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Weekly Fixed Income Commentary

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Hawkish Fed rhetoric boosts Treasury yields

U.S. Treasury yields rose after hawkish comments from U.S. Federal Reserve officials. The Dallas Fed President signaled support for additional rate hikes as soon as June, while most other officials support a pause. Chair Powell declined to repeat this hawkish language, but pushed back against market pricing for rate cuts later this year.

HIGHLIGHTS

- **MBS, ABS, investment grade and high yield corporates and emerging markets all had negative returns, but outperformed Treasuries.**
- **Preferred securities led gains, while senior loans also rallied.**
- **Municipal bond yields rose substantially. New issue supply was $8.5B with outflows of -$187M. This week's new issuance is expected to be $5.8B.**

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Watchlist

- *U.S. Treasury yields rose significantly.*
- *Spread assets gained relative to Treasuries.*
- *Increased seasonal supply should provide an attractive entry point for municipal bonds.*

INVESTMENT VIEWS

"Higher for longer" remains as a theme, as the Fed battles 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 businesses investment. This combination should keep corporate defaults low.

Treasury yields are likely to fall slightly this year, and we expect the 10-year Treasury yield to end 2023 around 3.25%.

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: China, Russia, Turkey, Iran.

INVESTMENT GRADE CORPORATES SEE HIGHEST INFLOWS IN SIX WEEKS

U.S. Treasury yields increased across maturities last week. 10-year yields ended 21 basis points (bps) higher at 3.68%, while 2-year yields rose 28 bps. The moves were mostly driven by hawkish rhetoric from Fed officials. Dallas Fed President Logan signaled that she may support additional rate hikes as soon as June. Most other Fed officials suggested they support a pause. Chair Powell declined to repeat this hawkish language, but continued to push back against market pricing for rate cuts later this year. As a result, markets are pricing in a 17% chance of a hike next month and 45 bps of rate cuts over the second half of the year, down from 70 bps of cuts priced before the Fed speeches.

Investment grade corporates sold off alongside the move in Treasuries, returning -1.47% for the week. However, spreads tightened and the asset class outperformed similar-duration Treasuries by 12 bps. Inflows were sizable, with $4.2 billion entering the asset class, the most in six weeks. That helped the market digest a surprisingly heavy week of new issuance, led by the third-largest deal of all time: a $31 billion bond deal from Pfizer to finance the acquisition of Seagan. Overall, new issue supply was around $61 billion and concessions were around 13 bps on average.

High yield corporates returned -0.43%, but outperformed similar-duration Treasuries by 51 bps. Senior loans returned 0.01%. Lower-quality market segments outperformed, helped by their generally shorter duration profile. High yield and loan funds had outflows of -$1.2 billion and -$954 million, respectively, while new issuance in the two markets totaled $4.2 billion and $1.2 billion, respectively. A few deals had to revise pricing wider to induce enough demand to be completed, as investors are still discriminating when it comes to credit quality.

Emerging markets also weakened, returning -1.13% but beating similar-duration Treasuries by 31 bps. In the hard currency sovereign space, investment grade spreads tightened -7 bps, while high yield spreads narrowed only -1 bps. A few idiosyncratic dynamics dragged on the high yield segment, as Turkey (-9 points in price) and Ecuador (-5 points) both underperformed due to local politics. Hard currency funds had their fourteenth consecutive week of outflows at -$857 million. Across emerging markets, there was more than $12 billion of new issuance, though concessions were relatively narrow at around 10 to 15 bps.

MUNICIPAL BONDS SELL OFF DUE TO OUTSIZED NEW SUPPLY

Municipal bond yields rose substantially last week, due primarily to outsized new issuance. Short-term yields rose 36 bps, while longer-term rates increased 16 bps. Underwriters struggled to get new deals sold, and fund flows were negative for the fourteenth consecutive week.

It's good news/bad news for fixed income markets. First the bad news: Markets are skittish due to uncertainty surrounding the U.S. debt ceiling, the potential that the Fed could raise rates again in June, and the billions of dollars of bonds being force-liquidated from the portfolios of failed banks. In addition, municipal bond new issuance has been outsized over the last few weeks.

We think the good news should overcome the bad: More than $105 billion of muni reinvestment money is expected over the next three months. Also, inflation is clearly falling. If the Fed continues to raise short-term rates, it would be because inflation is not falling fast enough.

