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CIO Weekly Commentary
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CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

Don't shrink from the Fed's balance sheet runoff

Bottom line up top:

The U.S. Federal Reserve's plan to shed pandemic pounds from its balance sheet isn't a crash diet. Markets expect the Fed's upcoming quantitative tightening (QT) to reduce its balance sheet more quickly than previously anticipated, and at a more aggressive pace than the Fed's 2017-era unwinding of quantitative easing (QE). Even if so, we see little reason for concern. We'll hear details at the Fed's May meeting, but we expect QT to be implemented passively and through maturing assets when possible. The Fed has already indicated a maximum pace of $95 billion per month ($60 billion of Treasuries and $35 billion of mortgage-backed securities).

The U.S. economy can handle it. Quantitative policy (easing or tightening) allows the Fed to add or reduce liquidity to the financial system when needed. Demand for liquidity was exceedingly high amid the Covid outbreak in 2020, when about $3 trillion of the $5 trillion in QE asset purchases occurred. But that pace declined quickly as the pandemic's impact on the economy waned. The rate of spending growth in the current recovery has been far stronger than following the 2008 financial crisis, and the reality is that the Fed and other central banks don't need to hold as many assets.

QT isn't happening "on the QT." The Fed's actions are well telegraphed. To us, this suggests the events should hold few surprises for investors and shouldn't significantly impact portfolio construction strategies.

Saira Malik, CFA
Chief Investment Officer

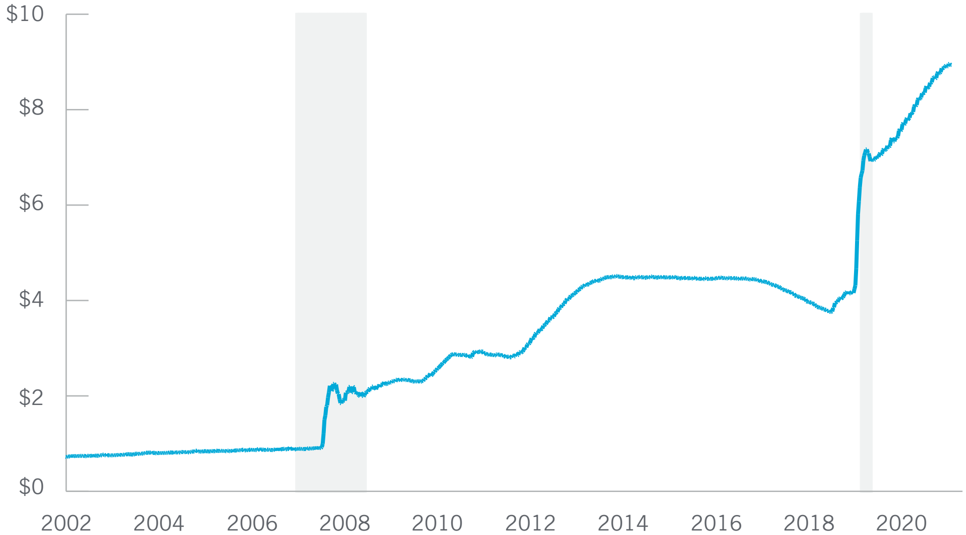
On behalf of Nuveen's Global Investment Committee

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 believe the Federal Reserve’s plans to shrink its balance sheet will create additional portfolio risks.

FIGURE 1: THE FED IS PREPARING TO LIGHTEN ITS LOAD

U.S. Fed balance sheet ($ trillions)



Data source: Bloomberg, L.P., 18 Dec 2002 to 06 Apr 2022. Shaded areas indicate U.S. recessions.

Portfolio implications

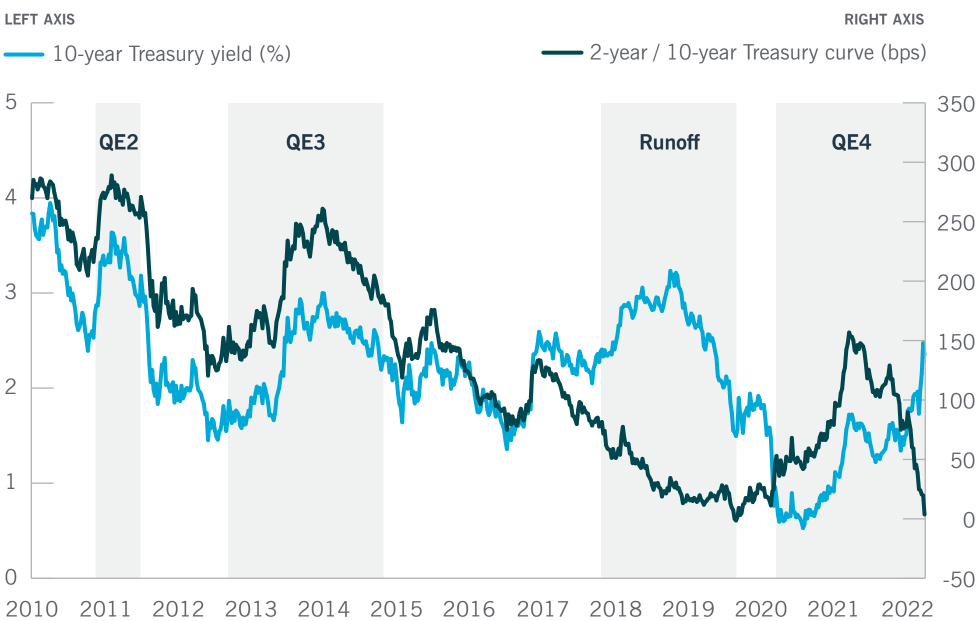
What a difference five years makes. Today’s backdrop for balance sheet reduction bears little resemblance to the last time the Fed initiated QT in September 2017.

- At that point, the Fed was almost two years into a hiking cycle before it began shrinking its balance sheet, which had ballooned to $4.5 trillion. Today, the Fed has just begun to hike ahead of the anticipated May start of reducing its now nearly $9 trillion of QE-padded assets (Figure 1).
- During the previous runoff, the 10-year Treasury yield fell and the 2-year/10-year curve flattened appreciably (Figure 2). This year, the curve is already flat as QT approaches. We don’t think it will get much flatter or invert in the near term. With inflation at or near its peak, we expect the 10-year Treasury yield to rise a bit more over the course of 2022, to about 2.90%.
- For now, it appears the bond market has priced in the balance sheet runoff and is generally giving more weight to the Fed’s anticipated rate hike trajectory. In fact, over the past week, the 2-yr/10-year curve steepened markedly, meaning that investors may be giving the Fed — as well as the economy — a somewhat stronger vote of confidence.

QT and rate hikes don't alter our asset allocation views. Given the positive near-term growth outlook, we continue to favor fixed income spread sectors and credit risk over duration risk. Further potential increases in longer-term yields should benefit floating-rate assets such as loans, as well as shorter-duration categories like high yield credit and select emerging markets. We also see opportunities in preferred securities, which in our view have underperformed more than warranted this year.

Central bank actions are not causing us to change our views: We continue to favor fixed income spread sectors and credit risk over duration risk.

FIGURE 2: THIS TIME, THINGS LOOK DIFFERENT



Data source: Bloomberg, L.P., 05 Jan 2007 to 30 Mar 2022. **Past performance is no guarantee of future results.**

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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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