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Weekly Fixed Income Commentary

25 September 2023

Treasury yields rise as the Fed holds steady

U.S. Treasury yields rose again on strong inflation data. The U.S. Federal Reserve kept interest rates unchanged as expected, but the guidance for future policy was more hawkish than anticipated.

HIGHLIGHTS

- **Treasuries, investment grade and high yield corporates, MBS, taxable munis, ABS, preferreds and emerging markets all experienced negative total returns last week.**
- **Investment grade corporates and ABS outperformed Treasuries, while senior loans had positive total returns.**
- **Municipal bond yields increased. New issue supply was only $5.0B with outflows of -$27M. This week's new issuance is $8.3B.**

Anders Persson
CIO of Global Fixed Income

Daniel Close
Head of Municipals

Watchlist

- *10-year U.S. Treasury yields increased, but we anticipate modest declines over the rest of 2023.*
- *Spread assets underperformed Treasuries.*
- *Increased seasonal supply should provide an attractive entry point for municipal bonds.*

INVESTMENT VIEWS

"Higher for longer" rates remains as a theme, as central banks battle to control inflation. Higher interest rates are likely to cause additional volatility.

The underlying growth outlook remains healthy thanks to strong consumer balance sheets and solid levels of business investment. This combination should keep corporate defaults low.

Treasury yields are likely to fall slightly this year, and we expect the 10-year Treasury yield to end 2023 around 3.75%.

We favor selectively taking on risk in this environment of attractive prices and yields. Credit selection is key as we search for bonds with favorable income and solid fundamentals.

KEY RISKS

- Inflation fails to moderate as expected, weighing on asset prices.
- Policymakers tighten too rapidly, undermining the global economic expansion.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.

SENIOR LOANS CONTINUE TO OUTPERFORM

U.S. Treasury yields rose again last week, with 10-year yields ending 10 bps higher at 4.44% after the Fed delivered a hawkish hold. The more policy-sensitive 2-year yield rose 8 bps. The Fed kept interest rates steady as expected, but the guidance for future policy was more hawkish than anticipated. The dot plot of interest rate forecasts continued to show that the Fed expects another rate hike later this year, while the dots for 2024 showed median expectations for only two rate cuts, down from the prior expectation for four rate cuts next year.

Investment grade corporates sold off, returning -0.34% for the week, but the asset class outperformed versus similar-duration Treasuries by 27 bps. Performance was aided by a healthy inflow of $937 million. The new issue market remained healthy, with 11 issuers bringing $16.7 billion of new supply, matching expectations. Those deals were 3.1x oversubscribed, leading to healthy but unspectacular average concessions of around 6 bps.

High yield corporates lagged, returning -0.66% for the week and underperforming similar-duration Treasuries by -44 bps. Senior loans continued to outperform, returning 0.08% for the week. Loans saw the fourth consecutive weekly inflow, at $539 million, while high yield funds lost -$416 million. The new issue market remained dominated by refinancing deals, though the volume was elevated, with $5.6 billion in high yield and $17.8 billion in loans.

Emerging markets also weakened, returning -0.63% and lagging similar-duration Treasuries by -12 bps. Within the sovereign space, investment grade outperformed, with spreads tightening -2 bps. High yield sovereigns widened 7 bps. Local funds returned -0.75%, pressured by the stronger dollar, which gained 0.25% for its tenth consecutive weekly rally. Meanwhile, emerging market funds saw their eighth consecutive weekly outflow, with -$787 million leaving hard currency funds and -$466 million exiting local funds.

OUR OUTLOOK FOR MUNIS IS BULLISH

Municipal bond yields increased dramatically last week. The new issue calendar was light, yet some deals traded at losses to get bonds sold. Weekly mutual fund flows were negative yet again. Dealers will have to be generous on yield concession with this week's new issuance to pique investor interest.

The Fed left open the possibility of one hike and quashed talk of lowering rates anytime soon. Fixed income—including munis—sold off accordingly. Nevertheless, Nuveen remains bullish. We expect choppiness through the end of the year but would view those episodes as buying opportunities. Tax losses are giving institutions the opportunity to rearrange portfolios. And higher rates are bringing retail investors back into the market. Investors can get 3% tax-exempt income in the short portion of the yield curve, 4% in the mid section and 5% on the long end. We think these investments should look attractive by mid-2024.

