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CIO Weekly Commentary
29 January 2024

CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

Bullish on bonds

Bottom line up top

During the nearly two turbulent years from the Federal Reserve's initial rate hike in March 2022 through the end of October 2023, taxable fixed income markets were particularly hard-hit. The seismic shift in monetary policy persisted longer than initially anticipated, as inflation proved to be anything but "transitory." The Fed and other major central banks maintained their laser focus on bringing down inflation through rate hikes (Figure 1), aware that their aggressive tightening risked dragging economies into recession. Many investors spooked by this environment sold their bond positions and piled their money into cash and cash equivalents.

The outlook for fixed income from here looks far better. While inflation remains above central bank targets, it has moderated significantly. And a recession has so far been kept at bay. In fact, slowing but still-resilient economic growth has fueled market optimism that a "soft landing," not a contraction, could be the ultimate outcome. Against this backdrop, in December the Fed signaled peak rates and adopted a dovish posture, projecting 75 basis points (bps) of rate cuts in 2024. Friday's release of December's Personal Consumption Expenditure (PCE) Index data supported the Fed's stance, with both headline and core PCE (which excludes volatile food and energy components and is the Fed's preferred inflation barometer) meeting expectations.

In pledging to stay data-dependent, the Fed will continue to proceed with caution, while awaiting further evidence that inflation has fallen far enough to justify lowering policy rates. Meanwhile, the European Central Bank and Bank of England have also put their rate hikes on "pause," and to date have shown little inclination to telegraph sooner-rather-than-later rate cuts. The Bank of Japan, whose longtime yield-curve control policy had made it a dovish outlier among major central banks, is preparing to overhaul its approach, which would allow yields on Japanese government bonds to increase beyond their previously more-restrictive bands.

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.

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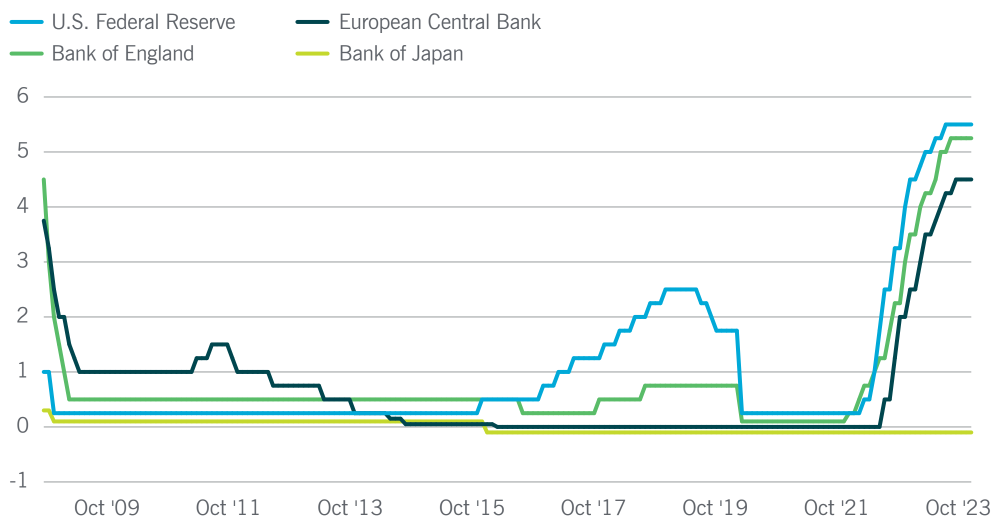
This cycle of rate hikes may be over, but we don't anticipate seeing cuts until closer to midyear.

Given this caution across central banks — and contrary to what financial markets are currently pricing in — we believe the odds of Fed rate cuts occurring in the first quarter of 2024 remain low, and that the much-anticipated policy pivot won't begin until midyear. Still, with inflation falling and monetary policy expectations recalibrating, we encourage investors to assess their taxable fixed income portfolio allocations and to take advantage of opportunities we see across the asset class.

FIGURE 1: MOST CENTRAL BANKS WILL LIKELY START EASING, BUT NOT QUITE YET

Central bank policy rates



Data sources: Bloomberg L.P., Oct 2008 to Dec 2024.

