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CIO Weekly Commentary
8 August 2022

CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

A preferred take on the financials sector

Bottom line up top:

The good news: U.S. banks are strong. The old saying "there's safety in numbers" takes on a new and different meaning if the "numbers" refer to the billions dollars U.S. banks have on hand to meet — and far exceed — regulatory capital requirements (Figure 1). This capital strength was on display again with June's release of the Fed's 2022 "stress test" results. A total of 33 institutions were subject to hypothetical crisis scenarios that included "a severe global recession accompanied by a period of heightened stress in commercial real estate and corporate debt markets," per the Fed. The banks proved able to absorb more than $600 billion in losses while, on average, topping minimum common equity capital requirements by at least 2x for the duration of the test. Separately, banks have increased their loan loss reserves this year given economic uncertainty, but actual delinquency rates and credit trends have generally remained benign.

But earnings for the financials sector are down sharply. Banks and other financial companies released 2Q results beginning in mid-July, but since they're always among the first to report, it can take some time to meaningfully assess their earnings growth relative to other sectors and the S&P 500 Index as a whole. Now, with earnings season winding down, financials ended up the weakest performing sector in terms of 2Q year-over-year earnings growth (-25% for the sector and -28% for banks specifically, versus +4% for the overall index) and had the second-lowest percentage of earnings beats (63%) and revenue beats (56%). There were some bright spots, including higher net interest income and net interest margins.

Saira Malik, CFA
Chief Investment Officer

On behalf of Nuveen's Global Investment Committee

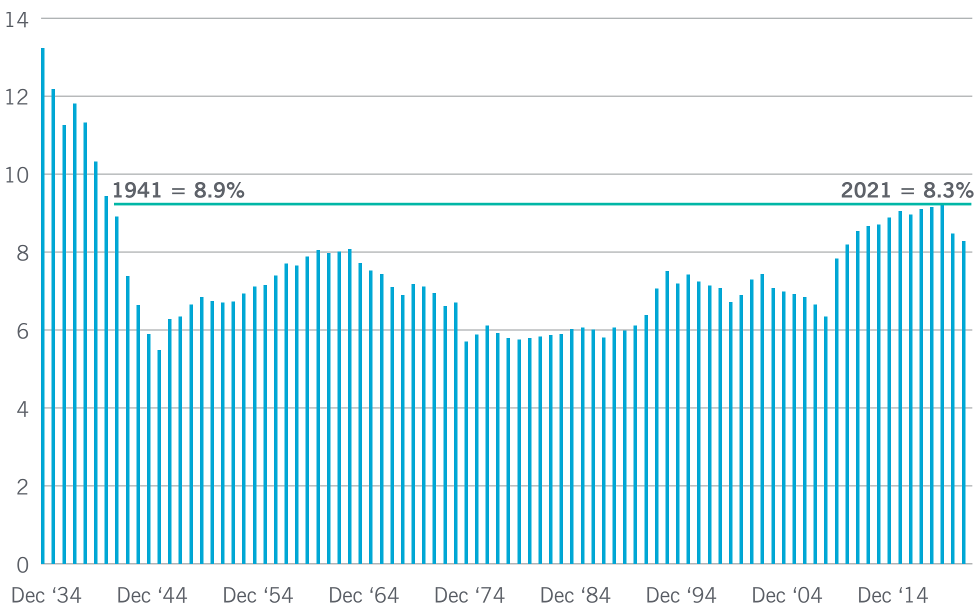
As Nuveen's CIO and leader of our Global Investment Committee, Saira drives market and investment insights, delivers client asset allocation views and brings together the firm's most senior investment leaders to deliver our best thinking and actionable investment ideas. In addition, she chairs Nuveen's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

Preferred securities: a way to benefit from the underlying strength of the financials sector. Despite this year's lower earnings environment, preferred securities — 75% or more of which are issued by banks and insurance companies — can be a compelling portfolio allocation. In addition to healthy credit fundamentals, preferreds offer generous yields, both absolute and after-tax, with their high income stream serving as a total return buffer against future spread volatility. These and other advantages may make the asset class especially attractive for investors with tax considerations, as we demonstrate below.

The latest stress tests showed banks could absorb more than $600 billion in losses and still exceed capital requirements by 2x.

FIGURE 1: CAPITAL HELD BY BANKS REMAINS NEAR ITS HIGHEST LEVEL IN 80 YEARS

U.S. banks' tangible common equity ratio (%)



Data source: Federal Deposit Insurance Corporation, New York Federal Reserve Bank and Barclays Research from 1934 – 2021. 31 Dec 2021.

