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Weekly Fixed Income Commentary

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Treasury yields rise on hawkish Fed sentiment

U.S. Treasury yields rose and the curve flattened, as markets continue to re-price U.S. Federal Reserve expectations in a more hawkish direction, despite mixed economic data. Spread assets were mixed after recent strong gains.

HIGHLIGHTS

- **Total returns were negative in Treasuries, MBS, CMBS, ABS, investment grade corporates and emerging markets.**
- **High yield corporates, leveraged loans, preferreds, and taxable municipals all enjoyed positive returns.**
- **Municipal bond yields ended the week higher. New issue supply was \$10B, with flows of \$231M. This week's new issue supply is \$9.5B (\$1.6B taxable).**

Anders Persson
CIO of Global Fixed Income

John Miller
Head of Municipals

Watchlist

- *10-year Treasury yields rose last week, and we anticipate increases in the quarters ahead.*
- *Spread assets were mixed 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. While investors continue to focus on more hawkish Fed policy, overall rates are likely to remain low.

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

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 vaccine rollout, as well as new variants.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.

MODEST ISSUANCE SUPPORTS HIGH YIELD CORPORATES

U.S. Treasury yields rose again last week, with the moves led by the short end. Two-year Treasury yields ended 11 basis points (bps) higher at 0.97%, while 10-year yields moved only 2 bps higher to 1.79%. Economic data were mixed, with consumer price inflation meeting consensus expectations at 7.0% year-over-year. Retail sales disappointed, falling -1.9% in December, with the drop led by online retailers and durable goods.

Investment grade corporates weakened, returning -0.44% for the week and underperforming similar-duration Treasuries by -26 bps. The primary market continues to be very busy, with another $35 billion pricing last week, taking the issuance volumes for the first two weeks of the year to 40% higher than the same period last year. Concessions rose, averaging 4.5 bps, up from 3.3 bps the prior week, and oversubscription rates fell to 2.2x. Another week of elevated supply is expected this week, as major U.S. banks exit their earnings blackout periods. In parallel to the deluge of supply, investor demand softened, with -$5.7 billion leaving the asset class last week, the largest outflow since March 2020.

High yield corporates outperformed, gaining 0.07% for the week and beating similar-duration Treasuries by 23 bps. Continuing the theme so far this year, high yield has been supported by a much more modest issuance calendar than the high grade market. Relatively high cash balances have supported the primary market, with oversubscription rates hitting 5-10x last week. The loan market has also seen relatively modest supply, and prices have continued to grind higher, helped by the move in interest rates. Around one-third of the loan market now trades above par, which will likely lead to some refinancing activity in the weeks ahead.

Emerging markets continue to be pressured by several headwinds, returning -0.95% for the week and underperforming similar-duration Treasuries by -77 bps. In addition to the increase in developed market rates, the asset class has been pressured by idiosyncratic headwinds. Geopolitical tensions continue to rise between Russia and Ukraine, with both countries seeing 10-year yields rise by 100-125 bps for the week. Meanwhile, concerns linger over the China property sector, with spreads on China's high yield corporate index widening 300 bps to retrace most of the prior week's rally.

MUNICIPAL INVESTORS WAITING FOR THE FED TO ACT

Municipal bond yields sold off last week, primarily on the short end. The 5-year yield ended the week 8 bps higher, while long-term rates rose only 1 bps. Demand was tepid for new issuance, but fund flows were positive. This week's new issuance will need to be priced to sell to pique investor interest.

U.S. Inflation has reached its highest level in 40 years, and interest rates – both Treasury and municipal – have risen as a result. However, Fed Chair Powell has acknowledged that inflation is a problem and committed to raising interest rates to bring it into check. It is estimated that the Fed may have to raise short-term rates four times in 2022, with the first hike as soon as March.

Both Treasury and municipal yields have been relatively stable since the selloff. Investors are waiting for the Fed to show its mettle with tighter monetary policy to curtail inflation.

The Chicago Board of Education issued $863 million general obligation bonds (rated BB). The deal was priced to sell and well received. Bonds were trading in the secondary market right around where the deal was priced. This shows the continued need for high yield tax-exempt securities.

