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Weekly Fixed Income Commentary

25 July 2022

Treasury yields fall as another Fed hike looms

U.S. Treasury yields fell last week and spread sectors outperformed. The yield curve remained inverted, with front-end yields supported by expectations for near-term U.S. Federal Reserve tightening, with another 75 basis point hike expected this week.

HIGHLIGHTS

- **Total returns were positive across fixed income markets, including Treasuries, agencies, taxable munis, investment grade and high yield corporates, preferreds, MBS, CMBS, ABS, loans and emerging markets.**
- **Municipal bond yields declined. New issue supply was outsized at $8.3B, with outflows of -$699M. This week's new issue supply should be light at $2.8M.**

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Watchlist

- *10-year Treasury yields declined. We expect them to remain volatile, but move modestly higher this year.*
- *Spread assets benefited from the improved economic growth outlook.*
- *Net-negative supply should provide some support to municipal bonds.*

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 remains 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 3.25%.

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

EMERGING MARKETS OFFER A POSITIVE WEEK OF RETURNS

U.S. Treasury yields fell across the curve, with the 10-year yield ending -16 basis points (bps) lower at 2.75%. The entire rally came in the week's last two sessions, after a hawkish European Central Bank meeting and weaker global economic data. Flash U.S. and European composite PMIs for July both fell sharply. They dipped below the 50-level, indicating economic contraction. The yield curve remained inverted. Front-end yields were supported by expectations for near-term Fed tightening, with another 75 bps hike expected this week.

Investment grade corporates rallied strongly, returning 1.58% for the week and outperforming similar-duration Treasuries by 55 bps. The market easily digested an elevated week of supply, with $45 billion pricing, led by money center banks. Preferreds joined the rally, gaining 2.04%, as the decision by several major banks to suspend share buybacks was greeted with enthusiasm by fixed income investors.

High yield corporates outperformed, gaining 2.48% and outperforming similar-duration Treasuries by 173 bps. Loans also gained, returning 1.50%. In both markets, B rated corporates outperformed BBs, as the recent trend of decompression moderated. In contrast to the broader trend, CCCs lagged again, as the most-stressed borrowers continue to struggle amid the uncertain economic environment. Both high yield and loan funds saw net outflows for the week, but a robust acceleration in CLO creation partially offset this dynamic, sparking a bid for loans and pushing the market higher.

Emerging markets snapped a recent streak of underperformance, returning 1.83% and outperforming similar-duration Treasuries by 77 bps. As in other markets, decompression moderated, with junk-rated sovereigns and corporates outperforming substantially. In the sovereign space, high yield spreads tightened -80 bps, versus a -35 bps rally in investment grade. Elsewhere, Italian sovereign bonds underperformed German bunds by around 15 to 20 bps after Prime Minister Draghi resigned. Ukraine announced a debt moratorium, causing short-dated bonds to fall -20 points in price.

FAVORABLE TECHNICALS BENEFIT THE MUNICIPAL BOND MARKET

The municipal market rallied along with the U.S. Treasury market last week, and both markets ended the week with solid tones. Muni new issuance is light, as is typical during the summer. Yet reinvestment money is robust, with billions dollars anticipated over the next several weeks. We expect solid demand to continue throughout the summer.

This supply/demand imbalance has caused municipals to remain rich, mainly due to strong demand for tax-exempt income. However, some institutional investors are showing heightened interest in tax-exempt bonds now that the Treasury curve is inverted, with short-term bonds yielding more than long-term bonds. Some investors expect a recession, thus long-term Treasury yields may decline further. Institutional investors are applying this same logic to the tax-exempt market, buying longer-term munis even if they look relatively rich. They believe tax-exempt rates will also move lower.

The state of Washington issued $214 million general obligation bonds (rated Aaa/AA+). Bonds continued to trade richer in the secondary market as the week progressed. The deal included 5% bonds due in 2045 yielding 3.40%. Those bonds traded in the secondary market at 3.28%. This reflects how the market strength increased as the week progressed.

