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Weekly Fixed Income Commentary

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Favorable inflation data send Treasury rates lower

U.S. Treasury yields fell sharply after October inflation numbers came in lower than expected for only the third time since the start of 2021. The market responded by pricing a less hawkish path for U.S. Federal Reserve policy rates in 2023.

HIGHLIGHTS

- **Total returns were positive for Treasuries, agencies, investment grade and high yield corporates, taxable munis, MBS, ABS, preferreds, convertibles, senior loans and emerging markets.**
- **Municipal bond yields declined. New issue supply was light at $4.5B, with outflows of -$2.5B. This week's new issuance should rise to $8.5B.**

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Watchlist

- *10-year Treasury yields fell sharply across the curve last week.*
- *Spread assets gained amid the drop in rates.*
- *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 have risen this year, but the pace of long-term increases should remain relatively modest.

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.

DEMAND RETURNS TO HIGH YIELD CORPORATE FUNDS

U.S. Treasury yields rallied substantially after October inflation numbers wound up being lower than expected. Headline prices rose 7.7% year-over-year, -0.2 percentage points less than forecasted. That is only the third time since the start of 2021 that inflation has come in lower than anticipated. Core prices also moderated, to 6.3% year-over-year. Both continue to run high, but the trend has moved toward lower inflation. The market responded by pricing a less hawkish path for Fed policy rates, fully removing an entire 25 basis point (bps) hike from 2023 pricing. Two-year yields accordingly fell -33 bps, while 10-year yields fell -35 bps.

Investment grade bonds rallied, returning 2.62% for the week and beating similar-duration Treasuries by 40 bps. At the index level, yields were down -39 bps, while spreads tightened -5 bps. That was the biggest decline in yields since spring 2020. The most liquid names led the rally, as accounts generally scrambled to add risk after the soft CPI report. Before the inflation data, supply had been heavy, with $46 billion of new issuance, comfortably exceeding expectations for less than $20 billion. At the same time, outflows continued at -$1.7 billion, though the post-CPI euphoria vastly outweighed the technical headwinds from supply and outflows.

High yield corporates also gained, returning 1.19% for the week, though the asset class lagged similar-duration Treasuries by -32 bps. As in high grade markets, new issuance picked up, with $6 billion of new deals pricing for the week. Demand returned as well at $1.3 billion. Loan funds continued their recent strong performance, returning 0.60%, despite a -$582 million outflow.

Emerging markets outperformed, rallying 2.41% and outpacing similar-duration Treasuries by 41 bps. The soft CPI number sparked a substantial selloff in the dollar, which weakened -3.9%. The weaker dollar has cascading benefits for emerging markets economies, which benefit from lower funding costs and less pressure on external accounts. Sovereign spreads tightened -14 bps, with high yield sovereigns leading the way, -23 bps tighter, after lagging for most of this year.

THE MUNICIPAL MARKET RALLIES

Municipal and Treasury bond yields rallied after the CPI report was published Thursday morning. Short-term muni yields closed 8 bps lower, while long-term rates ended down 18 bps. The municipal bond new issue calendar remained light. While fund outflows continued, tax-exempt exchange-traded funds and money market funds both saw positive flows.

Thursday's CPI report showed inflation was beginning to subside, suggesting that the Fed may be closer to ending its short-term rate hikes. The 10-year Treasury bond rallied 29 bps on Thursday, and the curve remains inverted, meaning many investors expect long-term rates will be lower in 2023.

The municipal market is alive and well. The MMD 10-year yield declined 12 bps on Thursday. Strong interest in tax-exempt bonds continues at these high yields. However, we expect continued volatility in munis through the end of the year due to an outsized amount of tax loss trading. Looking ahead, we believe 2023 should be a good year for tax-exempt bonds.

The Florida Department of Transportation issued $192 million turnpike revenue bonds (rated Aa2/AA). The deal included 5% coupon bonds due in 2047 that came at a yield of 4.57%. Those bonds traded in the secondary market at 4.26%.

