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CIO Weekly Commentary
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CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

Prepare for a plateau, not a plummet, in rates

Bottom line up top

The rate rollercoaster hasn't stopped — yet. For the past two years, inflation-fighting central bankers have acted like theme park attendants, tightening safety restraints and pulling levers to take the trajectory of monetary policy to new heights. The result has been a wild ride for interest rates and investors. The steep climbs and sharp drops in the 10-year U.S. Treasury yield alone have been enough to make anyone's stomach drop: from below 2% in early 2022 to 3.9% at the end of that year, to a peak of nearly 5% this past October, to a plunge back to 3.9% by the end of 2023. But while many investors welcome a reprieve from dizzying heights, we caution weary passengers that this rate ride likely has a bit further to go. Last week, for example, yields kicked off 2024 with a bump up from recent lows, as minutes from the U.S. Federal Reserve's December meeting, coupled with evidence of further labor market resilience, challenged the market's narrative of sooner-rather-than-later loosening of monetary policy.

A new year's resolution: temper high hopes for lower rates. Uncertainty is often cited as the number one enemy of financial markets because it leads to greater volatility. If that's true, then the broad rally in both equity and fixed income markets in the closing months of 2023 can be explained simply by investors' increased confidence that peak rates are behind us — a conclusion based on dovish interpretations of the Fed's November and December meetings. But minutes from the December meeting reinforced the central bank's commitment to remaining data dependent. That leaves the door open for keeping rates at their current plateau, or even to more tightening, should inflation data call for it.

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.

Against this backdrop, we believe markets may be too optimistic in their interest rate expectations. The economy has shown ongoing resilience in the face of higher rates. With inflation still above the Fed's stated 2% target, we're not convinced that a significant unwinding of tight policy is imminent. Rather, we think the Fed is more likely to stand pat in the near-to-medium term to avoid the kind of reacceleration of inflation that occurred in the 1970s, when policy rates were cut prematurely. This stance suggests that real rates — i.e., nominal interest rates less the inflation rate — will remain steady, similar to the hypothetical path reflecting 75 basis points (bps) worth of cuts shown in Figure 1. Investors eager to position their portfolios for a wave of rate cuts in 2024 would be well served to instead seek investments that stand to benefit from a steady, albeit still elevated, rate environment.

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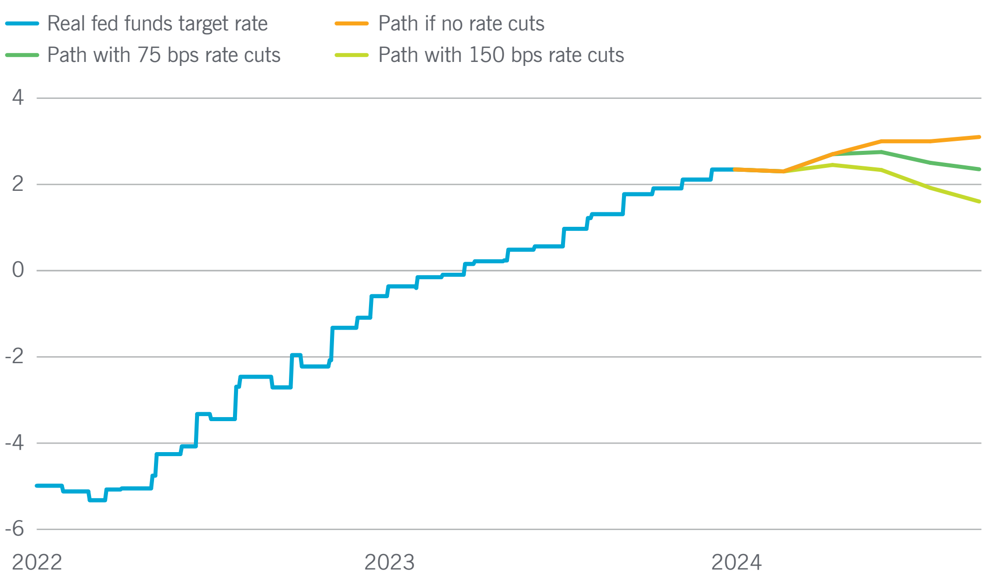
FIGURE 1: INFLATION EXPECTATIONS TEMPER THE IMPACT OF POTENTIAL FED CUTS

Real Fed funds target rate path (%)



Data sources: Bloomberg L.P., Nuveen. 03 Jan 2024.

