 new issue deals this week, but their total size is relatively medium to small for a typical week.

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In focus

Inflation sparks a selloff

June headline inflation surprised to the upside for the third consecutive month. Headline prices rose 9.1% year-over-year, while core prices rose 5.9%. The consistent inflationary pressures beyond expectations are significantly impacting the Fed's planned sequence of rate hikes and reverberating throughout fixed income markets.

The details under the surface were also unfavorable. Some of the increase was due to energy prices (7.5% month-over-month), although prices have started to decline in July. Rents and owners' equivalent rent, two key measures of housing costs, rose at the fastest paces in more than three decades. Since housing costs make up around one-third of the CPI basket, the acceleration in these metrics presents substantial risks.

June data sparked a selloff in interest rates, with the market briefly pricing in a three-in-four chance that the Fed will hike by 100 bps, rather than 75 bps, at the July meeting. Some major banks revised their official forecasts to reflect a larger hike this month.

We do not think this single report will shift the Fed's calculus, and expect another sizable hike in July. The University of Michigan survey, which Chair Powell has cited as a key input, showed a moderation in long-term inflation expectations to 2.8% in the preliminary July print. That is down -0.5 pp from the preliminary June print.

Overall, elevated inflation supports the case for the Fed to continue hiking rates aggressively in the coming months, but we do not think the most 'hawkish' forecasts will materialize in the near term.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	3.13	0.02	0.17	2.39
5-year	3.04	-0.09	0.00	1.77
10-year	2.92	-0.16	-0.10	1.41
30-year	3.08	-0.17	-0.11	1.18

Source: Bloomberg L.P., 15 Jul 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	1.70	-0.09	-0.25	1.46
5-year	2.00	-0.05	-0.22	1.41
10-year	2.44	-0.05	-0.28	1.41
30-year	2.98	-0.03	-0.20	1.49

Source: Bloomberg L.P., 15 Jul 2022. **Past performance does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	83
30-year AAA Municipal vs Treasury	96
High Yield Municipal vs High Yield Corporate	60

Source: Bloomberg L.P., Thompson Reuters, 15 Jul 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	2.98	–	6.66	0.31	1.46	-7.65
High yield municipal	5.17	233[1]	10.26	0.35	1.92	-10.07
Short duration high yield municipal[2]	4.71	246	4.24	0.12	0.96	-4.71
Taxable municipal	4.32	121[3]	9.35	1.19	0.18	-13.82
U.S. aggregate bond	3.70	54[3]	6.46	0.89	0.62	-9.80
U.S. Treasury	3.14	–	6.49	0.84	0.28	-8.88
U.S. government related	3.75	64[3]	5.47	0.29	-0.03	-9.20
U.S. corporate investment grade	4.63	150[3]	7.66	1.06	1.12	-13.43
U.S. mortgage-backed securities	3.69	41[3]	5.74	0.97	0.82	-8.03
U.S. commercial mortgage-backed securities	4.11	103[3]	4.85	0.58	0.21	-8.09
U.S. asset-backed securities	3.94	78[3]	2.23	0.06	-0.18	-3.94
Preferred securities	6.32	265[3]	4.84	0.53	1.51	-12.54
High yield 2% issuer capped	8.58	531[3]	4.18	0.26	1.78	-12.66
Senior loans[4]	9.80	658	0.25	0.35	0.17	-4.29
Global emerging markets	7.44	434[3]	6.27	-1.29	-1.58	-18.45
Global aggregate (unhedged)	2.86	57[3]	7.04	0.09	-0.58	-14.41

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, 15 Jul 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, 15 Jul 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 13 Jul 2022.

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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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