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Weekly Fixed Income Commentary

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Treasury yields rise on a slightly more hawkish Fed

U.S. Treasury yields rose for a third consecutive week, as domestic political and geopolitical developments appeared increasingly favorable for open global trade. And rhetoric from various Federal Reserve (Fed) officials reinforced expectations for a gradual but steady path of rates hikes in 2018. A June hike is now regarded as a 90% probability, as inflation approaches the Fed's 2% target and the labor market tightens further.

HIGHLIGHTS

- **Credit-related sector performance was mixed, with preferred and high yield delivering the best returns.**
- **High yield municipal bond performance was unchanged last week, with municipal-to-Treasury ratios declining.**
- **Investment grade corporates trailed other fixed income sectors, a recurring theme this year.**

U.S. TREASURY YIELDS MARCH HIGHER

All segments of the Treasury curve experienced rising yields last week, for the third consecutive week.[1] The steady move up was methodical and all yields for maturities out to 10 years finished higher or unchanged every day.[1] There were few discernible drivers, as economic data was generally positive but not overwhelmingly strong. Fed officials have been slightly more hawkish than expected, indicating more possible future rate hikes than markets anticipated. Inflation expectations drifted consistently higher throughout the week, with the implied inflation rate in 10-year TIPS increasing every day to reach a 3-year high.[1]

The preferred securities sector was the only taxable sector to produce a positive total return last week.[1] Performance in the credit-related sectors was mixed, as preferred and high yield delivered the best returns and investment grade corporates suffered the worst performance.[1] Investment grade posted the lowest weekly total return and is now down more than -3% for the year.[1] The longer duration part of the index has dragged down performance, with the longer sub-sectors underperforming significantly.[1] The Global Aggregate Index was the second-worst performing sector as all regions posted negative total returns.[1]

Investors and Fed officials continue to focus on the flattening of the yield curve, as the difference in yield shrinks between short and long maturity Treasuries.[1] Our base case forecast does not call for a flattening to the point of inversion, where short maturity yields exceed longer maturities. However, we are paying particular attention to the evolution of the Fed's rate projections and demand for long maturity Treasuries.

Municipals sold off less than Treasuries, partially due to low new issue supply.

MUNICIPAL DEMAND REMAINS SUBSTANTIAL

Municipal bonds sold off last week.[1] New issue tax-exempt supply was $5.4 billion,[2] with negative fund flows of -$515 million.[3] This week's new issuance is expected to be a manageable $8.3 billion.[2]

Yields are at the highest level in a decade, but demand remains substantial.[1,3] Municipals have sold off less than Treasuries, partially due to low new issue supply of just $84 billion year to date.[2] Bonds removed from the system total $118 billion, leaving a net supply of -$24 billion.[2] Negative net new supply is expected to reach -$76 billion by the end of the summer.[2] This should help support municipal bond performance in the months ahead.

Montgomery Co. Higher Education and Health Authority, PA issued $492 million revenue bonds for Thomas Jefferson University (TJU) (rated A2/A+).[4] The deal was well received and the underwriters were able to lower yields on the deal upon final pricing. The insatiable demand for higher yielding tax-exempt bonds continues.

The state of California issued $2.1 billion of taxable bonds last week.[5] Taxable deals are becoming more prevalent in the municipal arena.

High yield municipal bond performance was unchanged last week, with municipal-to-Treasury ratios declining.[1] Credit spreads continued to contract.[1] High yield municipal fund flows remained positive despite negative flows for the broader municipal market.[3] The 7-week stretch of positive flows totals +$862 million.[3] We expect demand to increase, as cash balances continue to build prior to the first of three large reinvestment flows on June 1.

High yield municipal new issue supply is expected to be light this week, headed by a competitive deal for Illinois general obligation bonds and another for Delta Airlines/ Laguardia Airport.[2]

HIGH YIELD CORPORATES FINISH WITH A SMALL LOSS, BUT MARKET TONE REMAINS POSITIVE

High yield corporate bonds posted a slightly negative total return despite narrowing spreads, higher oil prices and the strongest positive fund flows since December 2016.[1,3] New high yield issuance held steady compared to the prior week.[2]

Lower-rated high yield tiers continued to outperform, with CCCs adding to their year-to-date advantage over Bs and BBs.[1] Retail, industrials and energy were the best performing high yield sectors, producing positive total returns.[1] Food & beverages, health eare and cable & satellite lagged.[1]

Investment grade corporates trailed other fixed income sectors, a recurring theme this year.[1] An early-week rally faded amid higher commodity prices, rising Treasury yields and ongoing geopolitical uncertainty.

