NUVEEN ASSET MANAGEMENT

Supply Boost Further Steepens the Treasury Yield Curve

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Weekly Fixed Income Commentary

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Supply boost further steepens the Treasury yield curve

Longer maturity Treasury yields increased and shorter maturity rates fell again last week, as increases in Treasury auction sizes were much larger than expected. The yield curve steepened considerably as a result. Market-based expectations reflect the fed funds rate actually falling below zero late in 2020.

HIGHLIGHTS

- **Emerging markets delivered the highest weekly returns, followed by high yield corporates and senior loans.**
- **High-grade municipal bonds rallied, while the high-yield municipal sector continues to lag.**
- **The global aggregate experienced a negative total return and lagged U.S. markets, as the European region sharply underperformed.**


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INCREASED TREASURY SUPPLY DRIVES YIELDS HIGHER

Longer maturity Treasury yields increased and shorter maturity rates fell again last week.[1] The Treasury announced its refunding schedule mid-week, and the increases in auction sizes were much larger than expected. The jump in supply will be especially large for longer maturities, including the new 20-year Treasury. This announcement came at a time when the Federal Reserve (Fed) is gradually decreasing the amount of Treasuries it purchases each day. So, with expectations of more issuance and less buying support from the Fed, the Treasury yield curve steepened considerably.[1]

Risk assets fared well again last week, despite record-setting deterioration in U.S. economic data. All U.S. sectors except investment grade corporates posted higher returns than Treasuries.[1] The highest risk sectors enjoyed the best performance. Emerging markets delivered the highest returns, followed by high yield corporates and senior loans.[1] While total returns for these sectors are still negative for the year, the second quarter has been positive so far.[1] The investment grade corporate sector was dragged down by heavy issuance and a longer duration. Spreads widened and the sector suffered a negative total return, well behind Treasuries.[1] Likewise, the global aggregate sector experienced a negative total return and lagged U.S. markets, as the European region sharply underperformed.[1]

Short rates continue to be anchored, as the Fed has policy rates pegged at the zero bound. Last week, markets began pricing in the possibility of negative policy rates. Market-based expectations reflect the fed funds rate falling below zero late in 2020.

High yield municipal credit spreads are generally widening without regard for underlying security features.

HIGH GRADE MUNICIPALS GRIND RICHER

High-grade municipal bonds rallied last week, while long Treasury yields drifted higher.[1] New issuance of $5 billion was priced to sell and well received.[2] Fund flows were negative at -$408 million.[3] This week's new issue calendar is $8.1 billion ($3.4 billion taxable).[2]

Fixed income in general has a good tone, as inflation is muted the Fed has vowed to keep short-term rates near zero for as long as necessary. However, while high *grade* municipal bonds continue to grind richer, the high *yield* sector lags. In fact, certain BBB tax-exempt bonds are trading with higher yields than BBB taxable corporate bonds.[4]

Why the relative underperformance? The municipal market is less efficient than corporates, and most bond dealers don't want more tax-exempt inventory risk right now. Dealers point out that tax-exempt high yield looks compelling, yet the bonds continue to lag. However, the June 1 reinvestment is scheduled to be "massive" at $40 billion, totaling 43% of the entire new issue calendar of $92 billion year to date.[2,5] This may be the catalyst necessary for high yield tax-exempt municipals to compress.

New York Metropolitan Transit Authority issued bonds originally slated at $672 million with a maximum 30-year yield of 5.15% (rated A2/A-).[5] Strong demand allowed underwriters to increase the deal to $1.12 billion and lower the 30-year yield to 5.08%. Secondary market demand was also very strong.

The dislocation in the high yield municipal market continues. Fund flows remained negative as credit uncertainty prevailed.[3] Credit spreads widened more for short-duration high yield because the curve has steepened and spreads have widened, making many shorter credits less attractive.[1] Credit spreads are generally widening without regard for underlying security features designed to support debt service during revenue disruptions. The state of Illinois is not helping market sentiment by trying to rush a $2 billion deal to market, only to postpone it two weeks in a row.[4]

EM DEBT LEADS, WHILE HIGH YIELD CREDIT BEATS INVESTMENT GRADE

Emerging markets (EM) debt was the top-performing fixed income asset class for the second consecutive week.[1] Despite moderate fund outflows, substantial new issuance was well-absorbed last week, and EM spreads tightened by 115 bps.[1] Extremely easy monetary conditions prevailed worldwide, with central bank bond purchases supporting pockets of risk. A continued recovery in crude oil prices helped Colombia, Mexico, Oman and oil-producing nations in sub-Saharan Africa outperform.

