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Weekly Fixed Income Commentary

10 June 2019

Sentiment improves, but Treasury yields fall further

U.S. Treasury yields continued declining last week, despite improved sentiment. Rates vacillated until Friday's weaker-than-expected payrolls report pushed rates lower. Market-based probabilities that the Federal Reserve (Fed) will cut rates in 2019 are near certainty.

HIGHLIGHTS

- **Among the U.S. sectors, high yield performed best, followed by preferred securities and investment grade corporates.**
- **High yield municipal credit spreads widened, improving the relative value of the asset class.**
- **The global aggregate sector posted the highest return, based on strong performance from the Pan-European region.**

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INVESTOR SENTIMENT IMPROVES, BUT YIELDS CONTINUE TO FALL

Sentiment improved last week, but Treasury rates still declined as market expectations of Fed rate cuts climbed. The week began with lower yields, as the risk off tone carried through from the previous week. 2- to 5-year maturities experienced their largest move of the week on Monday, falling 7 to 9 basis points (bps).[1] The tone shifted on Tuesday while rates rose, with the 30-year closing higher for the first time in eight trading sessions.[1] Rates vacillated until Friday's weaker-than-expected payrolls report pushed rates lower, led by the longer maturities.[1] The late drop offset the earlier increase. The 30-year finished the week nearly unchanged, while shorter maturities ended 5 to 7 bps lower.

Higher risk assets experienced strong performance, and most sectors outperformed Treasuries. In an unusual situation, rates declined, but the higher risk sectors posted the best returns.[1] High yield corporates delivered the highest total return for all U.S. sectors, with only the global aggregate sector outpacing it.[1] Among the U.S. sectors, high yield was followed by preferred securities and investment grade corporates.[1] The securitized sectors experienced the worst performance. Non-U.S. markets enjoyed strong returns.[1] The global aggregate sector posted the highest return across fixed income, based on strong performance from the Pan-European region.[1]

Market-based probabilities of a Fed rate cut in 2019 settled near certainty, with a 95% likelihood of the initial cut happening in September. Given this timeframe, 3-month T-bill rates have remained relatively high.[1] Although 3-month yields are at 2019 lows, they have only fallen by about 10 bps this year, while the 10-year is down 60 bps.[1]

Municipal bond fund flows are $38.6 billion year to date, the highest since records began in 1992.

MUNICIPAL BOND FUND FLOWS SET A YEAR-TO-DATE RECORD

The municipal market traded sideways last week, but ended with a strong tone.[1] New issue supply totaled $6.9 billion and was readily absorbed.[2] Weekly fund flows were positive for the 22nd consecutive week at $793 million.[3] Fund flows are $38.6 billion year to date, the highest since records began in 1992.[3] This week's new issue supply is expected be $10.4 billion.[2]

The fixed income market continued to rally, reflecting that most investors believe the U.S. economy is slowing. In fact, the market anticipates that the Fed will have to cut rates more than once by the end of this year. We think this also bodes well for municipal bonds. Bond prices have ticked down slightly because supply has increased. However, it appears institutional buyers are using this dip and outsized supply to invest large amounts of money. We expect this trend to continue through the summer, and see any sell-offs as buying opportunities.

Tennessee Housing Development Agency issued $200 million residential housing revenue bonds (rated Aa1/AA+).[4] The bonds are par bonds, and thus more volatile, but the tax-exempt yield made them attractive. The 10-year bonds were yielding 2.35% at par, which is approximately 120% of the 10-year Treasury yield and substantially more than conventional premium bonds.

High yield municipal bond yields are declining less than the general market, causing credit spreads to widen and improving the relative value of the asset class.[1] High yield municipal net fund flows totaled $250 million last week.[3] Nine high yield municipal bond deals are expected this week, but only one is set to carry a public rating.[2] Two non-rated deals consist of a larger charter school deal for an existing network in Florida, as well as a larger industrial development revenue bond deal to build a new plant for an existing and proven plastic bottle recycling company that supports major beverage companies.

