

## CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

# What's scarier: central banks or inflation?

## Bottom line up top:

**“Halloween Ends,” but the U.S. Federal Reserve’s outsized rate hikes keep producing sequels, despite poor reviews from the markets.** Projections call for a 75 basis points hike in the fed funds rate at this week’s meeting, another +75 bps in December and +25 bps in February 2023, which would bring the target rate to between 4.75% and 5.00%. As Chair Jerome Powell has made clear, the Fed wants to see positive real rates across the entire yield curve. Real rates are already positive when measured by TIPS yields (nominal yields minus inflation expectations), so the additional tightening in store over the next few months could go beyond what’s necessary to tame the inflation monster, even if it’s not enough to persuade the Fed to hit the brakes.

**Like the Fed, non-U.S. central banks generally fear inflation more than the reaper — for now.** Despite the specter of recession, most are pursuing hawkish policies that have driven market volatility. (The Bank of Japan, with its unique “yield curve control” policy, is the notable exception.) Whether the banks can or will stick by their guns as determinedly as the Fed is an open question. In fact, members of our Global Investment Committee recently offered varied projections on which central bank will be the first to reverse course from its current policy (Figure 1) as the recessionary impacts become clear. On balance, our GIC leans toward the view that non-U.S. central banks will be under more pressure than the Fed to make a U-turn. We asked Anupam Damani, Nuveen’s Head of International and Emerging Markets Debt, for insights into the complex challenges these central banks face. She and her team offered these perspectives:



**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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## FIGURE 1: WHICH CENTRAL BANK WILL REVERSE COURSE SOONEST?

Voting poll by Nuveen GIC members

BOE	BOJ	ECB	FED	RBA	PBOC
1	3	3	2	0	2

Legend: **BOE**: Bank of England; **BOJ**: Bank of Japan; **ECB**: European Central Bank; **FED**: U.S. Federal Reserve; **RBA**: Reserve Bank of Australia; **PBOC**: People's Bank of China.

**European Central Bank:** The ECB, which hiked rates by 75 bps last week, with another 50 bps expected in December, is battling widespread inflation while simultaneously confronting a looming energy crisis. The impact of tightening will likely feed through to the region's economies in the coming months, as sentiment indicators are weak and purchasing managers' indexes are falling. After December, we expect the ECB to continue hiking, but at a slower pace of 25 bps per meeting, toward a terminal rate of 2.50% to 3.00% in the first half of 2023. At the same time, we anticipate the ECB's balance sheet will begin to wind down in the form of passive quantitative tightening.

**Bank of England:** The BoE has been raising its base rate amid a daunting mix of political, fiscal and economic challenges. While recent fiscal policy changes may have created a less negative outlook regarding debt sustainability issues, the combination of higher rates and fiscal austerity will likely weigh heavily on the economy. We foresee a U.K. recession lasting from 3Q 2022 to 2Q 2023 followed by only tepid improvement into mid-2024. In terms of BoE tightening, a peak in the base rate is difficult to predict, but we anticipate it will reach 4.5% to 5.0% in mid-2023.

**Bank of Japan:** The BoJ delivered no surprises at last week's policy meeting and remains the lone dovish outlier among developed market central banks. But swimming against the current has come with a heavy cost: extreme weakness in the yen, resulting in BoJ intervention to prop up the currency along with emergency bond buying. Meanwhile, inflation at 3% is high by Japanese standards and faces upward pressure. We think a recalibration of BoJ monetary policy is inevitable. An abrupt shift from the bank's yield curve control program, established in 2016, is unlikely any time soon, as it might prove a shock to the system. Still, a policy tweak could happen as early as later this year, or sometime next year, before or after BoJ governor Haruhiko Kuroda's term ends.

## Portfolio considerations:

**A cash conundrum.** Immutable central bank policy has dampened investor enthusiasm across many markets and asset classes. Given this year's near-universal negative investment returns, some investors are asking why they shouldn't simply put their money in cash, which — thanks to the very hawkish monetary policies that have pummeled equity and fixed income markets — is paying attractive yields. The slightly positive expected real yield (assuming inflation does in fact fall in the next 12 months) on ultra-short-term U.S. Treasuries may be enticing for investors with cash to invest (Figure 2). But for most investors we work with, earning ~1% real yield before fees and taxes on a large portion of their assets is not a sustainable strategy.