High yield corporates posted gains for the second week in a row and fifth of the last seven.[1] Among fixed income asset classes, high yield now trails only preferred securities for the second quarter to date, with a total return exceeding 5%.[1] Although sectors such as energy, retail, and gaming and leisure have seen a number of bankruptcies, recent corporate earnings reports for those sectors have generally been better than expected. Last week's new issuance (about $10 billion) was dominated by higher-quality names within the high yield space.[2]

New investment grade issuance is 98% ahead of last year's pace year to date.

Investment grade corporate bonds were unable to rebound from the previous week's decline.[1] While fund flows improved to $5.7 billion, demand was dwarfed by the $91.4 billion in primary supply that came to market last week.[2,3] The majority of new deals were in BBB credits and in the middle of the curve. Year to date, new investment grade issuance is 98% ahead of last year's pace.[2]

In focus

Muni defaults: depression, recession and pandemic

U.S. government shutdown orders to curb the spread of the coronavirus have led to a collapse in many economic sectors. How do municipal defaults during past crises compare to today?

The Great Depression. From 1929 to 1937, the principal amount of bonds defaulting equaled about 7% of the average amount of debt outstanding. Of the 48 cities with populations over 25,000 that defaulted, all were out of default by 1938. Permanent losses totaled about $100 million, or 0.5% of the amount of debt outstanding.[6]

The Great Recession. Since July 2013, S&P has maintained a separate index for defaulted bonds, which have subsequently been excluded from the main S&P Municipal Bond Index. During that initial month, the par value of bonds in default equaled 0.5% of the combined value of both the main and the defaulted bond index. By August 2015, that ratio had fallen to 0.3%.[7]

Pandemic. As of April 2020, the par amount of bonds in the S&P defaulted bond index was just $21.0 billion, of which $16.1 billion was attributable to Puerto Rico issuers. By comparison, the S&P Municipal Bond Index held bonds with a par value of $2.321 trillion.[7]

Looking ahead. Fortunately, the economy has had time to strengthen significantly since the last recession, and most governments have benefited from that economic strength.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	0.16	-0.03	-0.04	-1.41
5-year	0.34	-0.02	-0.03	-1.36
10-year	0.69	0.07	0.05	-1.23
30-year	1.39	0.14	0.10	-1.01

Source: Bloomberg L.P. As of 8 May 2020. **Past performance is no guarantee of future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	0.63	-0.24	-0.28	-0.41
5-year	0.87	-0.17	-0.22	-0.22
10-year	1.16	-0.19	-0.30	-0.28
30-year	1.97	-0.19	-0.31	-0.12

Source: Bloomberg L.P. As of 8 May 2020. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	168
30-year AAA Municipal vs Treasury	142
High Yield Municipal vs High Yield Corporate	71

Source: Bloomberg L.P., Thompson Reuters. As of 8 May 2020. 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	2.02	–	5.92	0.78	1.11	-0.79
High Yield Municipal	5.57	381[8]	10.72	0.51	1.08	-9.05
Short Duration High Yield Municipal[9]	4.96	398	4.28	0.02	0.24	-4.65
Taxable Municipal	2.86	205[10]	9.82	-0.66	-0.61	2.18
U.S. Aggregate Bond	1.36	77[10]	5.75	-0.33	-0.44	4.52
U.S. Treasury	0.53	–	7.20	-0.30	-0.37	8.48
U.S. Government Related	1.48	100[10]	5.82	0.22	0.20	1.60
U.S. Corporate Investment Grade	2.79	212[10]	8.25	-1.04	-1.37	0.03
U.S. Mortgage-Backed Securities	1.07	41[10]	1.44	0.11	0.11	3.59
U.S. Commercial Mortgage-Backed Securities	2.07	163[10]	5.33	0.50	0.50	2.93
U.S. Asset-Backed Securities	1.63	143[10]	2.11	0.36	0.41	1.54
Preferred Securities	4.40	316[10]	4.65	0.47	0.15	-4.48
High Yield 2% Issuer Capped	7.89	725[10]	3.87	0.82	0.64	-8.14
Senior Loans[11]	8.66	836	0.25	0.68	0.55	-8.97
Global Emerging Markets	5.68	508[10]	6.28	0.91	0.95	-6.25
Global Aggregate (unhedged)	1.05	71[10]	7.19	-0.79	-0.84	0.78

8 Yield difference between the Bloomberg Barclays High Yield Municipal Index and the 20-year AAA MMD scale. **9** 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. **10** Option-adjusted spread to Treasuries. **11** 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 8 May 2020. **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, 8 May 2020. **3** Lipper Fund Flows. **4** JPMorgan. **5** Market Insight, MMA Research, 6 May 2020. **6** National Bureau of Economic Research. **7** Standard & Poor's.

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 Taxable Municipal Bond Index** is a rules-based, market-value-weighted index engineered for the long-term taxable bond market. **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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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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