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Weekly Fixed Income Commentary

05 December 2022

Treasury yields drop on dovish Fed rhetoric

U.S. Treasury yields fell sharply after U.S. Federal Reserve Chair Powell stated that he did not want to "overtighten," supporting fixed income returns. Separately, economic data was mixed.

HIGHLIGHTS

- **Total returns were positive for Treasuries, agencies, investment grade and high yield corporates, taxable munis, MBS, ABS, preferreds, senior loans and emerging markets.**
- **Municipal bond yields declined further. New issue supply was muted at $1.1B, with outflows of -$1.4B. This week's new issuance should be $7.4B.**

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Watchlist

- *U.S. Treasury yields fell across maturities.*
- *Spread assets appreciated.*
- *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 have risen 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.

INVESTMENT GRADE CORPORATES CONTINUE STRONG PERFORMANCE

U.S. Treasury yields fell sharply across the curve after Fed Chair Powell leaned dovish in a speech on Wednesday. Powell said he did not want to "overtighten," which will likely signal more caution around rate hikes moving forward. A downshift in the magnitude of hikes, to 50 bps, is likely at the meeting this month. 10-year Treasury yields fell -19 bps. Separately, economic data was mixed. The ISM manufacturing survey fell to 49.0, the first sub-50 reading since May 2020. However, the labor market continues to expand strongly, and wage growth was revised higher for the last few months. This suggests there is still a long way to go before inflation fully moderates back to the Fed's 2% target.

Investment grade bonds continued their recent strong performance, returning 1.72% for the week, as the rally in rates helped longer-duration asset classes. Spreads widened slightly, however, and investment grade corporates therefore lagged similar-duration Treasuries by -1 bps. After several weeks of inflows, the trend reversed again, with -$3.9 billion leaving the asset class. New supply was healthy, with 20 issuers bringing around $22.5 billion of new deals, though the pace is likely to slow into year-end.

High yield corporates performed similarly, returning 0.94% while underperforming similar-duration Treasuries by -5 bps. As in investment grade, outflows resurfaced, with -$1.7 billion leaving the high yield bond market. Loans gained 0.15%, despite a -$880 million outflow for the week. Both asset classes were quiet in the primary market, though issuers are likely to re-test the market in coming weeks, given the strong tone.

Emerging markets gained again, returning 2.19% for the week and outperforming similar-duration Treasuries by 71 bps. With the dovish Fed rhetoric helping rates broadly, the dollar also continued to soften. It is now -8.4% down from its peak in September, which is providing a healthy tailwind for emerging markets sovereigns and corporates. In both markets, high yield names outperformed investment grade. Hard currency funds also saw their third consecutive inflow, totaling $580 million, providing a further support for the market.

THE BACKDROP FOR MUNI BONDS IS POSITIVE

The municipal bond market rallied strongly last week, with the 10-year yield declining 25 bps. Weekly new issue supply was muted and fund flows remained negative.

Fed Chair Jerome Powell indicated that short-term rate increases may be able to moderate as the Fed makes progress on curtailing inflation. Fixed income in general rallied on this news, as bond investors believe 2023 should be a good year for fixed income markets.

The backdrop for munis is very positive for several reasons. Rates in general are substantially higher compared to the beginning of the year, attracting new investors to the asset class. Also, new issue supply has been muted and demand should be strong for several weeks as billions of dollars return to the municipal market via coupons being paid on 01 December and 01 January. These funds will need to be reinvested.

The Commonwealth of Massachusetts issued $500 million of general obligation bonds (rated Aa1/AA). The deal was well-received and bonds traded at a premium in the secondary market. For example, 5% coupon bonds due in 2045 came at a yield of 3.78% and traded later in the secondary market at 3.65%.

The high yield municipal market also continues to rally as investor demand for current market yield strengthens and liquidity normalization allows bond pricing to begin realigning with fundamental values. Latent tax-loss selling is keeping headline net fund flows negative. But December reinvestment cash flows should boost demand to net positive and in turn strengthen crossover demand. The State of California is currently operating a Dutch auction tender transaction for its tobacco securitization bonds. A strong result will likely cause downward pressure on overall high yield municipal credit spreads.

Billions of dollars in December and January coupon payments should boost municipal bond demand.

In focus

Muni market rebounds in November

After their worst start to a year since 1981, municipal bonds came roaring back in November. The Bloomberg Municipal Bond Index returned 4.68%, the largest monthly return since 1986.

Amid a broader shift toward lower interest rate expectations, municipals outperformed on strong fundamentals, attractive yields, low issuance and reignited investor interest.

The first weekly inflow since August occurred in mid-November. While open-end fund outflows have continued at -$3.4 million per week over the past four weeks, municipal exchange-traded funds showed inflows of $1.4 million per week during this time frame. Issuance was down 44% compared to last November. As a result, muni market technicals improved meaningfully.

Municipal yields are significantly higher relative to the past few years. The index currently yields 3.47% after backing off its high of 4.22% on 28 October. This is still 1.26% higher than the average yield of the index over the past decade, presenting an attractive income opportunity.

Municipals are well-positioned heading into 2023, but tax-loss harvesting and broader macro trends should continue to influence performance. However, November's strong performance indicates clear investor interest for municipal debt.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	November 2022	Year-to-date
2-year	4.27	-0.18	-0.17	3.54
5-year	3.65	-0.21	-0.49	2.39
10-year	3.49	-0.19	-0.44	1.98
30-year	3.55	-0.19	-0.43	1.65

Source: Bloomberg L.P., 02 Dec 2022. **Past performance does not predict or guarantee future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	November 2022	Year-to-date
2-year	2.43	-0.22	-0.75	2.19
5-year	2.53	-0.20	-0.71	1.94
10-year	2.61	-0.25	-0.78	1.58
30-year	3.48	-0.11	-0.64	1.99

Source: Bloomberg L.P., 02 Dec 2022. **Past performance does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	71
30-year AAA Municipal vs Treasury	93
High Yield Municipal vs High Yield Corporate	68

Source: Bloomberg L.P., Thompson Reuters, 02 Dec 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	November 2022	Year-to-date
Municipal	3.47	–	6.19	1.09	4.68	-8.34
High yield municipal	5.71	244[1]	7.74	1.58	5.82	-12.13
Short duration high yield municipal[2]	5.40	283	4.28	1.04	2.76	-5.91
Taxable municipal	4.94	122[3]	8.36	2.03	4.50	-16.18
U.S. aggregate bond	4.39	50[3]	6.31	1.54	3.68	-11.44
U.S. Treasury	3.89	–	6.33	1.52	2.68	-10.95
U.S. government related	4.50	58[3]	5.41	1.46	3.16	-9.96
U.S. corporate investment grade	5.12	130[3]	7.36	1.72	5.18	-13.98
U.S. mortgage-backed securities	4.39	44[3]	5.68	1.43	4.08	-10.21
U.S. commercial mortgage-backed securities	5.06	124[3]	4.67	1.34	2.63	-10.13
U.S. asset-backed securities	5.21	100[3]	2.90	0.72	0.99	-4.52
Preferred securities	7.19	261[3]	4.90	1.20	3.62	-13.03
High yield 2% issuer capped	8.40	440[3]	3.84	0.94	2.16	-9.81
Senior loans[4]	10.44	640	0.25	0.15	1.11	-1.29
Global emerging markets	7.37	354[3]	6.22	2.19	6.63	-14.89
Global aggregate (unhedged)	3.42	52[3]	6.89	1.60	4.71	-15.13

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, 02 Dec 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, 02 Dec 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 30 Nov 2022.

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.

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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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