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Weekly Fixed Income Commentary

30 October 2023

Treasury yields decline as markets await the Fed

The 10-year U.S. Treasury yield declined ahead of this week's U.S. Federal Reserve meeting, where officials are expected to keep policy rates steady. Similarly, the European Central Bank held steady at its meeting last week.

HIGHLIGHTS

- **Total returns were broadly positive, including Treasuries, investment grade and high yield corporates, taxable munis, MBS, preferreds and emerging markets.**
- **Senior loans lagged, with a slightly negative return.**
- **Municipal bond yields remained essentially unchanged. New issue supply was $12.3 billion and outflows totaled -$935M. This week's new issuance is estimated at only $3.4B.**

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Watchlist

- *The 10-year U.S. Treasury yield declined, and we anticipate modest declines in overall rates during the rest of 2023.*
- *Spread assets generally outperformed versus Treasuries.*
- *Increased seasonal supply should provide an attractive entry point for municipal bonds.*

INVESTMENT VIEWS

"Higher for longer" rates remains as a theme, as central banks battle to control inflation. Higher interest rates are likely to cause additional volatility.

The underlying growth outlook remains healthy thanks to strong consumer balance sheets and solid levels of business investment. This combination should keep corporate defaults low.

We favor selectively taking on risk in this environment of attractive prices and yields. Credit selection is key as we search for bonds with favorable income and solid fundamentals.

KEY RISKS

- Inflation fails to moderate as expected, weighing on asset prices.
- Policymakers tighten too rapidly, undermining the global economic expansion.
- Geopolitical flare-ups intensify: China, Russia, Turkey, Iran and Israel.

INVESTMENT GRADE AND HIGH YIELD CORPORATES REBOUND

U.S. Treasury yields stabilized somewhat last week, with the 10-year yield peaking at 5.02% on Monday before moderating over the rest of the week and ending at 4.84%. The 2-year yield also rallied, ending at 5.00%. The yield curve is approaching its least-inverted level in more than a year, at -17 basis points (bps). The European Central Bank kept rates steady at its policy meeting, after hiking at each of the previous 10 meetings. This week, the Fed is expected to keep rates steady again, though Chair Powell will likely maintain the option of hiking again in December if inflation remains uncomfortably high.

Investment grade corporates rebounded after the prior week's selloff, returning 0.78% for the week and beating similar-duration Treasuries by 15 bps. The asset class is still set for negative performance for October, down -1.50% month-to-date. Outflows continued at -$3.8 billion, though new issuance was somewhat muted. Only $8.3 billion of new supply priced last week, less than expectations of $10-$15 billion. November new issuance is expected to be in-line with historical averages at around $100 billion.

High yield corporates also rebounded, though by less than investment grade. The asset class returned 0.40% for the week, outperforming similar-duration Treasuries by 3 bps. Senior loans returned -0.12%, the third weekly selloff over the last five weeks after 17 consecutive weekly gains. Secondary market liquidity was thin for both asset classes, and outflows continued. -$942 million exited high yield funds, while -$123 million left loan funds.

Emerging markets gained, returning 0.50% for the week, though the asset class lagged similar-duration Treasuries by -4 bps. The dollar strengthened again – now ~7% stronger than the troughs in July – which has weighed on emerging markets performance. Outflows continued, though they decelerated from the recent pace. In hard currency funds, -$778 million exited, while local funds had outflows of -$755 million. New issuance was relatively light as well, with only $4.5 billion pricing for the week, heavily skewed (more than 80%) toward investment grade.

WE REMAIN FUNDAMENTALLY BULLISH ON MUNICIPAL BONDS

The municipal bond yield curve remained essentially unchanged last week, except for long yields that 4 bps higher. Outsized new issue supply was priced to sell, and deals cleared the market. Fund flows were negative for the eighth consecutive week. This week's new issue supply is undersized as investors await the results of Wednesday's Fed meeting.

All eyes are on the Fed, and virtually everyone expects rates to remain unchanged. Inflation is heading toward the Fed's 2% target, and elevated interest rates are having a cooling effect on the economy and inflation. Look for rates to be higher for longer.

All in all, muni bond yields are driven by Treasury yields. We remain fundamentally bullish on munis, while we expect volatility through the end of the year for several reasons. Muni trading volume has been heavy as investors retool portfolios. New issue supply remains outsized, yet we don't see a lot of new money entering the muni space. We believe Treasury yields and muni yields should be lower than current levels by sometime in 2024.

