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CIO Weekly Commentary
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CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

Why the yield curve is flattening: investment implications

Bottom line up top:

Recession? No. Rate hikes? Yes. While a flat or inverted yield curve has sometimes predicted the end of a growth cycle, we believe the current U.S. expansion is alive and kicking. From this perspective, the flatter shape of the curve looks more indicative of today's economic heat wave (and a nod to the near-certainty of associated Fed rate hikes) than of a cold snap farther down the road.

Markets apparently agree. Shorter-term yields – which are highly sensitive to changes in Fed policy – have risen much more than longer-term yields (Figure 1). This implies aggressive tightening at first and a moderating pace later on as some heat is taken out of inflation and the economy. Such a scenario works only if Fed officials resist the urge to move too fast, too soon. The risk of their going "too far" may be remote, however, as the market has already priced in as many as seven rate hikes for 2022.

Real interest rates (nominal rates less the rate of inflation) **have climbed markedly,** and **the real yield curve remains steep —** another indication that bond markets are not worried about a recession. Put another way, while inflation expectations are driving nominal short rates higher, investors remain confident the Fed will keep inflation contained in the long run.

Saira Malik, CFA
Chief Investment Officer

On behalf of Nuveen's Global Investment Committee

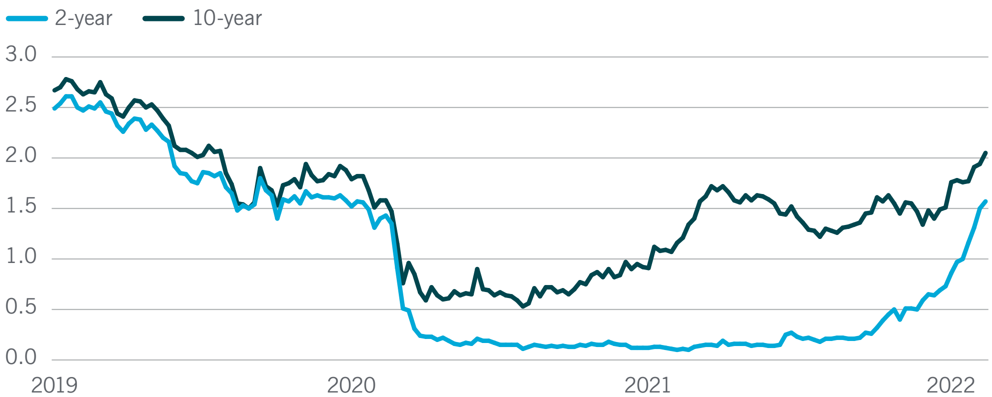
As Nuveen's CIO and leader of our Global Investment Committee, Saira drives market and investment insights, delivers client asset allocation views and brings together the firm's most senior investment leaders to deliver our best thinking and actionable investment ideas. In addition, she chairs Nuveen's Equities Investment Council and is a portfolio manager for several key investment strategies.

> ***We don't think the flattening yield curve signals a recession. Now is not the time to get defensive.***

What does this mean for portfolios? Watching the curve's shape and movement is prudent, but we wouldn't rely on an inversion of the curve as a timing signal. Historically, even after an inversion, most asset classes have produced healthy returns in the subsequent years (Figure 3).

FIGURE 1: RISING SHORT-TERM RATES ARE FLATTENING THE CURVE

U.S. Treasury yield (%)



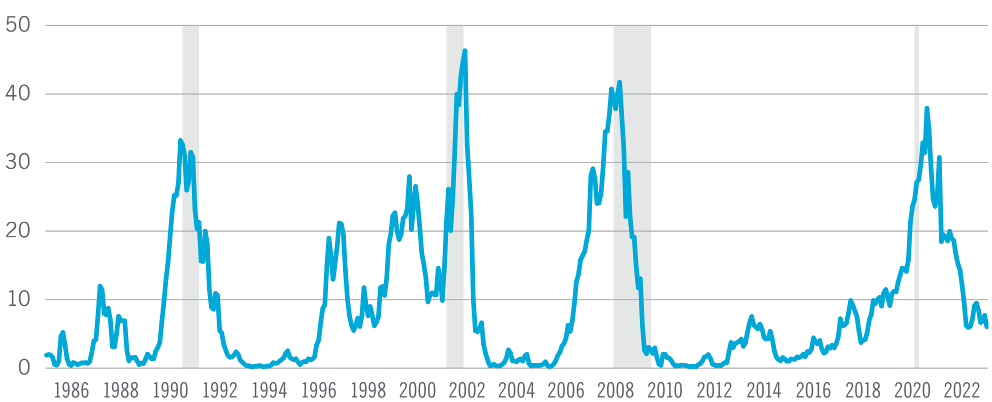
Data source: Bloomberg, L.P. January 2019 to January 2022, weekly readings. **Past performance is no guarantee of future results.**

What does this mean for portfolios?

To start, **we don't think now is the time to get defensive.** Although bearish indicators have stolen headlines this year, the probability of recession implied by the shape of the yield curve remains low at approximately 6% today (Figure 2).

FIGURE 2: WE SEE LITTLE CHANCE OF A RECESSION IN THE NEAR TERM

% chance of U.S. recession by date (1-year in advance)



Data source: Bloomberg, L.P., New York Federal Reserve. January 1985 to January 2022, monthly readings. Data depicts the New York Federal Reserve's "Probability of U.S. Recession Predicted by Treasury Spread" model. Shaded areas reflect past recessions.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

Even if the curve does invert, history suggests most asset classes can enjoy healthy returns.

