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Weekly Fixed Income Commentary

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Treasury yields rise as the Fed upgrades its outlook

10-year U.S. Treasury yields rose another 10 basis points (bps) last week, the seventh consecutive weekly increase, and are now up 65 bps over that period. The Federal Reserve (Fed) upgraded its economic forecasts but maintained its commitment to keep rates at zero over the medium term, pushing long-term interest rates higher.

HIGHLIGHTS

- **Preferred securities and investment grade credit saw positive excess returns, while high yield bonds and loans weakened.**
- **Municipal bond prices sold off sharply. New issue supply was $9.7 billion, with flows of $1.3 billion. This week's new issue supply is expected to be $11.3 billion ($2.0 billion taxable).**
- **Emerging markets sovereign debt outperformed, returning 0.29% and handily beating Treasuries.**

Anders Persson
CIO of Global Fixed Income

John Miller
Head of Municipals

Watchlist

- *Long Treasury yields rose after the Fed signaled it will maintain zero rates through the end of 2023.*
- *Risk assets were pressured by the move in yields, with high yield bonds and preferreds weakening, while investment grade credit spreads narrowed.*
- *Municipal bonds are unlikely to remain so rich.*
- *Emerging markets debt and currencies gained, helped by the Fed's commitment to low policy rates.*
- *Bond and loan funds saw inflows, as did high grade and high yield municipals.*

INVESTMENT VIEWS

Unprecedented global fiscal stimulus will boost consumption and growth this year.

Zero/negative global interest rate policy remains a key market support, but investors are beginning to focus on the eventual normalization of policy.

Record supply of investment grade corporates has been followed by issuance from high yield, middle market loans, broadly syndicated loan market and certain COVID-exposed names/sectors. Taxable municipal supply continues to grow.

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 remain the most attractive. Essential service municipal credits also look compelling.

KEY RISKS

- Further complications with the COVID-19 vaccine rollout.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.
- Policymakers become cautious or run out of stimulus capacity.
- Inflation rises in a disorderly way, forcing premature policy tightening.

RISK ASSETS DECLINE AS RATES RISE

10-year Treasury yields rose another 10 basis points (bps) last week and the curve steepened. At its meeting, the Federal Reserve signaled its continued commitment to keep policy rates at zero over the medium term, but upgraded its economic outlook substantially. The renewed commitment to allow the economy to run "hot" over the next few years, coupled with Chair Powell's lack of push back against the recent rise in yields, support the case for higher long-term interest rates.

Investment grade (IG) credit spreads narrowed, providing 28 bps of excess returns, as the technical backdrop improved. Foreign buyers showed signs of entering the market on the long end, and IG funds saw strong inflows of $2.25 billion. BBBs and cyclical sectors outperformed, continuing recent themes.

High yield and loans returned -0.53% and -0.06%, respectively, as risk assets were pressured by the rise in rates. However, in a similar dynamic to that seen in high grade credit, lower-rated securities outperformed, with CCCs outperforming in both bonds and loans. Both also saw inflows, of $401 and $907 million for bonds and loans, respectively.

Emerging markets (EM) debt rallied, with total returns of 0.29% and excess returns of +63 basis points. Similar to the dynamic seen in U.S. credit markets, there were signs of Asia-based investors buying longer-duration, high-grade sovereign bonds. Several EM central banks hiked rates as well, namely in Russia and Turkey, helping EM currencies strengthen versus the dollar. However, this move partially retraced over the weekend after Turkey's credible central bank governor was removed from his position, causing the lira to weaken more than 10%.

MUNICIPAL MARKET IS UNDER PRESSURE

Municipal bond prices sold off sharply last week, underperforming Treasury bonds. We expect municipal-to-Treasury yield ratios to remain under pressure, as the 10-year ratio closed last week at a historically rich 67%. Municipal bonds are unlikely to remain so rich, with a large new issue calendar of $11.3 billion this week ($2 billion taxable).

Investors continue to be disappointed by Fed Chair Jerome Powell, and they voice their displeasure by demanding higher interest rates. The 10-year Treasury yield reached 1.75% last week, the highest it has been since *before* the pandemic. Chair Powell is adamant that inflation is not a concern, but investors are less certain. Either Powell must say he is committed to controlling inflation, or the inflation embers that are currently heating up must begin to cool. Until either of those scenarios happen, we expect upward pressure to continue on both Treasury and municipal interest rates.

The state of Illinois issued $1.25 billion general obligation bonds (rated Baa3/BBB-). The deal was very well received, but bonds traded at a discount in the secondary market as the market in general sold off. The 25-year bond with a 5% coupon originally yielded 2.75%, and traded at a 2.82% yield by week's end.

High yield municipal bonds continue to outperform, while fixed income assets are being challenged by rising Treasury yields. High yield municipal bond yields increased just 5 bps last week, compared to much larger increases in AAA-rated municipal and Treasury yields. Demand continues to be robust, with $650 million in fund flows last week. Since the -$722 million in outflows three weeks ago, investors have added more than $1.0 billion in net flows. High yield municipal deals continue to be heavily oversubscribed, and we are expecting to see at least 15 new deals this week.

Municipal bonds are unlikely to remain so rich, with a large new issue calendar of $11.3 billion this week.

In focus

The Fed gets bullish but stays dovish

Speedy vaccinations and the enactment of a $1.9 trillion stimulus plan led the Federal Reserve to upgrade its U.S. economic forecasts at its March 17 meeting. Despite this increased optimism, a majority of Fed members expects to keep interest rates near zero at least through 2023.