The high yield municipal market was relatively stable last week, despite -$300 million in fund outflows. An $878 million new deal from New York LaGuardia Delta (rated Baa3/BB+) was seven times oversubscribed, readjusted 15 bps lower from initial pricing and traded between 10 and 17 bps tighter in the secondary market. This deal speaks to the lack of supply, as the market reacts dramatically when volume is offered at new yield levels. We are tracking 11 high yield muni deals for this week at just $248 million in issuance.

Secondary market liquidity was thin for both high yield corporates and senior loans, and outflows continued.

In focus

A little less "PEPP" in the ECB's step?

After 10 straight rate hikes, the European Central Bank (ECB) held rates steady last week, while postponing decisions about its balance sheet. The ECB left markets guessing whether it will stop reinvesting principal payments from maturing securities in its flexible Pandemic Emergency Purchase Program (PEPP) or perhaps engage in partial reinvestment.

The ECB's decision to hold rates at their all-time high 4% deposit rate was widely expected after stating in September that "key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target." Eurozone headline inflation fell last month to 4.3%, but remained more than double the ECB's 2% target. We think early indicators of monetary policy slowing the broad economy support slightly dovish adjustments to the ECB's communications.

The ECB did not discuss whether (or when) it might stop reinvesting principal payments in its €1.7 trillion (about $1.8 trillion) PEPP, which began in March 2020. PEPP reinvestments are guided to continue "at least until the end of 2024." We expect the ECB will make a decision in early 2024, with a potential move to partial PEPP reinvestments or an earlier wind down.

Markets were essentially unmoved by the ECB meeting. The euro dipped slightly against the U.S. dollar, while Germany's 10-year bund was little changed.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	5.00	-0.07	-0.04	0.57
5-year	4.76	-0.10	0.15	0.76
10-year	4.84	-0.08	0.27	0.96
30-year	5.02	-0.06	0.32	1.05

Source: Bloomberg L.P., 27 Oct 2023. **Performance data shown represents past performance and does not predict or guarantee future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	3.65	-0.02	-0.01	1.05
5-year	3.49	0.00	0.08	0.97
10-year	3.59	0.00	0.14	0.96
30-year	4.57	0.04	0.23	0.99

Source: Bloomberg L.P., 27 Oct 2023. **Performance data shown represents past performance and does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	74
30-year AAA Municipal vs Treasury	91
High Yield Municipal vs High Yield Corporate	69

Source: Bloomberg L.P., Thompson Reuters, 27 Oct 2023. 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. **Performance data shown represents past performance and 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	4.49	–	6.47	-0.04	-0.89	-2.26
High yield municipal	6.44	211[1]	7.98	-0.20	-1.62	-1.62
Short duration high yield municipal[2]	6.22	268	4.44	-0.10	-0.94	1.31
Taxable municipal	5.82	88[3]	7.76	0.64	-1.75	-0.88
U.S. aggregate bond	5.58	57[3]	6.06	0.68	-1.28	-2.48
U.S. Treasury	4.96	–	5.74	0.55	-0.88	-2.39
U.S. government related	5.46	49[3]	4.99	0.44	-0.74	-0.39
U.S. corporate investment grade	6.28	128[3]	6.61	0.78	-1.50	-1.49
U.S. mortgage-backed securities	5.90	77[3]	6.46	0.86	-1.88	-4.10
U.S. commercial mortgage-backed securities	6.34	141[3]	4.32	0.38	-0.68	-0.52
U.S. asset-backed securities	5.87	79[3]	2.55	0.21	-0.06	1.93
Preferred securities	8.37	284[3]	4.91	0.03	-3.35	-0.78
High yield 2% issuer capped	9.37	437[3]	3.56	0.40	-1.46	4.33
Senior loans[4]	10.40	575	0.25	-0.12	0.03	9.94
Global emerging markets	8.36	337[3]	5.67	0.50	-1.50	-0.61
Global aggregate (unhedged)	4.32	53[3]	6.49	0.42	-0.93	-3.11

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, 27 Oct 2023. **Performance data shown represents past performance and 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, 27 Oct 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 25 Oct 2023.

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.

Important information 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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