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Weekly Fixed Income Commentary

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Focus on strengthening economy keeps 10-year Treasury yield above 3%

Improving retail sales and productivity data, as well as leading indicators, point to ongoing solid U.S. economic growth. As a result, the U.S. dollar is strengthening and 10-year U.S. Treasury yields remained above 3% for the entire trading week. The bond market stumbled in response, and the market has repriced expectations for Federal Reserve (Fed) rate hikes through 2019.

HIGHLIGHTS

- **Taxable fixed income returns were negative, with most sectors underperforming similar-duration Treasuries.**
- **Municipal credit spreads continue to contract due to a supply/demand imbalance and strong credit fundamentals.**
- **Investment grade and high yield corporate bonds stumbled amid rising interest rates.**

10-YEAR U.S. TREASURY YIELD REMAINS ABOVE 3% ALL WEEK

The 10-year Treasury yield closed above 3% every day last week for the first time since 2011.[1] There was no specific catalyst, but the largest jump occurred after Tuesday's retail sales report.[1] While April sales were as expected, the previous month's sales were revised higher. Longer maturities led the rate increase.[1] By the close of business Thursday, 10- and 30-year Treasury yields had risen more than 14 basis points for the week.[1] Fiscal concerns in Italy caused global yields to retreat on Friday.

Taxable fixed income returns were negative across the board last week and most sectors underperformed similar-duration Treasuries.[1] Although spreads were unchanged, the investment grade corporate sector was dragged down by its long duration and posted the lowest total return for any domestic sector.[1] There was no clear risk-off market sentiment last week, but concerns regarding emerging markets weighed on that sector. Global emerging markets have struggled in April and May, and have significantly lagged U.S. Treasuries. The Global Aggregate Index produced the lowest overall total return last week as both Europe and Asia were significantly negative.[1]

This week's release of the May Fed meeting minutes may provide insight into the Fed's reference to a symmetric inflation objective, concerns about a potential inverted yield curve and use of forward policy guidance. We expect Treasury yields to drift modestly higher as the Fed continues to gradually increase policy rates. We believe stable inflation and continued strength in the labor markets will support the Fed's ongoing tightening of monetary policy, which should not derail U.S. growth.

High yield municipal credit spreads have potential for further compression.

FURTHER MUNICIPAL CREDIT SPREAD COMPRESSION IS LIKELY

The municipal market sold off last week.[1] New issue supply was outsized at $10.1 billion, and some new deals broke to cheaper levels by the end of the week.[2] Fund flows were positive at $207 million.[3] This week's new issue supply is expected to be $6.5 billion and should be well received.[2] The new issue calendar should be very light this summer.[2]

Fixed income yields rose in general last week.[1] Investors see the U.S. economy improving, which would require higher interest rates. Municipal bonds are not immune, although light supply and solid demand have provided support. While municipal supply remains thin, municipals are expensive versus U.S. Treasuries and buyers are not eager to invest cash.[1]

The Chicago Board of Education issued $561 million unlimited tax general obligation refunding bonds (rated NR/B; some maturities insured by Assured Guaranty rated AA).[4] The deal was so well received that the issuer doubled the size of the original offering and lowered yields. This demonstrates the municipal market's appetite for high yield tax-exempt bonds.

Municipal credit spreads continue to contract due to a supply/demand imbalance and strong credit fundamentals.[1] Spreads remain roughly 100 basis points higher than the all-time lows reached in 1997 and 2007, suggesting there is plenty of room for further compression.[1]

High yield municipal fund inflows totaled $416 million last week, with $636 million of the $1.7 billion year to date total coming in the last two weeks.[3] New issue supply is expected to be light this week.[2] Investors will increasingly need to lean on the secondary market and their market access to find bonds. Credit research remains highly critical in this environment.

High yield municipals remain attractive based on long-term averages for credit spreads and the potential for further compression.