Portfolio considerations

Persistently higher-for-longer rates may tempt some investors to plead, "Stop the ride – I want to get off!" But we see investment opportunities that make staying on board a better choice.

In the municipal bond space, we prefer a modestly overweight duration position, supported by an upward-sloping yield curve (Figure 2). While short to intermediate muni-to-Treasury ratios declined in December, longerdated ratios held steady. AAA rated municipals beyond the 10-year tenor are currently yielding more than U.S. Treasuries on a taxable-equivalent basis, with the spread between the two growing as you move further out the curve . There's also compelling value in lower-quality investment grade (BBB) munis, which are yielding 230+ bps more than their AAA muni counterparts across short- and long-term maturities.

Additionally, there are compelling opportunities within the "up in-quality" part of the high yield muni market, which also offers longer duration. Credit profiles are strong, and we expect credit spreads in this segment to stay stable, with default rates low and idiosyncratic.

Fundamentals for the asset class are healthy, as municipalities continue to maintain ample rainy day and reserve funds. And though revenue collections are below 2022 peaks, they remain above pre-pandemic levels. Supply and demand dynamics are favorable as well: 2024 issuance could hover near 2023's muted levels and is expected to start the new year slowly, while demand should accelerate as investors seek to take advantage of still-attractive yields and add to their muni allocations before the Fed pivots to rate cuts.

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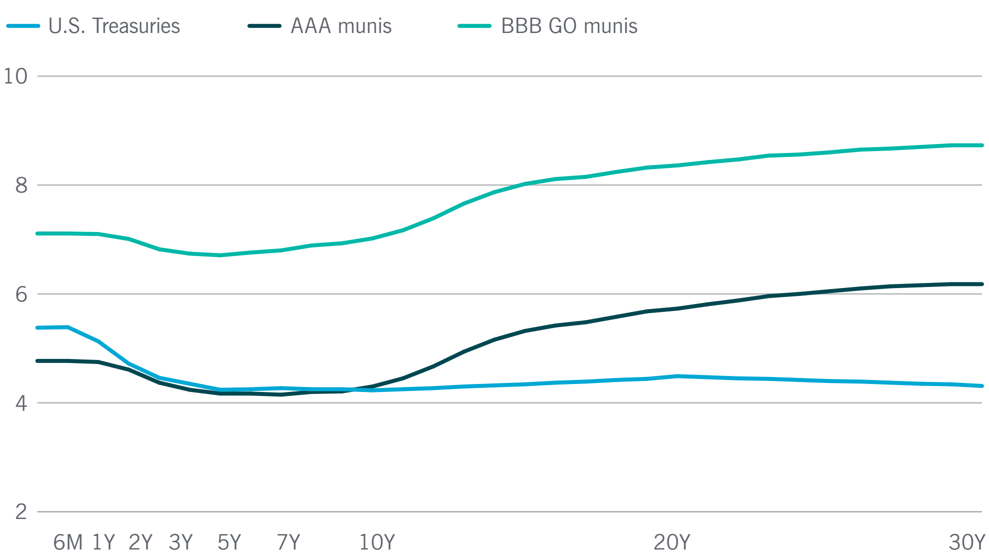
FIGURE 2: MUNICIPAL CURVE FAVORS ADDING DURATION

Taxable-equivalent yield curve (%)



Data source: Bloomberg L.P., 29 Dec 2023. Taxable-equivalent yield assumes a 40.8% maximum tax rate. **Representative indexes: U.S. Treasuries:** U.S. Treasury actives curve; **AAA municipals:** Bloomberg municipal AAA curve; **BBB GO munis:** U.S. general obligation BBB muni yield curve.

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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