HIGH YIELD CORPORATE BONDS LEAD THE RISK RALLY

High yield corporates bounced back after four weeks of negative returns.[1] Trade war headlines contributed to volatility, but the asset class was helped by surging equity markets, which grew increasingly confident that the Fed will cut rates this year. High yield spreads narrowed by more than 25 bps.[1] On the downside, falling oil prices continued to weigh on the energy sector, and fund outflows were in the $3 billion range for the third time in the past four weeks.[3] Higher-quality (BB) paper outperformed B and CCC rated issues.[1]

Emerging markets (EM) debt performance was broadly positive last week.[1] With the 10-year U.S. Treasury yield hovering only modestly above 2%, demand for higher-yielding assets boosted EM returns across sovereign, corporate and local rates markets.[1] Mexico faced U.S. tariff threats and a sovereign rating downgrade but saw spreads widen by just 2bps.[1] Almost all EM currencies strengthened against the U.S. dollar.

High yield spreads narrowed by more than 25 bps.

Investment grade corporates extended their winning streak. After recording gains in eight of the past ten weeks, investment grade credit is now the top-performing taxable sector for the second quarter to date.[1] Fund inflows totaled $4.8 billion, the second-highest weekly amount since early 2015.[3] In the primary market, issuers took advantage of lower interest rates and tightening credit spreads to bring nearly $22 billion to market.[2]

In focus

Convertible bonds may benefit an income portfolio

Convertible bonds are often viewed as a niche asset class, and many investors may be reluctant to invest in them directly. However, we believe convertible bonds can play a useful role in an income portfolio, particularly in periods of higher equity volatility.

As a type of hybrid security, convertible bonds offer bond-like features such as interest payments, while also providing the opportunity of owning the company's stock. These qualities may allow convertible securities to partially participate in equity market upside with a measure of risk mitigation.

Convertible bonds have performed second only to equities in terms of broad asset class returns year to date as of 31 May.[1] And convertible returns are often not as severe during market downturns. For example, the S&P 500 Index was down -6.35% in May, while the ICE BofAML U.S. Convertibles Index captured just over half that move, falling -3.28%.[5]

In addition, convertibles provide a current yield of 2.7%, which is a 30% premium to the S&P 500.[1] This yield, along with the low historical correlation between convertibles and U.S. investment grade bonds of -0.11,[6] means that convertibles can potentially help diversify an income strategy without sacrificing significant yield.

ICE BofAML U.S. Convertibles Index consists of convertible bonds traded in the U.S. dollar denominated investment grade and non-investment grade convertible securities sold into the U.S. market and publicly traded in the United States.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	1.85	-0.07	-0.07	-0.64
5-year	1.85	-0.06	-0.06	-0.66
10-year	2.08	-0.04	-0.04	-0.60
30-year	2.57	0.00	0.00	-0.44

Source: Bloomberg L.P. As of 7 Jun 2019. **Past performance is no guarantee of future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	1.32	-0.07	-0.07	-0.46
5-year	1.35	-0.07	-0.07	-0.59
10-year	1.61	-0.04	-0.04	-0.67
30-year	2.30	-0.02	-0.02	-0.72

Source: Bloomberg L.P. As of 7 Jun 2019. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	77
30-year AAA Municipal vs Treasury	89
High Yield Municipal vs High Yield Corporate	71