In its policy statement, the Fed acknowledged COVID-19's "human and economic hardship" and that "the path of the economy will depend significantly on the course of the virus." Chair Jerome Powell nonetheless believes the U.S. is on the right track, reflected in the Fed's more bullish outlook for growth, inflation and employment for 2021 and beyond.

On the dovish side — in addition to standing pat on rates — Powell stated that the Fed wouldn't consider tapering its $120 billion/month bond-buying program until substantial growth in the U.S. economy is evident in actual data, not just forecasts. There's still plenty of slack left in the labor market, for example, and thus no need for the Fed to sound the inflation alarm.

Moreover, the Fed has already made it clear that it will allow the economy to run hotter to compensate for periods of low inflation (such as that seen during the pandemic). Even GDP growth of 6.5% (the Fed's new projection for 2021) is unlikely to produce the type of inflation in the near term that would cause Powell and his colleagues to tighten policy.

U.S. Treasury market

Maturity	Yield	Change (%) Week	Month-to-date	Year-to-date
2-year	0.15	0.00	0.02	0.03
5-year	0.88	0.04	0.15	0.52
10-year	1.72	0.10	0.32	0.81
30-year	2.44	0.06	0.28	0.79

Source: Bloomberg L.P. As of 19 Mar 2021. **Past performance is no guarantee of future results.**

Municipal market

Maturity	Yield to Worst	Change (%) Week	Month-to-date	Year-to-date
2-year	0.21	0.12	0.02	0.07
5-year	0.57	0.14	0.01	0.35
10-year	1.16	0.14	0.02	0.45
30-year	1.79	0.14	-0.01	0.40

Source: Bloomberg L.P. As of 19 Mar 2021. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	67
30-year AAA Municipal vs Treasury	73
High Yield Municipal vs High Yield Corporate	82

Source: Bloomberg L.P., Thompson Reuters. As of 19 Mar 2021. AAA municipals represented by the MMD scale. The high yield ratio equals the yield-to-worst for the Bloomberg Barclays High Yield Municipal Index divided by the yield-to-worst for the Bloomberg Barclays High Yield Corporate Index. **Past performance is no guarantee of future results.**

Characteristics and returns

Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Returns (%) Week	Month-to-date	Year-to-date
Municipal	1.25	–	5.31	-0.51	0.21	-0.76
High Yield Municipal	3.71	212[1]	7.46	-0.39	0.51	1.53
Short Duration High Yield Municipal[2]	3.10	229	3.71	-0.11	0.24	1.59
Taxable Municipal	2.53	82[3]	9.77	-0.44	-2.02	-3.95
U.S. Aggregate Bond	1.62	33[3]	6.39	-0.28	-1.49	-3.61
U.S. Treasury	0.99	–	6.81	-0.30	-1.63	-4.34
U.S. Government Related	1.45	44[3]	6.01	-0.09	-0.93	-2.96
U.S. Corporate Investment Grade	2.32	95[3]	8.42	-0.20	-2.39	-5.30
U.S. Mortgage-Backed Securities	1.85	15[3]	4.09	-0.36	-0.62	-1.21
U.S. Commercial Mortgage-Backed Securities	1.66	67[3]	5.20	-0.32	-0.91	-2.12
U.S. Asset-Backed Securities	0.52	32[3]	2.11	0.00	-0.11	-0.10
Preferred Securities	3.06	181[3]	4.84	-0.08	0.56	-1.03
High Yield 2% Issuer Capped	4.56	338[3]	3.93	-0.53	-0.74	-0.04
Senior Loans[4]	4.85	450	0.25	-0.06	0.02	1.97
Global Emerging Markets	3.90	269[3]	6.70	0.29	-0.88	-3.12
Global Aggregate (unhedged)	1.16	33[3]	7.40	-0.22	-1.42	-3.97

1 Yield difference between the Bloomberg Barclays 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. As of 19 Mar 2021. **Past performance is no guarantee of future results.** Unless otherwise noted, the index is Bloomberg Barclays. 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, 19 Mar 2021. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 12 Mar 2021.

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 Barclays Municipal Index; **high yield municipal:** Bloomberg Barclays High Yield Municipal Index; **short duration high yield municipal:** S&P Short Duration Municipal Yield Index; **taxable municipal:** Bloomberg Barclays Taxable Municipal Bond Index; **U.S. aggregate bond:** Bloomberg Barclays U.S. Aggregate Bond Index; **U.S. Treasury:** Bloomberg Barclays U.S. Treasury Index; **U.S. government related:** Bloomberg Barclays U.S. Government-Related Index; **U.S. corporate investment grade:** Bloomberg Barclays U.S. Corporate Index; **U.S. mortgage-backed securities;** Bloomberg Barclays U.S. Mortgage-Backed Securities Index; **U.S. commercial mortgage-backed securities:** Bloomberg Barclays CMBS ERISA-Eligible Index; **U.S. asset-backed securities:** Bloomberg Barclays Asset-Backed Securities Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **high yield 2% issuer capped:** Bloomberg Barclays High Yield 2% Issuer Capped Index; **senior loans:** Credit Suisse Leveraged Loan Index; **global emerging markets:** Bloomberg Barclays Emerging Market USD Aggregate Index; **global aggregate:** Bloomberg Barclays Global Aggregate Unhedged Index.

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A word 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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