The high yield municipal market saw its third consecutive week of fund inflows. High yield munis are beginning to rally in response to improving technical factors amid stabilizing U.S. Treasury yields. Tobacco and Puerto Rico bonds are leading the way, signals that liquidity and demand are strengthening. Municipal-to-Treasury ratios widened last week, but high yield muni bond yields tightened, especially short-duration.

Institutional investors are showing heightened interest in tax-exempt munis now that the Treasury curve is inverted.

In focus

Yield curve signals elevated risk of recession

After briefly dipping below zero in March and June, the U.S. Treasury yield curve has inverted more deeply and durably in July. The 2 year-10 year spread has spent 20 days below zero, as front-end yields remain at higher rates than longer-maturity bonds. A yield curve inversion has preceded each of the last six U.S. recessions going back to the 1970s, and has never sent a false recessionary signal over that period.

Bulls point to other curves, such as the 3 month-10 year or the Fed's preferred metric of solely the front-end of the curve. Both metrics remain in positive territory, which tempers the overall recessionary signal. However, forward rates show that markets expect these other curves to invert in the next three to six months as well. At that point, they too will soon imply elevated recession risks.

Taking a holistic view of the curve and its recessionary signals, our models suggest that the odds of a recession in the next 12 and 24 months are elevated, at 58% and 86%, respectively. The good news is that these models say nothing about the depth or breadth of a future recession.

Though we continue to think that downside risks to the economic outlook are elevated into 2023, we still think that a potential recession would be mild by historical standards. Consumer and business balance sheets are healthier than they have been ahead of previous recessions, and there are fewer macro imbalances to unwind.

U.S. Treasury market

Maturity	Yield	Change (%) Week	Month-to-date	Year-to-date
2-year	2.97	-0.15	0.02	2.24
5-year	2.84	-0.19	-0.2	1.58
10-year	2.75	-0.17	-0.26	1.24
30-year	2.98	-0.11	-0.21	1.07

Source: Bloomberg L.P., 22 Jul 2022. **Past performance does not predict or guarantee future results.**

Municipal market

Maturity	Yield to Worst	Change (%) Week	Month-to-date	Year-to-date
2-year	1.70	0.00	-0.25	1.46
5-year	1.94	-0.06	-0.28	1.35
10-year	2.39	-0.05	-0.33	1.36
30-year	2.99	0.01	-0.19	1.50

Source: Bloomberg L.P., 22 Jul 2022. **Past performance does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	86
30-year AAA Municipal vs Treasury	100
High Yield Municipal vs High Yield Corporate	64

Source: Bloomberg L.P., Thompson Reuters, 22 Jul 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

Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Returns (%) Week	Month-to-date	Year-to-date
Municipal	2.94	–	6.66	0.24	1.70	-7.43
High yield municipal	5.15	230[1]	10.23	0.40	2.33	-9.71
Short duration high yield municipal[2]	4.64	243	4.21	0.44	1.40	-4.29
Taxable municipal	4.18	120[3]	9.35	1.25	1.42	-12.74
U.S. aggregate bond	3.53	51[3]	6.45	1.17	1.79	-8.74
U.S. Treasury	2.97	–	6.51	1.01	1.30	-7.96
U.S. government related	3.58	62[3]	5.52	1.09	1.06	-8.21
U.S. corporate investment grade	4.43	144[3]	7.72	1.58	2.72	-12.05
U.S. mortgage-backed securities	3.54	37[3]	5.61	1.07	1.90	-7.04
U.S. commercial mortgage-backed securities	3.90	100[3]	4.86	1.07	1.28	-7.11
U.S. asset-backed securities	3.76	75[3]	2.22	0.45	0.28	-3.50
Preferred securities	6.04	246[3]	4.80	2.04	3.57	-10.76
High yield 2% issuer capped	8.08	492[3]	4.08	2.48	4.30	-10.49
Senior loans[4]	9.05	605	0.25	1.50	1.67	-2.85
Global emerging markets	7.16	421[3]	6.37	1.83	0.22	-16.96
Global aggregate (unhedged)	2.74	56[3]	7.05	1.55	0.96	-13.08

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 Jul 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, 22 Jul 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 20 Jul 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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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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