CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

Rising rates: what to know, what to do

Bottom line up top

- **January's market tantrum:** Last month played out like Newton's third law of physics with a twist: for every feared Fed action, there was an equal and opposite overreaction. The 10-year Treasury yield spiked 27 bps, and U.S. large cap growth lagged U.S. large cap value by 7%, its worst relative showing since March 2001. The direction of the moves wasn't surprising, but the magnitude was, even for the most hawkish of Fed tightening scenarios.

- **The number of rate hikes this year isn't the most important question.** We're focused on the prospects for continued global reopening and solid corporate earnings growth, both of which should drive positive, if moderate, investment returns. There's precedent for such resilience: Global equities posted gains in all eight Fed tightening cycles over the past 40 years, with an average annualized return of 11.3%. Even core U.S. bonds were positive during those same eight cycles.

- **"Long duration bad, short duration good?" It's not that simple.** A shorter duration bias makes sense in a rising rate environment, but we wouldn't completely abandon investment grade taxable and tax-exempt fixed income as portfolio diversifiers. And for equities, we prefer a cyclical tilt while also looking for select high-quality growth stocks, especially U.S. software names that are trading at bargain prices.

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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Rising rates and portfolio construction

- Investors are more worried about duration today than in, say, December 2020 when the Fed was still patient. But the pickup in yields since then has led to a **more attractive risk/reward profile in the belly of the curve** (the three- to five-year duration segment).
- For predominantly **fixed income portfolios,** allocations in this range (but closer to three years) appear well-suited to the goal of minimizing drawdown due to higher rates.
- For **investors using fixed income to cushion other parts of their portfolios,** we think duration closer to four to five years may better absorb any unexpected growth shocks. As shown in Figure 1, a duration longer than five years could potentially produce negative returns with a 50 bps rate increase over the next year.

We're seeing the best value in the belly of the yield curve.

FIGURE 1: WHAT'S THE RIGHT AMOUNT OF DURATION WITHIN FIXED INCOME?

				HYPOTHETICAL FORWARD 1 YEAR RETURN SCENARIOS		
Duration (years)	Zero coupon yield December 2020	Zero coupon yield January 2021	Improvement	Rates fall 50 bps	Rates stay the same	Rates rise 50 bps
1	0.19%	0.92%	0.73%	0.92%	0.92%	0.92%
2	0.20%	1.36%	1.16%	2.31%	1.80%	1.30%
3	0.24%	1.56%	1.32%	2.98%	1.97%	0.97%
4	0.33%	1.66%	1.33%	3.47%	1.95%	0.46%
5	0.43%	1.72%	1.29%	3.99%	1.96%	-0.02%
6	0.55%	1.77%	1.22%	4.56%	2.01%	-0.46%
7	0.66%	1.81%	1.15%	5.09%	2.03%	-0.93%
8	0.76%	1.83%	1.07%	5.62%	2.04%	-1.40%
9	0.85%	1.86%	1.00%	6.15%	2.05%	-1.87%
10	0.94%	1.88%	0.95%	6.73%	2.10%	-2.30%
11	1.01%	1.91%	0.90%	7.34%	2.19%	-2.69%
12	1.08%	1.93%	0.85%	7.81%	2.13%	-3.22%

Data source: Bloomberg, L.P., 01 Jan, 2022. **Past performance is no guarantee of future results.** For a zero coupon bond, maturity is equal to each bond's duration. The implied one-year return scenarios assume the hypothetical zero coupon bond for each duration level is held for one year. Hypothetical returns are derived by calculating the present value of each zero coupon bond in one year using different rate assumptions. *Rates stay the same* uses the current yield curve, while *Rates fall* and *Rates rise* subtracts or adds 50 bps to the current yield, respectively.

