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Weekly Fixed Income Commentary

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Treasury yields mixed due to global trade and the Fed

U.S. Treasury yields closed mixed last week, with the 2-year ending higher and longer maturities unchanged or slightly lower. But the weekly change masked intra-week volatility. Friday saw the biggest shift, in response to China's announcement of retaliatory tariffs. The Federal Reserve (Fed) meeting minutes illuminated diverse opinions on rate policy, and Chair Powell sought to reassure the markets.

HIGHLIGHTS

- **The high yield corporate market bounced back with the highest return, followed by investment grade corporates and preferred securities.**
- **High yield municipal bond yields have decreased over the last two weeks, more than high grades.**
- **The global aggregate sector posted a slightly positive total return, but underperformed the broader U.S. market.**

Bill Martin
Head of Global Fixed Income

John Miller
Head of Municipals

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TREASURY YIELDS CLOSE MIXED

U.S. Treasury yields finished last week mixed, as the 2-year closed higher and all longer maturities unchanged or slightly lower.[1] Unlike the volatile last three weeks, most yields were only modestly different week over week.[1] However, the weekly changes masked considerable volatility within the week. For example, the 5-year Treasury finished nearly unchanged for the week, but averaged more than a 5 basis points (bps) change each day.[1] Yields fell on Tuesday and Friday, more than offsetting rising rates the other days for longer maturities.[1] The largest change occurred Friday, when rates fell in response to China's announcement of retaliatory tariffs.[1] The 2-year Treasury yield changed most, finishing more than 5 bps higher as markets priced in fewer future Fed rate cuts.[1]

The higher-risk sectors enjoyed positive returns last week, while the Treasury market ended negative.[1] The high yield market bounced back with the highest return, followed by investment grade corporates and preferred securities.[1] The government-related sector and mortgage-backed securities posted the weakest returns, underperforming similar-duration Treasuries.[1] The global aggregate sector posted a slightly positive total return, outperforming similar-duration Treasuries, but underperforming the broader U.S. market.[1]

Last week's Fed meeting minutes held few surprises, but illuminated the diverse opinions regarding appropriate rate policy. While most participants favored the 25 bps rate cut, some advocated for a larger 50 bps cut, while others preferred no change. Chair Powell's speech on Friday reassured that the Fed would act as appropriate to sustain the expansion and acknowledged significant risks to the economy.

High yield municipal credit spreads have contracted to +226 bps on average.

MUNICPALS MAINTAIN A GOOD TONE

The municipal and Treasury markets traded sideways last week until Friday, when additional U.S. tariffs on China were announced, prompting a rally in Treasuries.[1] Municipals remained unchanged for the week, but maintained a good tone.[1] New issue supply totaled $6.3 billion last week and was readily absorbed.[2] Fund flows were positive for the 33rd consecutive week at $1.6 billion, bringing the year-to-date total to $61.2 billion.[3] This week's new issue supply is expected to be $6.2 billion and should be readily absorbed.[2]

We expect both municipal and Treasury bond yields to remain lower for longer. Last week the Fed suggested it would probably lower rates 25 basis points at its September meeting. The market was disappointed, as most investors think rate cuts should be more aggressive to avoid a recession. U.S. tariffs imposed on China on Friday exacerbated fears.

City of Houston, TX issued $770 million Combined Utility System revenue bonds, both tax-exempt and taxable (rated AA2/AA).[4] Interest was lackluster and balances remained. This deal suggests buyer fatigue at these low yields. However, the Treasury market rallied dramatically on Friday, renewing interest in municipals and the Houston deal. Remaining bonds were selling Friday as the market rallied.

High yield municipal bond yields have decreased over the last two weeks, more than high grade municipals.[1] Credit spreads have contracted to +226 bps on average, and the pace of contraction is even faster for short duration high yield municipals.[1] High yield municipal bond fund flows continued to be strong, adding $479 million last week and totaling $13.3 billion year to date.[3] Only eight high yield municipal deals are expected this week.[2] We expect these deals to be oversubscribed and provide support in the secondary market, keeping downward pressure on credit spreads. Defaults are trending well below $1 billion year to date.[5] 60% of defaults have occurred in the senior living sector, which continues to show signs of overdevelopment.[5]

HIGH YIELD CORPORATES FIND THEIR FOOTING

High yield corporate bonds rallied, posting their first positive week since late July and only the third of the current quarter.[1] Gains were led by energy-related sectors, which rebounded despite a 1% drop in oil prices.[1] Overall, spreads narrowed by 30 bps last week, and fund outflows moderated considerably as sentiment improved.[1,3] Net flows into high yield funds are positive (+$10.4 billion) year to date, compared to steep outflows (-$23.6 billion) for the same period in 2018.[3]

Investment grade corporates continued to march higher.[1] The asset class recorded positive returns for the sixth consecutive week and now leads all taxable fixed income categories for the third quarter to date.[1] Persistently low and negative interest rates in other parts of the world have fueled strong foreign demand for U.S. corporate debt. Within the Global Aggregate Index, non-U.S. corporates were yielding just 0.74% at the end of last week, versus 2.82% for their U.S. counterparts.[1]

Investment grade corporate performance leads all taxable fixed income categories for the third quarter to date.