High yield municipals saw a small burst of outflows – triggered by a surge in rate volatility – that were easily absorbed by cash-rich high yield municipal mutual funds. Outflows appear to have abated, with rates stabilizing and high yield municipal bond prices exhibiting a muted response. New issuance has been limited. However, Chicago Board of Education widened spreads last week to price $850 million in bonds. The path to restructuring Puerto Rico's GO debt is becoming more certain. The current plan will deliver nearly $7 billion in cash to bond holders, a mighty stimulus to already under-supplied high yield muni demand.

Investment grade corporate issuance is 40% higher for the first two weeks of the year than the same period last year.

In focus

Municipal bonds should remain relatively stable

Munis held their value throughout 2021 despite moderately higher interest rates, producing among the best relative performance across fixed income.

The asset class enters 2022 on strong technical and fundamental footing. New issue municipal supply was up nearly 15% in 2021 and fund flows were positive in 51 of 52 weeks. As a result, new issue supply was easily absorbed and oversubscriptions were typical.

This led to municipals being one of the most stable fixed income asset classes in 2021, with positive performance and low volatility across the credit and duration spectrum. Credit outperformed by the largest margin in almost a decade, bolstered by record state and local revenues, federal spending, low defaults and idiosyncratic strength.

Despite these strong fundamentals, we see headwinds in 2022, given the Fed's renewed focus on fighting inflation. We anticipate a faster quantitative easing wind down and more rapid increases in rate hikes than projected.

These challenges will be felt across the fixed income market, but municipals should remain a relatively stable asset class due to strong fundamentals and the essential nature of their purpose.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	0.97	0.11	0.24	0.24
5-year	1.56	0.06	0.30	0.30
10-year	1.79	0.02	0.28	0.28
30-year	2.12	0.01	0.22	0.22

Source: Bloomberg L.P., 14 Jan 2022. **Past performance is no guarantee of future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	0.46	0.06	0.22	0.22
5-year	0.81	0.08	0.22	0.22
10-year	1.18	0.01	0.15	0.15
30-year	1.64	0.01	0.15	0.15

Source: Bloomberg L.P., 14 Jan 2022. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	67
30-year AAA Municipal vs Treasury	78
High Yield Municipal vs High Yield Corporate	70

Source: Bloomberg L.P., Thompson Reuters, 14 Jan 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 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	1.33	–	5.08	-0.24	-0.93	-0.93
High Yield Municipal	3.25	165[1]	6.66	-0.10	-0.75	-0.75
Short Duration High Yield Municipal[2]	2.67	163	3.63	-0.24	-0.43	-0.43
Taxable Municipal	2.56	77[3]	9.58	0.03	-1.92	-1.92
U.S. Aggregate Bond	2.04	38[3]	6.86	-0.29	-1.82	-1.82
U.S. Treasury	1.50	–	7.05	-0.17	-1.77	-1.77
U.S. Government Related	1.91	44[3]	6.08	-0.19	-1.56	-1.56
U.S. Corporate Investment Grade	2.62	96[3]	8.53	-0.44	-2.37	-2.37
U.S. Mortgage-Backed Securities	2.29	36[3]	5.38	-0.36	-1.49	-1.49
U.S. Commercial Mortgage-Backed Securities	2.16	67[3]	5.05	-0.20	-1.36	-1.36
U.S. Asset-Backed Securities	1.32	34[3]	2.29	-0.08	-0.41	-0.41
Preferred Securities	3.36	151[3]	4.66	0.04	-0.66	-0.66
High Yield 2% Issuer Capped	4.59	294[3]	3.92	0.07	-0.87	-0.87
Senior Loans[4]	5.41	425	0.25	0.24	0.52	0.52
Global Emerging Markets	4.67	306[3]	7.00	-0.95	-2.45	-2.45
Global Aggregate (unhedged)	1.47	37[3]	7.57	0.43	-0.75	-0.75

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, 14 Jan 2022. **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, 14 Jan 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 12 Jan 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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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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