New investment grade corporate debt issuance topped forecasts.[2] More than $37 billion in deals came to market as major global banks exited their first quarter blackout periods.[2] Issuance this week is expected to be slower.[2]

Lower-rated high yield corporate tiers continued to outperform.

The Global Aggregate Index lost ground for the week but remained in positive territory year to date.[1] Fund flows were flat for emerging markets debt, continuing a trend over the past few weeks.[3]

In focus

Tariffs unlikely to fuel inflation or sway Fed

Fears of a global trade war have eased somewhat since the announcement of new U.S. tariffs first rattled financial markets in March. Nonetheless, fixed income investors wonder whether higher taxes on certain imported goods could add to broader U.S. inflationary pressures and influence Fed rate policy.

In its latest *Beige Book* (a roundup of economic updates from the 12 regional Federal Reserve Banks), the Fed noted that recently imposed or contemplated tariffs were a “concern” and a source of “uncertainty” for economic growth.

But the notion that higher prices for certain imported goods would drive overall inflation significantly higher and/or lead to accelerated rate hikes isn’t supported by economic logic or the Fed’s policy perspective.

Tariffs are a threat to growth because they raise import prices, thereby reducing real spending. Moreover, even if price increases resulting from tariffs led to higher inflation readings, the Fed would likely regard this as transitory in nature—similar to an oil price shock. (In such a case, the inflation rate would adjust back down over time unless oil prices continued to increase). It’s highly unlikely the Fed would respond by raising rates in those circumstances.

U.S. Treasury market

		% Change		
Maturity	Yield	Week	Month-to-Date	Year-to-Date
2-year	2.46	0.10	0.19	0.57
5-year	2.80	0.13	0.24	0.59
10-year	2.96	0.13	0.22	0.56
30-year	3.15	0.12	0.17	0.41

Source: Bloomberg L.P. As of 20 Apr 2018. **Past performance is no guarantee of future results.**

Municipal market

		% Change		
Maturity	Yield to Worst	Week	Month-to-Date	Year-to-Date
2-year	1.79	0.06	0.14	0.23
5-year	2.11	0.03	0.07	0.43
10-year	2.45	0.06	0.03	0.47
30-year	3.02	0.08	0.07	0.48

Source: Bloomberg L.P. As of 20 Apr 2018. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	83
30-year AAA Municipal vs Treasury	96
High Yield Municipal vs High Yield Corporate	81

Source: Bloomberg L.P., Thompson Reuters. As of 20 Apr 2018. 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	2.75	–	5.95	-0.26	-0.10	-1.21
High Yield Municipal	4.94	204[6]	8.12	0.01	0.44	1.03
High Yield Municipal, ex Puerto Rico	4.97	207[6]	7.32	0.01	0.41	0.63
Short Duration High Yield Municipal[7]	4.76	249	3.71	0.05	0.32	1.96
Short Duration High Yield Municipal, ex Puerto Rico[7]	4.51	224	3.61	0.05	0.26	1.26
U.S. Aggregate Bond	3.29[8]	39	6.08	-0.62	-0.85	-2.30
U.S. Treasury	2.75[8]	–	6.05	-0.61	-1.01	-2.18
U.S. Government Related	3.28[8]	55	5.32	-0.57	-0.74	-1.75
U.S. Corporate Investment Grade	3.91[8]	106	7.35	-0.89	-0.92	-3.22
U.S. Mortgage-Backed Securities	3.44[8]	27	5.31	-0.44	-0.61	-1.80
U.S. Commercial Mortgage-Backed Securities	3.49[8]	66	5.36	-0.39	-0.88	-2.19
U.S. Asset-Backed Securities	2.93[8]	45	2.09	-0.06	-0.13	-0.51
Preferred Securities	3.69[8]	79	4.71	0.11	-0.11	-1.31
High Yield 2% Issuer Capped	6.11[8]	321	3.92	-0.06	1.03	0.16
Global Emerging Markets	5.17[8]	236	5.85	-0.58	-0.59	-2.05
Global Aggregate (unhedged)	1.94[8]	36	7.08	-0.71	-0.85	0.50

6 Yield difference between the Bloomberg Barclays High Yield Municipal Index and the 20-year AAA MMD scale. **7** 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. **8** Option-adjusted spread to Treasuries.

Source: Morningstar Direct, Bloomberg L.P. As of 20 Apr 2018. **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, 18 Apr 2018. **3** Lipper Fund Flows. **4** Market Insight, MMA Research, 20 Apr 2018. **5** JP Morgan Securities.

Any reference to municipal 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. **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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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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