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Weekly Fixed Income Commentary

20 December 2021

Treasury yields decline as the Fed turns hawkish

U.S. Treasury yields declined as central banks in developed markets, including the U.S. Federal Reserve, moved to withdraw accommodation faster than previously signaled. Spread assets weakened slightly after recent strong gains.

HIGHLIGHTS

- **Total returns were positive for Treasuries, asset- and mortgage-backed securities, commercial mortgage-backed securities, taxable munis, investment grade and high yield corporates, preferreds, and senior loans.**
- **Total returns were negative in convertibles and emerging markets, while excess returns were negative in investment grade and high yield corporates, taxable munis and ABS.**
- **Municipal bond yields ended the week range bound. New issue supply totaled $8.3B, with flows of $746M. This week's new issue supply is close to zero due to the Christmas holiday.**

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Watchlist

- *10-year Treasury yields fell last week, but we anticipate increases in the quarters ahead.*
- *Spread assets weakened slightly after recent strong gains.*
- *Municipal bonds are unlikely to remain so rich.*

INVESTMENT VIEWS

Zero/negative global interest rate policy remains a key market support. Investors continue to focus on tapering and an eventual increase in interest rates.

Unprecedented global fiscal stimulus should continue to boost consumption and growth into next year.

Record supply of investment grade corporates has been followed by high levels of issuance from high yield, middle market loans and the broadly syndicated loan market. Taxable municipal supply also 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 appear particularly attractive. Essential service municipal bonds also look compelling.

KEY RISKS

- Inflation rises in a disorderly way, negatively affecting asset values.
- Policymakers remove accommodation too rapidly, undermining the global economic expansion.
- Further complications with the COVID-19 vaccine rollout, as well as multiple variants.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.

HAWKISH CENTRAL BANK ACTIONS AFFECT TAXABLE MARKETS

U.S. Treasury yields fell last week, after the Fed moved forward with removing monetary accommodation as expected. The Fed doubled the pace of its taper, which is now expected to conclude in March. The Fed's dot plot of rate forecasts also now includes three hikes in 2022, matching the current market pricing. Other central banks also moved in a hawkish direction, with the Bank of England raising interest rates and the European Central Bank announcing a smaller-than-expected extension of asset purchases. In response, the market is pricing lower risks of persistently high inflation, but also higher odds of a premature slowdown in growth, causing long-end yields to fall and risk assets to weaken slightly.

Investment grade corporates benefited from the rally in Treasuries, returning 0.35% for the week. The asset class underperformed similar-duration Treasuries by -21 bps. The primary market was extremely quiet, with close to zero new issuance for the week, as we move forward into the year-end holiday period. Retail flows remained negative, with an outflow of -$1.3 billion from high-grade funds.

High yield corporates eked out a positive return, up 0.07% on the week, but underperformed similar-duration Treasuries by -17 bps. The primary market was also quiet, albeit slightly more active than in investment grade markets, with around $2.4 billion pricing from six issuers. High yield also saw a modest inflow of $200 million. Inflows into loan funds rebounded more strongly at $859 million, the largest inflow since before Thanksgiving. This helped the asset class return 0.05%.

Emerging markets lagged, returning -0.13% for the week, and underperforming similar-duration Treasuries by -61 bps. The more hawkish policy from developed market central banks led to some currency weakness in emerging markets, with an index of EM FX down -1.8% for the week. The biggest underperformer was the Turkish lira, after the central bank cut interest rates by -100 bps despite CPI inflation running at 21% year-on-year as of November. Turkish bonds weakened as well, with yields on local currency and USD 10-year bonds rising by 130 bps and 55 bps, respectively.

MUNICIPAL MARKET ANTICIPATES HEAVY REINVESTMENT MONEY

Municipal bond yields remained range bound last week, while Treasury yields ended slightly lower. Both markets closed Friday with strong tones. This week will still be busy, despite the upcoming Christmas holiday. We expect buyers to move aggressively in the secondary market, as $44 billion of January 1 reinvestment money must be redeployed.

The fixed income market has a very good tone, in part because Fed Chairman Powell has publicly acknowledged it is time to battle inflation. Easy monetary policies implemented in March 2020 to keep the U.S. economy afloat during the pandemic are being phased out. Not only is the era of easy money over, but the Fed is also expected to begin raising rates sometime in mid-2022 to continue its battle against inflation. The municipal market remains well bid. We expect this stability to remain for the foreseeable future, due to the heavy reinvestment money coming January 1.