Portfolio considerations

We believe the recent increase in bond yields has created ample opportunity for investors to benefit from what should be several rate cuts this year (beginning later than markets expect). Our outlook calls for the 10-year U.S. Treasury yield to fall from current levels to finish 2024 around 3.50%. Accordingly, we think extending duration in fixed income portfolios could be wise. But with a slowing U.S. economy and cracks appearing in consumer resilience, we also think credit sectors need to be approached with nimbleness and flexibility.

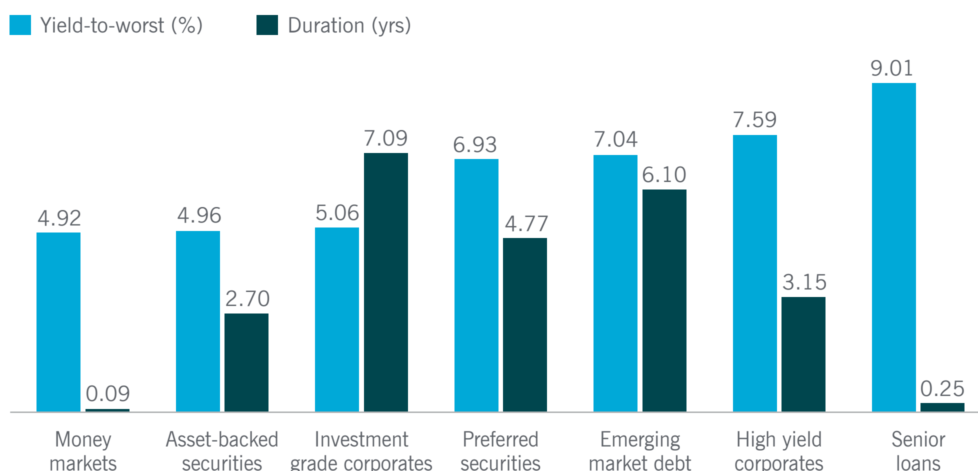
- In some investment grade sectors, yields are now north of 5%. This higher-yield environment is driving greater dispersion and creating more opportunities to capture attractive returns. **Investment grade corporate bonds**, for instance, offer a longer duration profile, and their higher relative quality could provide a cushion if the economy weakens more than we expect.
- We also like some nontraditional sources of income such as higher quality **asset-backed securities** (ABS) and **preferred securities**. Consumer and commercial credit performance has stabilized, which is a positive for ABS. But should the economy slow, it would likely mean lower quality credit cards and

auto loans would be the first to experience delinquencies and defaults. As for preferred securities, banks are facing increased regulation while continuing to pass the Fed's rigorous stress tests, which bodes well for investors.

- Across the below investment grade space, which now offers yields ranging between 7% and 9%, we are focused on higher-quality segments within sectors. For example, we favor BB rated **high yield bond** and **senior loan** issuers. Interest coverage ratios remain strong for these issuers, and they have staggered their debt maturities, thereby reducing refinancing risk at higher yields.
- Lastly, global macroeconomic risks today appear more balanced, a plus for **emerging market (EM) debt**. Many EM regions and countries still exhibit supportive growth levels, and some key EM central banks have begun cutting policy rates.

We think it makes sense to extend duration and focus on attractive credit sectors in fixed income markets.

FIGURE 2: COMPELLING YIELDS AND DURATION PROFILES CAN BE UNCOVERED ACROSS FIXED INCOME MARKETS



Data sources: Bloomberg, as of 31 Dec 2023. **Performance data shown represents past performance and does not predict or guarantee future results.** Representative indexes: **Money markets:** Yield is the average of all funds in the Morningstar Prime Money Fund category; duration is the 1-month U.S. Treasury Bill; **ABS:** Bloomberg Asset-Backed Securities Index; **Investment grade corporates:** Bloomberg U.S. Corporate Investment Grade Index; **Emerging market debt:** Bloomberg Emerging Market USD Aggregate Index; **Preferred securities:** ICE BofA U.S. All Capital Securities Index; **Senior loans:** Credit Suisse Leveraged Loan Index; **High yield corporates:** Bloomberg U.S. Corporate High Yield 2% Issuer Capped Index. **Yield to worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting. **Spreads** reflect option-adjusted spreads relative to U.S. Treasuries. **Duration** 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.

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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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