

09 January 2023

Treasury yields fall sharply on promising economic data

U.S. Treasury yields fell across the curve to start the year. Economic data dominated attention, showing continued economic expansion, somewhat softer inflationary pressures and nascent signs of a deeper economic slowdown.

HIGHLIGHTS

- **Total returns were positive across all major fixed income asset classes.**
- **Only ABS and emerging markets had negative excess returns.**
- **Municipal bond yields generally declined. New issue supply was muted, with outflows of -\$2.5B. This week's new issuance should be \$4.1B.**



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Watchlist

- *U.S. Treasury yields fell across the curve.*
- *Spread assets gained.*
- *Net-negative supply should provide some support to municipal bonds.*

INVESTMENT VIEWS

The end to central bank tightening appears near, as we expect Fed rate hikes to cease early this year. The overall level of rates is likely to remain historically low.

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 fall this year, and we expect the 10-year Treasury yield to end the year around 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.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.
- Covid cases increase, or new variants emerge.

HEAVY INVESTMENT GRADE CORPORATE SUPPLY FACED MUTED DEMAND

U.S. Treasury yields fell sharply to start the year, with the 10-year Treasury yield down -32 basis points (bps). Two-year yields also fell by -18 bps. Economic data dominated attention, showing continued economic expansion, somewhat softer inflationary pressures and nascent signs of a deeper economic slowdown. The December jobs report beat expectations for headline job creation, while average hourly earnings surprised to the downside. However, the latest job openings data suggest that the labor market remains unsustainably tight and the unemployment rate fell back to its 50-year low. The ISM surveys for both industrial and services sector activity dropped significantly into contractionary territory.

The investment grade corporate market saw elevated supply, with 34 issuers bringing \$58 billion of new supply. The asset class returned 2.00% for the week and beat similar-duration Treasuries by 6 bps. Demand for the deluge of supply was relatively muted, with deals only 2.4x oversubscribed on average, resulting in concessions of 12 bps. Separately, the asset class experienced an inflow of \$2.1 billion for the week. This was significant, but less than the historical average of more than \$5 billion in the typical first week of the year.

High yield corporates outperformed, returning 2.23% for the week and outpacing similar-duration Treasuries by 121 bps. Unlike in other asset classes, the below-investment grade new issue market remained light to start the year, with only one deal of around \$2.8 billion coming to market. Senior loans returned 0.69%. Both asset classes saw outflows, with high yield and loan funds losing -\$2.2 billion and -\$587 million, respectively.

Emerging markets lagged, returning 0.99% for the week and underperforming similar-duration Treasuries by -68 bps. Local markets gained 0.55%, boosted by a decline in the dollar. Both hard currency and local funds saw outflows of -\$219 million and -\$190 million, respectively. As in U.S. investment grade markets, emerging markets saw a surge of new issuance, with \$27 billion pricing for the week. None of the new supply was high yield, helping that segment to outperform. In the sovereign space, high yield spreads widened only 6 bps versus 23 bps for investment grade.

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DEMAND FOR MUNI BONDS INCREASES WITH JANUARY REINVESTMENT COUPON

Municipal bond yields experienced a strong rally last week, along with U.S. Treasuries. Short-term muni rates declined 19 bps and long-term yields finished 18 bps lower. Weekly fund flows remained negative with light new issuance.

Friday saw the biggest rate decline across fixed income markets. Monthly employment data were strong, but investors shrugged it off. Many believe the Fed is making progress on inflation and it could be wise to lock in current yields, as rates will likely be lower by year end.

Municipal bonds followed the Treasury rally, but there was also demand for tax-exempt bonds specifically. We expect this to continue for the next few weeks as the outsized January 1 reinvestment coupon remains to be invested. New issue supply should remain muted during that same period.

The Triborough Bridge and Tunnel Authority (New York) issued \$765 million bonds (rated AA+/AA+). The deal was well received. Underwriters were able to lower yields from the midpoint on out upon final pricing.

High yield municipal bonds started the new year with a strong week as demand intensified and liquidity began to normalize. Fund flows were mostly positive last week, as tax-loss selling has largely faded and gross mutual fund sales continue at a healthy pace. Average yields decreased by 15 bps last week in just four trading days. Some key liquidity and higher beta benchmark bonds like tobacco and Puerto Rico were as much as 30 to 40 bps tighter in yield after being over sold in the latter half of December. New issue supply was very light to start the year.