CORPORATE BONDS STRUGGLE IN THE FACE OF RISING TREASURY YIELDS

Investment grade and high yield corporate bonds stumbled amid rising interest rates last week.[1] Both 2- and 10-year U.S. Treasury yields hit multi-year highs.[1] Investment grade spreads held firm, however, despite a series of unsettling geopolitical headlines and robust primary supply.[1]

New issuance of $32 billion was in line with expectations last week.[2] This week, $25 billion to $30 billion of deals are anticipated.[2] Demand for investment grade debt was strong, with a fresh source of interest emerging from Asian insurers looking to buy 7-10 year paper.[3]

High yield spreads widened slightly.[1] Last week's $540 million in redemptions—mostly from actively managed accounts—brought the year-to-date total to more than $15 billion.[3] On a sector basis, only broadcasting, diversified media and retail posted positive returns for the week.[1] From a quality perspective, CCCs barely eked out a gain but still outperformed Bs and the more interest rate sensitive BBs.[1]

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Emerging market debt also lost ground, hurt by unstable trading conditions and continued dollar strength.[1] New issuance slowed significantly in this challenging environment.[2] Outflows for both hard and local currency funds were modest.[3]

In focus

Declining supply affects preferred securities

Reduced supply has been an important dynamic of the preferred securities market, as issuance has declined in recent years. A main reason for the decrease is that banks no longer need to raise additional capital.

In the past, banks proactively issued common stock and preferred securities to meet regulatory capital requirements. As asset bases declined, U.S. banks found themselves with more preferred securities outstanding than needed to meet requirements.

Declining issuance has continued in 2018, as U.S. banks call outstanding preferred securities. April and May saw significant call activity in the $25 par market, with more than $9 billion in calls being announced. These calls included deals that have been callable since 2013 and 2015, but are just now being redeemed.

As a result, the $25 par preferred market has experienced negative net issuance of approximately $12.7 billion in 2018 through May 4.[5]

Preferred securities market valuations still favor $1000 par value securities. The U.S. $25 par market has an average option-adjust spread (OAS) of -36 basis points as of 30 Apr, compared to the $1000 par denomination with an OAS of +209 basis points.[6]

U.S. Treasury market

		% Change		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	2.55	0.01	0.06	0.66
5-year	2.89	0.05	0.09	0.68
10-year	3.06	0.09	0.10	0.65
30-year	3.20	0.09	0.07	0.46

Source: Bloomberg L.P. As of 18 May 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	1.85	0.00	-0.02	0.29
5-year	2.08	0.03	-0.11	0.40
10-year	2.55	0.11	0.04	0.57
30-year	3.07	0.12	-0.04	0.53

Source: Bloomberg L.P. As of 18 May 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	78

Source: Bloomberg L.P., Thompson Reuters. As of 18 May 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	2.80	–	6.07	-0.38	0.30	-1.17
High Yield Municipal	4.93	197[7]	8.02	-0.30	0.76	1.80
High Yield Municipal, ex Puerto Rico	4.79	183[7]	7.25	-0.29	0.65	1.29
Short Duration High Yield Municipal[8]	4.75	243	3.71	-0.07	0.44	2.60
Short Duration High Yield Municipal, ex Puerto Rico[8]	4.51	219	3.61	-0.11	0.42	1.85
U.S. Aggregate Bond	3.39	41[9]	6.10	-0.46	-0.55	-2.73
U.S. Treasury	2.85	–	6.04	-0.40	-0.52	-2.49
U.S. Government Related	3.41	59[9]	5.27	-0.48	-0.55	-2.33
U.S. Corporate Investment Grade	4.04	109[9]	7.25	-0.60	-0.72	-3.92
U.S. Mortgage-Backed Securities	3.55	28[9]	5.48	-0.43	-0.46	-2.14
U.S. Commercial Mortgage-Backed Securities	3.55	62[9]	5.32	-0.28	-0.28	-2.27
U.S. Asset-Backed Securities	2.97	40[9]	2.07	-0.03	0.07	-0.35
Preferred Securities	4.39	115[9]	4.76	-0.23	0.02	-1.67
High Yield 2% Issuer Capped	6.35	337[9]	3.99	-0.19	0.01	-0.21
Global Emerging Markets	5.59	268[9]	5.76	-0.67	-1.41	-3.85
Global Aggregate (unhedged)	2.05	40[9]	7.05	-1.09	-1.57	-1.83

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.

Source: Morningstar Direct, Bloomberg L.P. As of 18 May 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, 16 May 2018. **3** Lipper Fund Flows. **4** Market Insight, MMA Research, 18 May 2018. **5** Morgan Stanley. **6** Based on the ICE BofA Merrill Lynch U.S. All Capital Securities Index.

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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