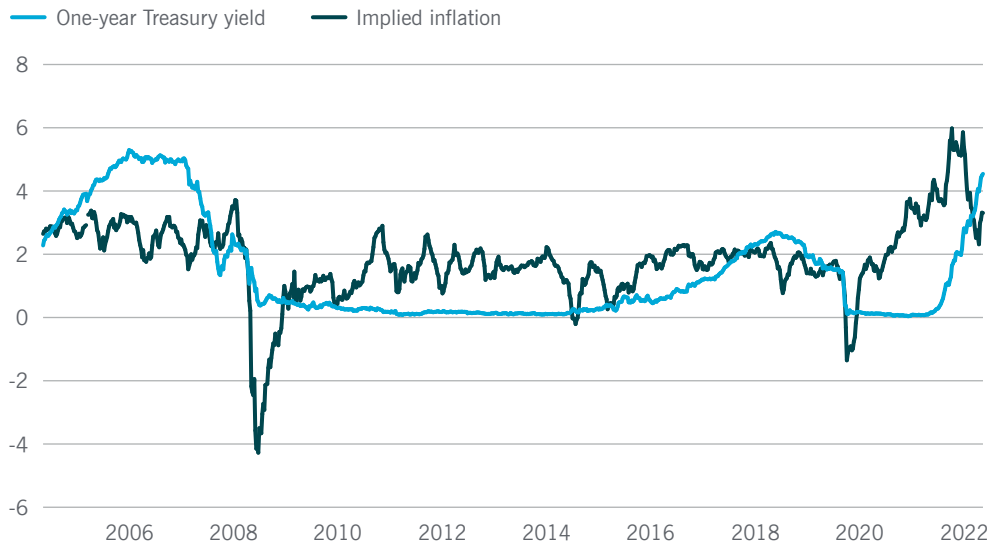
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**We prefer high quality U.K. and European corporate bonds over Japanese government bonds, U.K. gilts and European government bonds.**

– **Anupam Damani,**  
Head of International  
and Emerging  
Markets Debt

**FIGURE 2: BEWARE THE LURE OF HOLDING CASH**

*One-year Treasury yields and implied inflation*



Data source: Bloomberg, Oct 2004 to Oct 2022. Past performance does not predict or guarantee future results. One-year Treasury yield represented by the U.S. Treasury One-Year Zero Coupon Yield; Implied inflation represented by the one-year Consumer Price Index swap rate.

**We think a diversified fixed income approach should still win the day.**

Today, investors can lock in a 6% tax-equivalent nominal yield on a diversified portfolio of T-bills, high quality municipals, core fixed income and BB-rated corporate bonds (a 2% premium over the 4% that can be earned in T-bills alone). There is no crystal ball to tell us when inflation will recede and central banks will change course. But historically, when this diversified portfolio has had a starting yield spread of 2% or greater than owning T-bills, the probability of outperformance over the next 12 months has been greater (Figure 3).

**FIGURE 3: DIVERSIFIED FIXED INCOME HAS HISTORICALLY BEATEN CASH**

	All periods	When starting tax-equivalent yield premium vs. cash was 2% or greater
% of 12M rolling periods (Jun 2000 to Oct 2022) when a diversified fixed income portfolio outperformed cash	81.0%	86.7%
Total number of periods	269	211
Number of periods the diversified portfolio outperformed cash	218	183
Median 12-month excess return	3.1%	3.5%
5th percentile downside excess return	-3.4%	-1.6%

Data source: Bloomberg, Jun 2000 to Oct 2022. Past performance does not predict or guarantee future results. Diversified fixed income portfolio is an equal-weighted blend consisting of the Bloomberg U.S. T-Bills 1-3 Months Index, the Bloomberg U.S. Aggregate Bond Index, the Bloomberg Ba-rated U.S. High Yield Corporate Index, the Bloomberg Municipal High Quality Intermediate Index and the Bloomberg Municipal BAA Index, rebalanced monthly. The tax-equivalent yield adjustment on municipal sectors assumes 40% effective tax rate. Cash is represented by the Bloomberg U.S. T-Bills 1-3 Months Index. Median excess return reflects the median return of the diversified portfolio over cash. The 5th percentile downside excess return reflects the 12-month relative performance of the diversified portfolio versus cash during the period that was worse than 95% of the outcomes in the sample.

*We understand why some investors may think moving into cash would be compelling, but doing so could well be a mistake.*

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## 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](http://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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