High yield municipal bond yields rallied 17 bps on average last week, lagging high grade munis and 10-year Treasuries. Several events reminded investors of the underlying fundamental strength supporting this long-term value. Chicago was upgraded by Moody's, shedding its below investment-grade rating. California announced a tender offer for its tobacco bonds, recognizing the irrational prices bonds are currently trading. American Dream announced it restructured its construction bank debt while strengthening the mechanism to replenish reserve funds.

The weaker dollar has cascading benefits for emerging markets economies.

In focus

Interpreting an inverted Treasury curve

As inflation has continued to surprise to the upside this year, markets have ratcheted up expectations for Fed rate hikes. This has led the Treasury yield curve to flatten and invert more deeply.

The 2-year/10-year curve declined to -57 bps earlier this month, from a positive sloping level of 77 bps at the start of the year. Even after the October CPI report came in lower than expected, the curve remains inverted.

Inverted yield curves are one of the best predictors of economic recession. We closely monitor the 2-year/10-year curve, the 3-month/10-year curve and the near-term forward spread. The latter refers to the spread between 3-month rates and the 3-month rate 18 months forward, a measure that Fed Chair Powell has cited in the past.

For the first time since August 2019, all three curves are inverted. Before 2019, the last two times that all three curves were simultaneously inverted were in July 2007 and August 2000. While the 2019 episode was interrupted by the Covid recession, the prior two instances both preceded U.S. recessions by around six months.

Our models suggest a roughly two-in-three chance that a U.S. recession occurs in the next 12 months, and nearly 90% chance that one will occur in the next 24 months. These models do not specify the depth, severity or length of a recession, and there are good reasons to expect less economic and market pain this time than in prior recessions.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	4.33	-0.33	-0.15	3.60
5-year	3.94	-0.40	-0.29	2.67
10-year	3.81	-0.35	-0.24	2.30
30-year	4.05	-0.23	-0.11	2.15

Source: Bloomberg L.P., 11 Nov 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	3.01	-0.16	-0.17	2.77
5-year	3.04	-0.18	-0.20	2.45
10-year	3.14	-0.22	-0.25	2.11
30-year	3.88	-0.20	-0.24	2.39

Source: Bloomberg L.P., 11 Nov 2022. **Past performance does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	82
30-year AAA Municipal vs Treasury	96
High Yield Municipal vs High Yield Corporate	68

Source: Bloomberg L.P., Thompson Reuters, 11 Nov 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	3.99	–	6.33	1.40	1.73	-11.35
High yield municipal	6.10	243[1]	8.04	2.02	2.13	-16.00
Short duration high yield municipal[2]	5.81	274	4.44	0.90	1.02	-7.42
Taxable municipal	5.31	127[3]	8.15	2.76	2.22	-19.55
U.S. aggregate bond	4.73	57[3]	6.22	2.29	1.91	-14.10
U.S. Treasury	4.16	–	6.11	1.96	1.36	-13.14
U.S. government related	4.78	62[3]	5.21	1.86	1.45	-12.29
U.S. corporate investment grade	5.60	147[3]	7.08	2.62	2.31	-17.70
U.S. mortgage-backed securities	4.75	56[3]	5.99	2.62	2.55	-12.72
U.S. commercial mortgage-backed securities	5.41	132[3]	4.64	1.78	1.38	-12.03
U.S. asset-backed securities	5.37	102[3]	2.76	0.73	0.40	-5.48
Preferred securities	7.46	267[3]	5.08	3.28	2.27	-14.99
High yield 2% issuer capped	8.93	470[3]	3.97	1.19	0.37	-12.19
Senior loans[4]	10.62	633	0.25	0.60	0.84	-1.67
Global emerging markets	8.13	398[3]	5.99	2.41	2.39	-19.32
Global aggregate (unhedged)	3.63	57[3]	6.80	3.86	2.85	-18.17

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, 11 Nov 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, 11 Nov 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 09 Nov 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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