Emerging markets (EM) debt eked out a gain for the week, improving over the previous week's loss in spite of the sharply escalating U.S./China trade war.[1] EM bonds denominated in U.S. dollars fared best, as volatile conditions took a toll on currencies such as the Mexican peso, Chinese yuan and Indian rupee.

In focus

Municipal bonds cheapen versus Treasuries

Municipal bond yields failed to keep pace with rallying U.S. Treasury yields late last week. As a result, municipal-to-Treasury ratios materially increased, to 82% for the 10-year bond and 94% for the 30-year bond.[1]

Ratios have not been this high since the first quarter of 2019.[1] We believe municipal bonds are attractive at these ratios on a relative basis, considering their continued credit strength and support from a favorable technical backdrop.

Municipal supply has historically increased toward the end of the calendar year, and we believe any uptick in supply in 2019 would very likely be absorbed by the current outsized demand. The resulting pressure would likely push ratios lower, which could reflect favorably on municipal total return.

Additionally, the higher ratios in longer maturities point to a municipal yield curve that is steeper than Treasuries, which continues to compensate investors for moving to longer duration and may offer greater value through tax-exempt income.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	1.53	0.06	-0.34	-0.96
5-year	1.42	0.00	-0.41	-1.09
10-year	1.54	-0.02	-0.48	-1.15
30-year	2.03	-0.01	-0.50	-0.99

Source: Bloomberg L.P. As of 23 Aug 2019. **Past performance is no guarantee of future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	0.98	0.04	-0.09	-0.80
5-year	1.01	0.05	-0.10	-0.93
10-year	1.24	0.02	-0.28	-1.04
30-year	1.89	0.02	-0.35	-1.13

Source: Bloomberg L.P. As of 23 Aug 2019. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	82
30-year AAA Municipal vs Treasury	94
High Yield Municipal vs High Yield Corporate	68

Source: Bloomberg L.P., Thompson Reuters. As of 23 Aug 2019. 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	1.66	–	5.25	-0.12	1.45	7.48
High Yield Municipal	4.02	232[6]	6.98	0.03	2.16	9.64
Short Duration High Yield Municipal[7]	3.96	226	7.74	0.59	1.72	8.81
U.S. Aggregate Bond	2.16	50[8]	5.79	0.08	2.37	8.87
U.S. Treasury	1.59	–	6.69	-0.06	3.18	8.40
U.S. Government Related	2.26	65[8]	5.75	-0.05	2.38	8.94
U.S. Corporate Investment Grade	2.82	119[8]	7.90	0.43	3.00	13.78
U.S. Mortgage-Backed Securities	2.39	55[8]	2.57	0.00	0.66	5.28
U.S. Commercial Mortgage-Backed Securities	2.19	71[8]	5.30	0.05	2.16	9.14
U.S. Asset-Backed Securities	1.90	34[8]	2.14	0.02	1.04	4.23
Preferred Securities	3.18	125[8]	4.28	0.39	0.63	14.64
High Yield 2% Issuer Capped	5.88	407[8]	3.13	0.72	-0.09	10.46
Senior Loans[9]	6.14	474	0.25	0.11	-0.39	5.83
Global Emerging Markets	4.90	331[8]	6.08	0.09	0.13	10.62
Global Aggregate (unhedged)	1.22	47[8]	7.19	0.02	1.98	7.36

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. **9** 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 23 Aug 2019. **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.

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1 Bloomberg L.P. **2** The Bond Buyer, 23 Aug 2019. **3** Lipper Fund Flows. **4** Market Insight, MMA Research, 21 Aug 2019. **5** Municipals Weekly Bank of America/Merrill Lynch Research, 15 Jul 2019.

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 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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Investing involves risk; principal loss is possible. Debt or fixed income securities are subject to market risk, credit risk, interest rate risk, call risk, derivatives risk, dollar roll transaction risk and income risk. As interest rates rise, bond prices fall. Below investment grade or high yield debt securities are subject to liquidity risk and heightened credit risk. Preferred securities are subordinated to bonds and other debt instruments in a company's capital structure and therefore are subject to greater credit risk. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. Asset-backed and mortgage-backed securities are subject to additional risks such as prepayment risk, liquidity risk, default risk and adverse economic developments. The value of convertible securities may decline in response to such factors as rising interest rates and fluctuations in the market price of the underlying securities. Senior loans are subject to loan settlement risk due to the lack of established settlement standards or remedies for failure to settle. These investments are subject to credit risk and potentially limited liquidity, as well as interest rate risk, currency risk, prepayment and extension risk, and inflation risk

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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