For tax-sensitive income investors, preferreds can be a source of tax-efficient income that diversifies municipal bond holdings and other investments. That's because unlike bond coupons, many preferred securities pay distributions that are often taxed at the qualified dividend income (QDI) rate (23.8% for the highest earners), which is lower than the ordinary income rate (40.8%). Using the latest yield for the ICE BofA U.S. All Capital Securities Index of 5.69% and assuming 100% of income is QDI, this would imply a tax-equivalent yield (TEY) of 7.47% — attractive alongside tax-equivalent yields of 4.71% for investment grade municipals and 8.48% for high yield municipals (Figure 2).

Within preferreds, diversification across segments is key to obtaining more attractive risk/reward potential.

FIGURE 2: PREFERREDS CAN LOOK ATTRACTIVE AGAINST MUNIS

Tax-equivalent yields across preferreds and munis

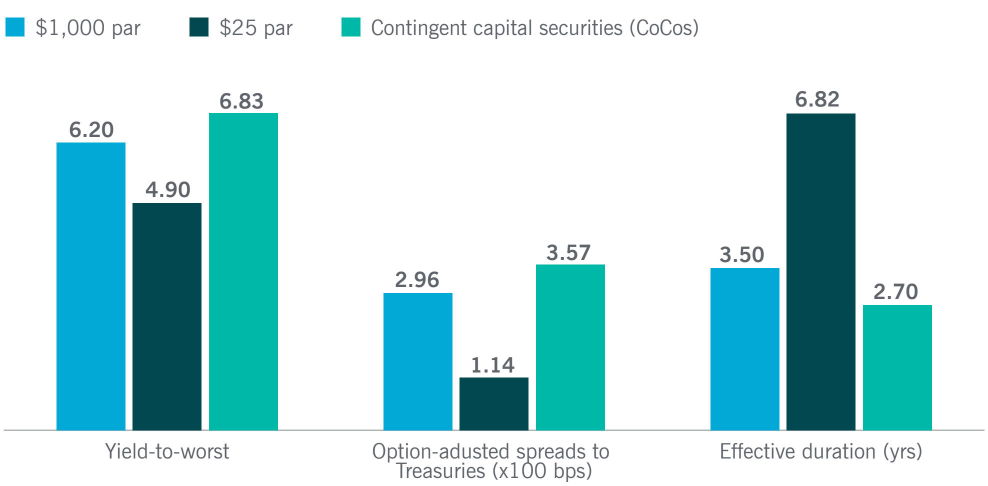
	Preferred securities	Investment grade munis	High yield munis
Gross index yield	5.69%	2.79%	5.02%
QDI rate	23.8%	23.8%	23.8%
Income rate	40.8%	40.8%	40.8%
% QDI	100%	0%	0%
% Tax free	0%	100%	100%
Tax-equivalent yield	**7.47%**	**4.71%**	**8.48%**

Data source: Bloomberg L.P. and Credit Suisse. 29 Jul 2022. **Past performance does not predict or guarantee future results. Representative indexes: municipal:** Bloomberg Municipal Bond Index; **high yield municipal:** Bloomberg High Yield Municipal Bond Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index.

Within preferreds, diversification across segments is key to obtaining more attractive risk/reward potential (Figure 3). For example, the $1,000 par market segment offers a spread over U.S. Treasuries of 296 basis points (vs. only 114 bps in the $25 par market) and has a duration of 3.5 years (vs. 6.8 years). With a yield-to-worst of 6.20% for $1,000 par preferreds, if market turmoil causes spreads to widen, a 100 bps move would result in just 0.56 years' loss of income. This is relatively low compared to most plus sector areas of fixed income.

FIGURE 3: NOT ALL PREFERREDS ARE CREATED EQUAL

Characteristics of major preferrered market segments (as of 31 Jul 2022)



Data source: Bloomberg L.P., 31 Jul 2022. **Past performance does not predict or guarantee future results. Representative indexes: $1000 par preferred:** market capitalization-weighted blend of the ICE BofA U.S. Investment Grade Institutional Capital Securities Index and the ICE BofA U.S. High Yield Institutional Capital Securities Index; **contingent capital (CoCos):** ICE USD Contingent Capital Index; **$25 par preferred:** ICE BofA Core Plus Fixed Rate Preferred Index.

Putting it all together: Credit spreads well above historical averages for preferreds and other credit sectors create an attractive entry point for longer-term oriented fixed income investors, particularly those with an eye toward tax efficiency.

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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Important information 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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