Source: Bloomberg L.P., Thompson Reuters. As of 7 Jun 2019. AAA municipals represented by the MMD scale. The high yield ratio equals the yield-to-worst for the Bloomberg Barclays High Yield Municipal Index divided by the yield-to-worst for the Bloomberg Barclays 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	2.04	–	5.42	0.20	0.20	4.92
High Yield Municipal	4.44	233[7]	7.94	0.22	0.22	6.34
High Yield Municipal, ex Puerto Rico	4.36	225[7]	7.74	0.16	0.16	5.93
Short Duration High Yield Municipal[8]	3.92	250	3.77	0.17	0.17	4.16
Short Duration High Yield Municipal, ex Puerto Rico[8]	3.91	249	3.68	0.15	0.15	3.92
U.S. Aggregate Bond	2.62	49[9]	5.75	0.36	0.36	5.17
U.S. Treasury	2.01	–	6.40	0.33	0.33	4.57
U.S. Government Related	2.68	66[9]	5.58	0.34	0.34	5.35
U.S. Corporate Investment Grade	3.37	127[9]	7.55	0.54	0.54	7.81
U.S. Mortgage-Backed Securities	2.80	45[9]	3.33	0.26	0.26	3.70
U.S. Commercial Mortgage-Backed Securities	2.67	72[9]	5.27	0.09	0.09	5.66
U.S. Asset-Backed Securities	2.29	39[9]	2.16	0.10	0.10	2.84
Preferred Securities	3.94	157[9]	4.53	0.55	0.55	10.78
High Yield 2% Issuer Capped	6.24	407[9]	3.43	0.91	0.91	8.47
Senior Loans[10]	6.38	452	0.25	0.13	0.13	5.33
Global Emerging Markets	5.14	310[9]	5.95	0.89	0.89	7.45
Global Aggregate (unhedged)	1.57	49[9]	7.09	1.20	1.20	4.52

7 Yield difference between the Bloomberg Barclays High Yield Municipal Index and the 20-year AAA MMD scale. **8** 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. **9** Option-adjusted spread to Treasuries. **10** 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. As of 7 Jun 2019. **Past performance is no guarantee of future results.** Unless otherwise noted, the index is Bloomberg Barclays. 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. All indices are unmanaged and unavailable for direct investment.

For more information, please visit nuveen.com.

1 Bloomberg L.P. **2** The Bond Buyer, 7 June 2019. **3** Lipper Fund Flows. **4** Market Insight, MMA Research, 5 June 2019. **5** *BofAML Global Convertibles Chartbook,* 3 June 2019. **6** Morningstar, 31 May 2019.

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.

Bloomberg Barclays Municipal Index covers the USD-denominated tax-exempt bond market. **Bloomberg Barclays High Yield Municipal Index** covers the USD-denominated, below investment grade tax-exempt bond market. **S&P Short Duration Municipal Yield Index** tracks the municipal bond market with maturities from 1 to 12 years. **Bloomberg Barclays U.S. Aggregate Bond Index** covers the U.S. investment grade fixed rate bond market. **Bloomberg Barclays U.S. Treasury Index** includes public obligations of the U.S. Treasury. **Bloomberg Barclays U.S. Government-Related Index** includes debt guaranteed, owned and sponsored by the U.S. government; it does not include debt directly issued by the U.S. government. **Bloomberg Barclays U.S. Corporate Index** is a broad-based benchmark that measures the investment grade, fixed-rate, taxable corporate bond market. **Bloomberg Barclays U.S. Mortgage-Backed Securities Index** is the MBS component of the U.S. Aggregate index and includes the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). **Bloomberg Barclays CMBS ERISA-Eligible Index** is the CMBS component of the U.S. Aggregate index and includes CMBS investment grade securities that are ERISA eligible under the underwriter's exemption. **Bloomberg Barclays Asset-Backed Securities Index** is the ABS component of the U.S. Aggregate index and includes credit and charge cards, autos and utilities. **ICE BofA Merrill Lynch U.S. All Capital Securities Index** is a subset of the BofA Merrill Lynch U.S. Corporate Index including all fixed-to-floating rate, perpetual callable and capital securities. **Bloomberg Barclays High Yield 2% Issuer Capped Index** measures the market of USD-denominated, non-investment grade bonds and limits each issue to 2% of the index. The **Credit Suisse Leveraged Loan Index** is designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market. Loans are added to the index if they qualify according to the following criteria: The highest Moody's/S&P ratings are Ba1/BBB+, only funded term loans are included, and the tenor must be at least one year. **Bloomberg Barclays Emerging Market USD Aggregate Index** is a flagship hard currency Emerging Markets debt benchmark that includes USD denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. **Bloomberg Barclays Global Aggregate Unhedged Index** measures the performance of global bonds. It includes government, securitized and corporate sectors and does not hedge currency. One **basis point** equals .01%, or 100 basis points equal 1%.

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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 advisor regarding the suitability 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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