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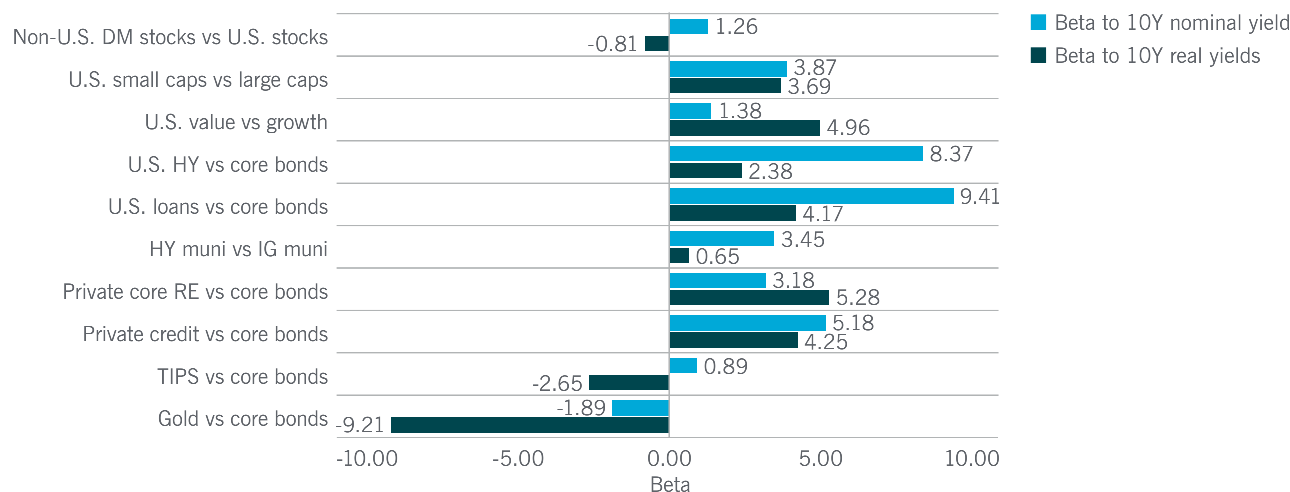
Positioning for rising rates by asset class

- We're **leaning toward credit in fixed income.** Broadly syndicated **U.S. loans remain a top choice,** given their favorable yield per unit of duration. In the last three Fed hiking cycles, loans outperformed U.S. core bonds by 283 bps, on average — significantly more than the 81 bps margin for high yield. Municipals should benefit from credit improvement as stimulus dollars support state and local budgets. We expect **high yield munis to continue their year-to-date outperformance** given the credit environment and the higher yields they offer. We also think **private credit may offer impressive yield with less volatility.**
- Further increases in the 10-year Treasury yield will likely be driven by higher real rates, not inflation expectations. For that reason, **now is not the time to overweight inflation hedges like TIPS or gold.**
- In equities, we're emphasizing **U.S. large cap value and U.S. small caps,** which look poised to outperform as rates rise. We also see compelling **opportunities in certain beaten-down growth stocks.** Additionally, we like **select non-U.S. developed markets.** Despite their weak historical correlation to changes in real yields, some of these markets should benefit from attractive valuations and economic reopening.
- In real estate, the market has not fully appreciated how much the pandemic has reset the cycle for certain industries. We see **sector valuation opportunities in areas like housing and storage,** for example. On a geographic basis, **non-U.S. real estate could outperform** due to comparatively delayed reopenings. Longer term, higher rates may hurt asset values, but that will largely depend on the pace and primary driver of rate increases.

In fixed income, we're leaning toward loans, which outperformed both high yield and core bonds during the last three hiking cycles.

FIGURE 2: POSITIONING FOR HIGHER REAL YIELDS

Sensitivity to changes in yields, Q1 2005 – Q3 2021



Data source: Bloomberg, L.P., 30 Sep 2004 to 30 Sep 2021. **Past performance is no guarantee of future results.** Beta is calculated using quarterly total returns. **Representative indexes: non-U.S. developed markets stocks:** MSCI World ex-U.S. Index; **U.S. stocks:** S&P 500 Index; **U.S. small caps:** Russell 2000 Index; **U.S. large caps:** Russell 1000 Index; **U.S. value:** Russell 1000 Value Index; **U.S. growth:** Russell 1000 Growth Index; **U.S. high yield:** Bloomberg U.S. Corporate High Yield 2% Issuer Capped Index; **core bonds:** Bloomberg U.S. Aggregate Bond Index; **U.S. loans:** S&P Leveraged Loan Total Return Index; **high yield municipals:** Bloomberg High Yield Municipal Index; **investment grade municipals:** Bloomberg U.S. Municipal Bond Index; **private core real estate:** NCREIF Fund Index Open End Diversified Core (ODCE) Total Returns Index; **private credit:** Cliffwater Direct Total Return Lending Index; **TIPS:** Bloomberg U.S. Treasury Inflation Notes Total Return Index; **gold:** Bloomberg Gold Total Return Subindex.

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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

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Endnotes

Sources

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

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