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Weekly Fixed Income Commentary

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Treasury yields rise again on prospects for a more aggressive Fed

U.S. Treasury yields rose again as inflation surprised to the upside, triggering concerns over even higher U.S. Federal Reserve rate hikes. The yield curve flattened, as the risk of recession increases in response to the more hawkish Fed.

HIGHLIGHTS

- **Preferred securities were the only major asset class to see a positive excess return.**
- **Core fixed income asset classes broadly delivered negative returns, including Treasuries, agencies, MBS, investment grade and high yield corporates, taxable munis, convertibles, and leveraged loans.**
- **Municipal bond yields increased dramatically. New issue supply was $8.8B, with outflows of -$1.4B. This week's new issue supply should be light at $1.1B.**

Anders Persson
CIO of Global Fixed Income

John Miller
Head of Municipals

Watchlist

- *10-year Treasury yields moved higher last week.*
- *Spread assets weakened amid macro uncertainty.*
- *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 the pace of long-term increases should remain relatively modest.

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.

SENIOR LOANS OUTPERFORM TREASURIES

U.S. Treasury yields moved sharply higher last week, led by the front-end. The market repriced Fed rate hike expectations after another upside inflation surprise. Core consumer prices rose 0.6% month-over-month in August, higher than the 0.3% expected. As a result, the market is now pricing an even more aggressive pace of Fed rate hikes and a higher terminal rate. Two-year Treasury yields increased 31 basis points (bps) last week, while 10-year yields rose 14 bps. That took the curve flatter, as the risk of recession increases in response to the more hawkish Fed. While front-end inflation breakevens moved higher, 10-year breakevens fell -5 bps, because tighter monetary policy will negatively impact growth and inflation in the more medium term.

Investment grade corporates weakened, returning -0.99% for the week and underperforming similar-duration Treasuries by -22 bps. Overall yields on the index reached a 12-year high at 5.14%, as interest rates broadly rose after the hot inflation data. However, investment grade spreads only widened by 1 bps. The primary market was relatively quiet, with only $19 billion of new issuance versus expectations for $25 billion, which provided a modest technical tailwind.

High yield corporates weakened, returning -2.02% and underperforming similar-duration Treasuries by -139 bps. Senior loans outperformed, returning -0.14%. Due to the volatility, the new issue market was very quiet. No new loan deals priced and only one high yield bond was issued. High yield funds saw a return of inflows at $734 million, after a streak of elevated outflows this summer. Meanwhile, loan funds saw an outflow of almost -$1 billion, but that will likely reverse in the weeks ahead, as higher rates increase the appeal of the floating-rate asset class.

Emerging markets followed the broader dynamic, returning -1.11% for the week and underperforming similar-duration Treasuries by -42 bps. The strong dollar especially weighed on local bonds, which returned -1.3%. The asset class saw elevated outflows of -$1.5 billion, which generated technical selling pressures. On the other hand, the new issue market was extremely quiet due to the market volatility, with no new deals for the week.

LIGHT MUNICIPAL BOND ISSUANCE WILL BE A WELCOME RELIEF

Municipal bond yields sold off dramatically last week. Short-term yields rose 18 basis points and long-term rates increased 11 basis points Weekly new issue supply was priced to sell and most deals cleared the market. Fund flows were negative for the sixth straight week. Light new issuance this week should be a welcome relief, helping to shore up the secondary market.

News of higher-than-expected inflation puts pressure on fixed income markets. The U.S. Treasury curve is inverted, mainly because many investors believe the Fed will eventually conquer inflation – perhaps by early 2023 – so they want to lock in long-term yields. Municipal bonds sold off last week, but the selloff was orderly. Institutional investors continue to rearrange portfolios back to their mandates. Also, there continues to be strong interest from individual investors at these high yields.

Pennsylvania Turnpike Commission issued $255 million turnpike revenue refunding bonds (rated A1/NR). The deal was priced to sell and was well received. It included 5% bonds due in 2033 that came at a yield of 3.46%. Those bonds traded at a premium of 3.43% in the secondary market.

The high yield municipal market is setting records on technicals (-$100 billion in outflows) and fundamentals ($240 billion in excess cash on municipal balance sheets). Interest rate anxiety and lack of conviction continue to roil markets, while credit quality remains strong. Attractive current market yields should drive performance long-term, but short-term volatility continue to paralyze investors.

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In focus

Inflation continues to spur the Fed

The hot August inflation report dominated market attention last week, sparking a new wave of uncertainty concerning the persistence of inflation, the associated Fed reaction and the implications for the broader macro outlook.

Core inflation rose 0.6% month-over-month, double the consensus expectation, taking the year-over-year rate to 6.3%. Headline inflation also ticked higher to 8.3% year-over-year. Especially worryingly, shelter inflation continues to grind higher, along with other measures of underlying pressures like the trimmed-mean and median indexes. We think the Fed is likely to maintain its hawkish policy and hike rates by 75 bps at its meeting this week.

The market is pricing in a significant chance of a 100 bps hike, but we do not think this is likely. Unlike earlier this year, when the Fed escalated the pace of hikes, we see improvement in some other recent inflation metrics. In particular, long-term expectations in consumer surveys and market pricing have both moved lower. That should be sufficient for the Fed to opt for a 75 bps hike.

We still think the Fed will remain aggressive over the next few meetings this year, and additional large rate hikes are possible, to take the policy rate above 4% by early next year.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	3.87	0.31	0.38	3.14
5-year	3.63	0.20	0.28	2.37
10-year	3.45	0.14	0.26	1.94
30-year	3.52	0.07	0.22	1.61

Source: Bloomberg L.P., 16 Sep 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	2.49	0.18	0.21	2.25
5-year	2.58	0.18	0.26	1.99
10-year	2.85	0.11	0.26	1.82
30-year	3.61	0.11	0.32	2.12

Source: Bloomberg L.P., 16 Sep 2022. **Past performance does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	83
30-year AAA Municipal vs Treasury	103
High Yield Municipal vs High Yield Corporate	64

Source: Bloomberg L.P., Thompson Reuters, 16 Sep 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	3.57	–	7.14	-0.69	-1.58	-10.07
High yield municipal	5.64	220[1]	10.62	-1.19	-2.80	-13.02
Short duration high yield municipal[2]	5.27	263	4.28	-0.45	-0.85	-5.46
Taxable municipal	4.80	115[3]	9.24	-1.00	-2.10	-16.63
U.S. aggregate bond	4.31	55[3]	6.33	-0.93	-1.82	-12.38
U.S. Treasury	3.76	–	6.28	-0.78	-1.62	-11.44
U.S. government related	4.34	58[3]	5.33	-0.91	-1.45	-10.88
U.S. corporate investment grade	5.14	142[3]	7.35	-0.99	-1.86	-15.80
U.S. mortgage-backed securities	4.35	53[3]	5.86	-1.10	-2.23	-11.09
U.S. commercial mortgage-backed securities	4.74	104[3]	4.74	-0.86	-1.27	-10.14
U.S. asset-backed securities	4.47	56[3]	2.20	-0.47	-0.53	-4.45
Preferred securities	6.56	234[3]	5.02	-0.50	-0.89	-12.20
High yield 2% issuer capped	8.76	489[3]	4.08	-2.02	-0.91	-12.02
Senior loans[4]	9.82	585	0.25	-0.14	-0.21	-1.38
Global emerging markets	7.37	366[3]	6.17	-1.11	-1.42	-17.05
Global aggregate (unhedged)	3.35	56[3]	6.88	-0.90	-2.06	-17.29

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, 16 Sep 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, 16 Sep 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 09 Sep 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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