Commonwealth of Massachusetts issued $500 million transportation fund revenue bonds (rated Aa1/AAA). Bonds traded cheaper in the secondary market. For example, 5% coupon bonds due in 2053 came at a yield of 4.34% and traded in the secondary market 9 basis points cheaper at 4.43%. This reflects the selloff in the fixed income market.

The average yield of Barclays High Yield Municipal Bond Index is now more than 6% for the first time in 2023. High yield muni bond funds saw -$302 million net redemptions last week, as average yields increased 14 bps, 10 bps of which occurred on Thursday. Nuveen is tracking nine high yield municipal bond deals for this week, including a $700 million+ refunding deal for Brightline Commuter Rail short-term bonds. On Friday, more than 600 people joined Brightline for the inaugural train ride from Miami to Orlando.

Senior loans saw the fourth consecutive weekly inflow last week, at $539 million.

In focus

The Fed plays wait and see

As expected, the Fed held rates steady, at 5.25%-5.50% last week. Additionally, the central bank reinforced its resolve to lower inflation to its long-term target of 2%.

The Fed's policy statement referenced inflation as "elevated," unchanged from July's statement. Regarding employment, the statement highlighted that job gains "have slowed in recent months but remain strong" compared to "have been robust" in July. And the pace of economic growth was characterized as "solid" rather than "moderate."

In his press conference, Chair Jerome Powell noted that the Fed can now "proceed carefully" thanks to its aggressive tightening early in this cycle. He also indicated that upcoming decisions will be made on a "meeting-by-meeting" basis. We believe his views, taken together, signal the strong possibility — but not a certainty — of one more 25 bps rate hike this year.

The Fed's updated dot plot suggests such a move is likely, with the fed funds rate still expected to peak between 5.50% and 5.75%. Other economic projections show a large upward revision to 2023 real GDP growth, from 1.0% estimated in June to 2.1%, while the core inflation forecast was revised down slightly, from 3.9% to 3.7%.

Markets quickly digested the prospect of another rate hike. The 2-year Treasury yield, which tracks the outlook for monetary policy, finished the week at 5.11%, its highest level since 2006.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	5.11	0.08	0.25	0.68
5-year	4.56	0.09	0.30	0.55
10-year	4.44	0.10	0.33	0.56
30-year	4.53	0.11	0.31	0.56

Source: Bloomberg L.P., 22 Sep 2023. **Performance data shown represents past performance and does not predict or guarantee future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	3.37	0.24	0.23	0.77
5-year	3.12	0.19	0.24	0.60
10-year	3.16	0.16	0.23	0.53
30-year	4.07	0.13	0.19	0.49

Source: Bloomberg L.P., 22 Sep 2023. **Performance data shown represents past performance and does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	71
30-year AAA Municipal vs Treasury	90
High Yield Municipal vs High Yield Corporate	69

Source: Bloomberg L.P., Thompson Reuters, 22 Sep 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.**

Characteristics and returns

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	4.06	–	6.30	-1.07	-1.42	0.15
High yield municipal	6.04	216[1]	7.83	-1.31	-1.53	1.94
Short duration high yield municipal[2]	5.76	265	4.24	-0.50	-0.59	3.15
Taxable municipal	5.48	87[3]	7.96	-0.64	-1.89	1.91
U.S. aggregate bond	5.26	49[3]	6.20	-0.50	-1.59	-0.24
U.S. Treasury	4.78	–	5.95	-0.50	-1.58	-0.89
U.S. government related	5.29	49[3]	5.13	-0.41	-1.35	0.86
U.S. corporate investment grade	5.88	116[3]	6.87	-0.34	-1.51	1.21
U.S. mortgage-backed securities	5.35	58[3]	6.36	-0.71	-1.79	-0.86
U.S. commercial mortgage-backed securities	6.07	131[3]	4.37	-0.33	-0.97	0.38
U.S. asset-backed securities	5.73	66[3]	2.67	-0.10	-0.38	2.05
Preferred securities	7.49	232[3]	4.73	-0.39	-0.40	3.43
High yield 2% issuer capped	8.75	386[3]	3.50	-0.66	-0.77	6.32
Senior loans[4]	10.03	540	0.25	0.08	0.99	10.03
Global emerging markets	7.86	312[3]	5.97	-0.63	-1.30	1.92
Global aggregate (unhedged)	4.14	48[3]	6.62	-0.49	-2.01	-1.29

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, 22 Sep 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.

For more information, please visit nuveen.com.

Performance: Bloomberg, L.P. **Issuance:** The Bond Buyer, 22 Sep 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 20 Sep 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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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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