Further, **we don't think investors should rely on an inversion of the curve as a timing signal.** The yield curve tends to flatten during hiking cycles and typically inverts during or afterward. But **historically, even after an inversion, most asset classes have produced healthy returns** (Figure 3). So even if investors think curve inversion is a reliable risk-off signal (we disagree), two years is a long time to be sitting in cash and underperforming strategic benchmarks and peers.

FIGURE 3: IF HISTORY REPEATS (OR EVEN RHYMES), INVESTORS SHOULD BE OKAY

Average annualized total return post curve inversion (%)

Asset class	+12M	+24M	+36M
U.S. large caps	13.9	10.2	3.8
U.S. small caps	5.8	4.4	1.4
Non-U.S. developed	6.0	2.7	-3.8
Emerging markets	18.0	11.4	0.6
U.S. core fixed income	6.5	7.4	8.1
U.S. high yield	3.7	1.4	1.4
Investment grade municipals	3.3	5.8	7.1
REITs	10.3	8.5	7.6

Data source: Bloomberg, L.P. Data depicts 12-, 24- and 36-month performance of each index following the last seven inversions of the 10-year to 2-year Treasury spread (August 1978, September 1980, December 1988, June 1998, February 2000, January 2006 and August 2019). The 36-month column excludes the August 2019 inversion due to timing. **Past performance is no guarantee of future results. Representative indexes: U.S. large caps:** S&P 500 Index; **U.S. small caps:** Russell 2000 Index; **non-U.S. developed:** MSCI World ex-U.S. Index; **emerging markets:** MSCI Emerging Markets Index; **U.S. core fixed income:** Bloomberg U.S. Aggregate Bond Index; **U.S. high yield:** Bloomberg U.S. Corporate High Yield 2% Issuer Capped Index; **investment grade municipals:** Bloomberg U.S. Municipal Bond Index; **REITs:** FTSE NAREIT All Equity REITS Total Return Index. Due to index inception dates, U.S. small caps and REITs reflect only the last six inversions, while emerging markets and investment grade municipals only reflect the last five inversions.

Where does that leave investors? Two differing approaches

If, like us, you're in the camp that a flattening or inverted curve does not signal an imminent recession, **we think it makes sense to maintain risk-on positioning.** We continue to favor a **shorter duration posture** (e.g., broadly syndicated and private loans), **non-U.S. and U.S. small cap equities** and **select private assets** (e.g., private equity and real assets) that tap into extended segments of the investable universe but have embedded volatility-mitigating qualities.

But what if we're wrong? If you think an inverted curve turns the future upside down, consider de-risking by reducing overall equities exposure and/or favoring low-volatility, income-generating stocks, and by extending duration into core bonds.

About Nuveen's Global Investment Committee

Nuveen's Global Investment Committee (GIC) brings together the most senior investors from across our platform of core and specialist capabilities, including all public and private markets.

Regular meetings of the GIC lead to published outlooks that offer:

- macro and asset class views that gain consensus among our investors
- insights from thematic "deep dive" discussions by the GIC and guest experts (markets, risk, geopolitics, demographics, etc.)
- guidance on how to turn our insights into action via regular commentary and communications

For more information, please visit nuveen.com.

Endnotes

Sources

All market and economic data from Bloomberg, FactSet and Morningstar.

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A word on risk

All investments carry a certain degree of risk and there is no assurance that an investment will provide positive performance over any period of time. Equity investing involves risk. Investments are also subject to political, currency and regulatory risks. These risks may be magnified in emerging markets. Diversification is a technique to help reduce risk. There is no guarantee that diversification will protect against a loss of income. Investing in municipal bonds involves risks such as interest rate risk, credit risk and market risk, including the possible loss of principal. The value of the portfolio will fluctuate based on the value of the underlying securities. There are special risks associated with investments in high yield bonds, hedging activities and the potential use of leverage. Portfolios that include lower rated municipal bonds, commonly referred to as "high yield" or "junk" bonds, which are considered to be speculative, the credit and investment risk is heightened for the portfolio. 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. As an asset class, real assets are less developed, more illiquid, and less transparent compared to traditional asset classes. Investments will be subject to risks generally associated with the ownership of real estate-related assets and foreign investing, including changes in economic conditions, currency values, environmental risks, the cost of and ability to obtain insurance, and risks related to leasing of properties. Socially Responsible Investments are subject to Social Criteria Risk, namely the risk that because social criteria exclude securities of certain issuers for non-financial reasons, investors may forgo some market opportunities available to those that don't use these criteria. Investors should be aware that alternative investments including private equity and private debt are speculative, subject to substantial risks including the risks associated with limited liquidity, the use of leverage, short sales and concentrated investments and may involve complex tax structures and investment strategies. Alternative investments may be illiquid, there may be no liquid secondary market or ready purchasers for such securities, they may not be required to provide periodic pricing or valuation information to investors, there may be delays in distributing tax information to investors, they are not subject to the same regulatory requirements as other types of pooled investment vehicles, and they may be subject to high fees and expenses, which will reduce profits. Alternative investments are not appropriate for all investors and should not constitute an entire investment program. Investors may lose all or substantially all of the capital invested. The historical returns achieved by alternative asset vehicles is not a prediction of future performance or a guarantee of future results, and there can be no assurance that comparable returns will be achieved by any strategy.

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