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Weekly Fixed Income Commentary

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Treasury yields decline over growth concerns

U.S. Treasury yields declined for the first time in six weeks. The move boosted total returns across fixed income markets, though spreads generally widened.

HIGHLIGHTS

- **Total returns were positive for Treasuries, agencies, MBS, CMBS, ABS, taxable munis and investment grade corporates.**
- **Returns were negative for higher-risk asset classes, including high yield corporates, convertibles, preferreds and loans.**
- **Municipal bond yields rose slightly across the curve. New issue supply was $12.6B, with outflows of -$2.4B. This week's new issue supply is manageable at $8.1B.**

Anders Persson
CIO of Global Fixed Income

John Miller
Head of Municipals

Watchlist

- *10-year Treasury yields declined, but we expect them to move modestly higher this year.*
- *Spread sectors were weaker amid elevated uncertainty.*
- *Municipal bonds appear attractive vs. Treasuries.*

INVESTMENT VIEWS

Accommodative interest rate policy remains a key market support. While investors continue to focus on more hawkish Fed policy, overall rates are likely to remain relatively low even after several rate hikes.

The underlying growth outlook is healthy, as consumers have strong balance sheets, businesses are reinvesting and Covid recedes. This should keep defaults low.

Treasury yields are likely to rise this year, but we don't expect the 10-year Treasury yield to rise much above 3%.

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

- The Russia/Ukraine conflict continues to escalate.
- Inflation fails to decline as expected, negatively affecting asset values.
- Policymakers remove accommodation too rapidly, undermining the global economic expansion.
- COVID-19 cases increase, or new variants emerge.

INVESTMENT GRADE CORPORATES SNAP SELL OFF STREAK

U.S. Treasury yields declined sharply last week, with the 10-year yield dropping -21 bps to 2.92%. The move came despite another upside surprise to U.S. consumer price inflation, which showed a 0.6% month-over-month core price increase in April. However, inflation is now decelerating year-over-year. Headline prices rose 8.3% versus a year ago, down from 8.5% in March. The market is now pivoting from worries about inflation to concerns about growth. Two-year yields fell -15 bps, flattening the curve, as the market removed around 11 bps of expected Fed rate hikes for this calendar year.

Investment grade corporates benefited from the rally in Treasuries, gaining 0.60% for the week and snapping a streak of five straight weekly selloffs. Yields for the index fell -8 bps, but spreads widened 7 bps, causing the asset class to underperform similar-duration Treasuries by -52 bps. The asset class benefited from a slower growth in supply, which is now running lower than year-ago levels, after approximately $21 billion priced for the week. For May, the market has seen around $40 billion of new supply, significantly less than the $65 billion expected through the first two weeks of the month. Concessions remain elevated at around 13 bps, as the market continues struggling to digest new issuance.

High yield corporates underperformed, returning -1.21% last week and underperforming similar-duration Treasuries by -192 bps. Spreads widened 50 bps, the biggest move since June 2020, marking significant decompression versus investment grade corporates. Within high yield, the same dynamic dominated, with BBs widening 30 bps compared to CCCs at 102 bps. Higher-quality segments tend to be longer-duration, so they benefited more from the rally in Treasuries. Loans also weakened, returning -1.63%, for their worst week since March 2020.

Emerging markets weakened slightly, returning -0.36% and underperforming similar-duration Treasuries by -138 bps. Under the surface, the asset class exhibited the same decompression dynamics as other fixed income markets, with high yield spreads widening 58 bps versus a more modest move of 6 bps for investment grade. Core European markets rallied alongside Treasuries, with 10-year German bund yields down -18 bps. Periphery spreads tightened somewhat after widening over the last several weeks.

MUNICIPAL BONDS OFFER VALUE VERSUS TREASURIES

Municipal bond yields sold off slightly last week across the curve, mainly due to outsized new issue supply and mutual fund redemptions. Short-term rates rose 4 bps and 30-year rates rose 15 bps.

The 10-year U.S. Treasury bond recently hit a four-year high of 3.13 %, but closed the week at 2.92%. Fed Chair Powell has suggested several more 50 bps rate hikes this year, and investors believe the Fed may be getting a better handle on inflation.