Clark Country, Nevada, issued $200 million highway revenue bonds (rated AA3/AA-). The deal included 5% coupon bonds due in 2033 that came at a yield of 2.65%. Those bonds traded in the secondary market at 2.88%, demonstrating the dramatic market sell off last week.

High yield municipal credit spreads contracted last week. High yield muni yields increased 13 bps on average versus 18 bps for high grades. New issuance is expected to be light again this week. After last week's yield adjustments, there should be attractive opportunities in the secondary market. High yield municipal bond fund flows turned slightly negative last week, but large June 1 cash flows are expected to bolster demand.

Investment grade corporates sold off, but spreads tightened and the asset class outperformed similar-duration Treasuries.

In focus

Emerging markets debt poised to rebound

After struggling in 2022, emerging markets debt has delivered positive returns this year, aided by several tailwinds. We believe an allocation to this dynamic and often-overlooked asset class merits consideration for long-term, diversified investors.

EMD has benefited from the elimination of China's zero-Covid policies (given the country's economic clout) and from a slowdown in the U.S. dollar's 2022 rally fueled by aggressive Fed monetary policy. We expect the Fed to keep rates elevated for some time due to persistently high levels of inflation, but even a pause in tightening policy would help weaken the greenback, making it easier for EM countries to service and pay off dollar-denominated debt.

EMD yields are attractive. Based on the JPM EMBI-GD Index, EM hard currency sovereigns (+8.7% yield) offer similar payouts to those on U.S. high yield bonds (+8.9%) but consist of 52% investment grade bonds based on market capitalization. In EM high yield, issues rated B (+11.3%) and BB (+7.4%) provide yields in line with, or greater than, their U.S. counterparts.

Looking ahead, the International Monetary Fund projects that EM economic growth will easily surpass GDP expansion in advanced economies this year and next. Many EM central banks are in the position to begin cutting rates, and the ongoing post-Covid reopening across the broad EM sphere should spur demand.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	4.27	0.28	0.26	-0.16
5-year	3.73	0.29	0.25	-0.27
10-year	3.68	0.21	0.25	-0.20
30-year	3.93	0.14	0.25	-0.04

Source: Bloomberg L.P., 19 May 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	3.05	0.36	0.36	0.45
5-year	2.65	0.32	0.27	0.13
10-year	2.55	0.24	0.20	-0.08
30-year	3.52	0.16	0.13	-0.06

Source: Bloomberg L.P., 19 May 2023. **Performance data shown represents past performance and does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	69
30-year AAA Municipal vs Treasury	89
High Yield Municipal vs High Yield Corporate	66

Source: Bloomberg L.P., Thompson Reuters, 19 May 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	3.59	–	6.10	-1.18	-0.78	1.75
High yield municipal	5.81	251[1]	7.64	-1.23	-0.83	2.47
Short duration high yield municipal[2]	5.45	292	3.90	-0.64	-0.23	2.42
Taxable municipal	4.97	104[3]	8.16	-1.85	-2.20	4.16
U.S. aggregate bond	4.62	57[3]	6.36	-1.37	-1.65	1.88
U.S. Treasury	4.04	–	6.22	-1.40	-1.50	2.00
U.S. government related	4.61	54[3]	5.31	-1.12	-1.13	2.53
U.S. corporate investment grade	5.43	143[3]	7.11	-1.47	-2.23	1.97
U.S. mortgage-backed securities	4.71	62[3]	6.26	-1.32	-1.51	1.50
U.S. commercial mortgage-backed securities	5.37	139[3]	4.50	-1.13	-0.93	1.73
U.S. asset-backed securities	5.13	81[3]	2.81	-0.64	-0.43	1.92
Preferred securities	7.57	284[3]	4.64	0.77	-2.43	0.54
High yield 2% issuer capped	8.87	479[3]	3.61	-0.43	-0.85	3.72
Senior loans[4]	10.15	619	0.25	0.01	-0.07	4.01
Global emerging markets	7.56	356[3]	6.16	-1.13	-1.07	1.45
Global aggregate (unhedged)	3.68	55[3]	6.79	-1.51	-1.81	1.58

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, 19 May 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, 19 May 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 17 May 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.