The state of Connecticut issued $800 million general obligation bonds (rated Aa3/A+). The deal was priced to sell and well received. Bonds up and down the yield curve were trading at slight premiums once the deal was free to trade.

High yield municipal bond yields declined by 4 bps on average last week, bringing average credit spreads back down to 184 bps. Fund flows remained strong at $483 million. Market activity is likely to scale back for the remainder of the year, except for a few pockets that present tax loss opportunities.

In the municipal market, $44 billion of January 1 reinvestment money must be redeployed.

In focus

Fed accelerates tapering and rate hike plans

Due to hotter inflation and a tightening labor market, the Federal Reserve announced last week that it will double the amount by which it tapers its quantitative easing (QE) asset purchases, from $15 billion/month to $30 billion/month, beginning in January. This faster pace means QE will end in March 2022.

The Fed pledged to keep the fed funds rate at its current 0%-0.25% target range until the labor market reaches maximum employment. At the same time, however, the closely watched “dot plots” showed that most Fed members foresee three rate hikes in 2022 — up from less than one in their September projections. The Fed rarely changes course so rapidly, but the economy has strengthened notably since then.

Stocks rallied in the immediate wake of the meeting, cheering the Fed’s resolve to rein in inflation and its bullish economic outlook (an upgraded GDP forecast for 2022 and lower unemployment). In contrast, bond markets were sedate, with the 10-year U.S. Treasury yield little changed amid a prevailing longer-term view of slower growth and cooler inflation.

Overall, investors — and even the Fed — may be anticipating too many rate hikes next year. We think fewer will be needed because inflation should decelerate sharply as supply-chain woes ease and more workers enter (or re-enter) the labor force.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	0.64	-0.02	0.07	0.52
5-year	1.18	-0.08	0.01	0.81
10-year	1.40	-0.08	-0.04	0.49
30-year	1.81	-0.07	0.01	0.16

Source: Bloomberg L.P., 17 Dec 2021. **Past performance is no guarantee of future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	0.24	-0.01	0.00	0.10
5-year	0.59	-0.01	0.00	0.37
10-year	1.03	0.00	0.00	0.32
30-year	1.48	0.00	0.00	0.09

Source: Bloomberg L.P., 17 Dec 2021. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	73
30-year AAA Municipal vs Treasury	81
High Yield Municipal vs High Yield Corporate	70

Source: Bloomberg L.P., Thompson Reuters, 17 Dec 2021. 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 is no guarantee of future results.**

Characteristics and returns

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	1.11	–	5.06	0.06	0.11	1.47
High Yield Municipal	3.12	183[1]	6.42	0.08	0.19	7.69
Short Duration High Yield Municipal[2]	2.66	179	3.59	0.07	0.15	5.93
Taxable Municipal	2.25	77[3]	9.58	0.49	-0.23	1.62
U.S. Aggregate Bond	1.72	40[3]	6.81	0.35	-0.04	-1.33
U.S. Treasury	1.18	–	7.25	0.48	-0.09	-1.91
U.S. Government Related	1.59	45[3]	6.16	0.31	0.15	-1.02
U.S. Corporate Investment Grade	2.31	98[3]	8.74	0.35	0.00	-0.97
U.S. Mortgage-Backed Securities	1.96	37[3]	4.68	0.18	-0.05	-1.01
U.S. Commercial Mortgage-Backed Securities	1.82	68[3]	5.09	0.43	0.13	-0.88
U.S. Asset-Backed Securities	1.10	41[3]	2.34	0.06	-0.13	-0.30
Preferred Securities	3.42	193[3]	4.71	0.17	0.62	2.54
High Yield 2% Issuer Capped	4.48	309[3]	3.91	0.07	1.14	4.50
Senior Loans[4]	5.24	441	0.25	0.05	0.41	5.17
Global Emerging Markets	4.53	326[3]	7.09	-0.13	0.96	-1.67
Global Aggregate (unhedged)	1.25	37[3]	7.63	0.05	0.21	-4.38

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, 17 Dec 2021. **Past performance is no guarantee of 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, 17 Dec 2021. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 10 Dec 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 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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