Heavy outflows continued across all municipal bond funds. But munis still offer value, with municipal-to-Treasury yield ratios nearing 110%. Credit quality remains strong, but substantial credit spread dispersion opportunities exist due to liquidity pressure. For those with a long-term fundamental view and cash on hand, this may be an attractive entry point for municipal credit risk. Outsized reinvestment money is expected in the next few months that should keep municipal bonds well bid – $44 billion on June 1 and $48 billion on July 1.

Dormitory State of New York (DASNY) issued $820 million Northwell Health Obligated Group revenue bonds (rated A3/A-). Demand for higher yielding tax-exempt bonds continues, and some bonds traded at a premium in the secondary market. For example, a 30-year bond with a 4.25% coupon came at a yield of 4.81%, then traded in the secondary market at 4.75%.

High yield corporate spreads widened 50 bps, the biggest move since June 2020.

In focus

Asset classes differ on odds of recession

Inflation is decelerating year-over-year for the first time since last summer, Treasuries rallied and lower-quality spreads widened further. As a result, attention seems to be pivoting away from inflation and toward recession.

With elevated volatility across markets, asset classes are signaling different risks of recession. We use models that convert current asset prices into ISM-equivalent growth readings. They presently indicate that equities discount an ISM of around 49, credit spreads around 53 and Treasuries around 63. For context, the current ISM manufacturing survey sits at 55.4, a very healthy level. Put differently, equities are implying a roughly 75% chance of a significant growth slowdown, while credit spreads imply only a 26% chance. Treasury yields, which have been rising and steepening lately, signal a near-zero chance of a sharp slowdown.

Clearly, these divergent signals cannot all be correct. Our base case remains for healthy growth this year and next, making current risk asset valuations appear increasingly attractive. High yield spreads, which currently imply a modest slowdown in economic growth, also price in a forward default rate of around 4.5%. The recent default rate has been sub-1%, and even after the recession in 2020 it peaked at 6.3%.

Even if the economy slows and defaults pick up, we believe current valuations are pricing in a more severe outcome and will likely generate positive total returns moving forward.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	2.58	-0.15	-0.14	1.85
5-year	2.87	-0.21	-0.09	1.60
10-year	2.92	-0.21	-0.02	1.41
30-year	3.08	-0.15	0.08	1.18

Source: Bloomberg L.P., 13 May 2022. **Past performance does not predict or guarantee future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	2.31	0.04	0.09	2.07
5-year	2.58	0.04	0.12	1.99
10-year	2.99	0.14	0.12	1.96
30-year	3.32	0.15	0.13	1.83

Source: Bloomberg L.P., 13 May 2022. **Past performance does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	102
30-year AAA Municipal vs Treasury	107
High Yield Municipal vs High Yield Corporate	69

Source: Bloomberg L.P., Thompson Reuters, 13 May 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 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	3.43	–	6.52	-0.72	-1.46	-10.15
High yield municipal	5.21	202[1]	9.76	-1.63	-2.83	-12.40
Short duration high yield municipal[2]	4.96	213	4.34	-0.92	-1.56	-6.41
Taxable municipal	4.23	120[3]	9.16	0.77	-1.35	-14.36
U.S. aggregate bond	3.48	50[3]	6.52	0.89	-0.23	-9.71
U.S. Treasury	2.87	–	6.51	0.92	-0.28	-8.76
U.S. government related	3.42	58[3]	5.56	0.61	-0.26	-8.75
U.S. corporate investment grade	4.38	141[3]	7.68	0.60	-0.73	-13.37
U.S. mortgage-backed securities	3.56	36[3]	5.86	1.19	0.27	-8.06
U.S. commercial mortgage-backed securities	3.81	95[3]	4.89	0.66	-0.09	-7.85
U.S. asset-backed securities	3.27	66[3]	2.28	0.34	0.36	-3.28
Preferred securities	6.02	275[3]	5.15	-0.50	-2.34	-12.44
High yield 2% issuer capped	7.62	453[3]	4.26	-1.21	-2.39	-10.39
Senior loans[4]	8.40	545	0.25	-1.63	-2.20	-2.13
Global emerging markets	6.58	366[3]	6.46	-0.36	-1.62	-14.56
Global aggregate (unhedged)	2.58	50[3]	7.16	0.30	-0.97	-12.16

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, 13 May 2022. **Past performance 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, 13 May 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 11 May 2022.

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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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