The below-investment grade corporate new issue market remained light.

In focus

Increase duration via core bonds in 2023

We expect economic growth to moderate in 2023 to a below-trend pace. We see heightened risks of recession in the U.S. and Europe, though the magnitude should be mild by historical standards.

U.S. jobs growth, which has remained very strong in recent months, is likely to decelerate in the coming quarters. Inflation has likely peaked, but will remain too high relative to central banks' targets. This will likely drag on consumer spending and prompt further central bank tightening.

In 2022, we witnessed the unraveling of what had been a historically helpful (i.e., negative or low) stock/bond correlation. Looking ahead, with the bulk of rate hikes behind us and the emergence of the Fed's "slower but longer" approach, we think it makes sense to modestly increase duration through bolstering core bond allocations, especially in investment grade credit.

We do not see much further upward pressure for long-end yields from current levels. Elevated short-end rates should benefit floating-rate investments like senior loans, while high yield credit and emerging markets should also be relatively well insulated.

U.S. Treasury market

Maturity	Change (%)			
	Yield	Week	Month-to-date	Year-to-date
2-year	4.25	-0.18	-0.18	-0.18
5-year	3.70	-0.31	-0.31	-0.31
10-year	3.56	-0.32	-0.32	-0.32
30-year	3.69	-0.28	-0.28	-0.28

Source: Bloomberg L.P., 06 Jan 2023. Performance data shown represents past performance and does not predict or guarantee future results.

Municipal market

Maturity	Yield to Worst	Change (%)		
		Week	Month-to-date	Year-to-date
2-year	2.41	-0.19	-0.19	-0.19
5-year	2.36	-0.16	-0.16	-0.16
10-year	2.48	-0.15	-0.15	-0.15
30-year	3.40	-0.18	-0.18	-0.18

Source: Bloomberg L.P., 06 Jan 2023. Performance data shown represents past performance and does not predict or guarantee future results.

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	70
30-year AAA Municipal vs Treasury	93
High Yield Municipal vs High Yield Corporate	67

Source: Bloomberg L.P., Thompson Reuters, 06 Jan 2023. 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. Performance data shown represents past performance and does not predict or guarantee future results.

For more information, please visit nuveen.com.

Performance: Bloomberg, L.P. **Issuance:** The Bond Buyer, 06 Jan 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 04 Jan 2023.

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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Characteristics and returns

Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Returns (%)		
				Week	Month-to-date	Year-to-date
Municipal	3.36	–	6.16	1.15	1.15	1.15
High yield municipal	5.67	248 ¹	7.79	1.88	1.88	1.88
Short duration high yield municipal ²	5.38	300	4.25	0.94	0.94	0.94
Taxable municipal	4.91	114 ³	8.35	3.04	3.04	3.04
U.S. aggregate bond	4.43	50 ³	6.27	1.85	1.85	1.85
U.S. Treasury	3.93	–	6.26	1.67	1.67	1.67
U.S. government related	4.57	62 ³	5.37	1.16	1.16	1.16
U.S. corporate investment grade	5.19	132 ³	7.26	2.00	2.00	2.00
U.S. mortgage-backed securities	4.41	44 ³	5.73	2.14	2.14	2.14
U.S. commercial mortgage-backed securities	5.01	115 ³	4.62	1.58	1.58	1.58
U.S. asset-backed securities	4.94	73 ³	2.87	0.60	0.60	0.60
Preferred securities	7.11	253 ³	4.96	3.23	3.23	3.23
High yield 2% issuer capped	8.45	439 ³	3.80	2.23	2.23	2.23
Senior loans ⁴	10.34	632	0.25	0.69	0.69	0.69
Global emerging markets	7.32	345 ³	6.17	0.99	0.99	0.99
Global aggregate (unhedged)	3.55	51 ³	6.79	1.39	1.39	1.39

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, 06 Jan 2023. Performance data shown represents past performance and 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.

by way of example. Performance data shown represents past performance and does not predict or guarantee future results. Investing involves risk; principal loss is possible.

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Important information 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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