nuveen
A TIAA Company

Second quarter 2023 outlook

Rates, risk and recession

Anders Persson
CIO of Global Fixed Income

Tony Rodriguez
Head of Fixed Income Strategy

With the Fed's hiking cycle nearly over, investor focus shifts to recession woes. Recent bank turmoil raised the risk profile of sectors like contingent capital securities, but we remain constructive on the U.S. bank sector. We also believe any recession should be moderate and short lived. We favor non-Treasury spread sectors, with an up-in-quality bias. We currently see attractive opportunities in preferred securities and BB-rated high yield and senior loans. Wider credit spreads present a more attractive entry point across many fixed income sectors.

KEY TAKEAWAYS:

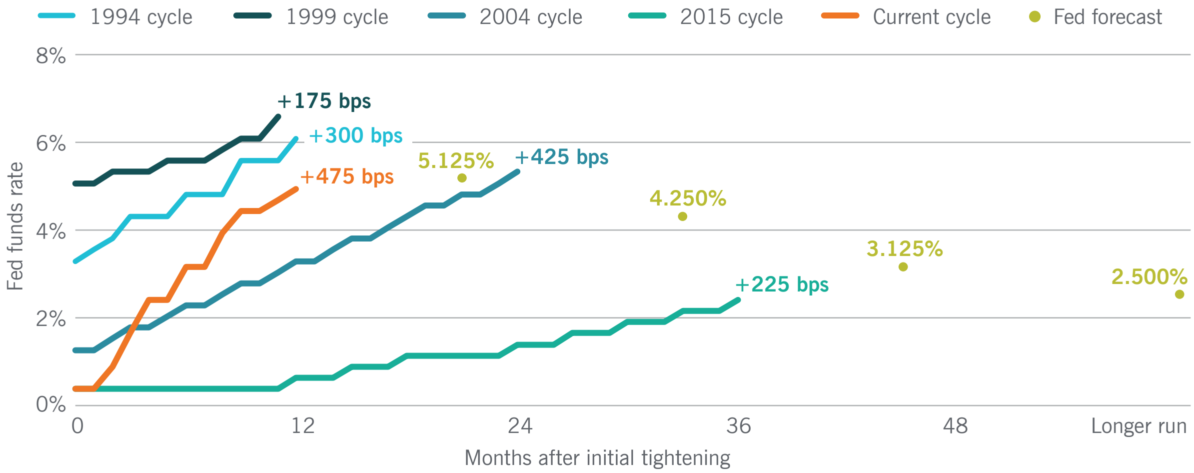
- Positive first quarter returns reflect the combined benefits of declining market yields and higher income.
- The increased risk in the bank sector highlights the importance of a well-diversified, actively managed portfolio.
- We favor credit sectors, especially higher quality segments of high yield and senior loans, as well as preferred securities.

HIKING CYCLE NEARLY COMPLETE

The U.S. Federal Reserve continued tightening with two more 25 basis point (bps) increases during the quarter. This brought the target range for the policy rate to 4.75%–5.00%, a fresh 16-year high. We anticipate one more 25 bps hike in 2023 before the cycle concludes. Compared to previous cycles, the Fed has moved much faster and in greater increments to combat persistently high inflation (Figure 1). While the Fed's projection of the ending level is yet higher, it also anticipates rate declines in the next year.

Figure 1: The Fed has moved much faster

Path of fed funds target rate compared to past cycles



Data sources: Bloomberg; Federal Reserve Projection Materials, 22 Mar 2023. Fed forecast represents the median forecast of each Federal Open Market Committee participant for the midpoint of the fed funds rate at year ends 2023, 2024, 2025 and longer run. Month 0 shows first rate increase.

BANKING CRISIS ADDS RISK

The quick rise in rates had an unexpected result: stressed bank balance sheets. Banks invest heavily in fixed income securities, and the sharp rate increase caused these assets prices to decline (when interest rates rise, bond prices fall). This trend — in conjunction with heavy depositor withdrawals — caused a few U.S. institutions with unique business models and already troubled Credit Suisse to require capital infusions. We believe broader contagion risks appear low for now, thanks to the quick and forceful reaction from policymakers.

We also remain constructive on the U.S. bank sector, including regional banks. Historically, regional banks and their more traditional, simplified business model have been a source of stability during otherwise turbulent times in the sector. Today, that stability comes from the larger money center banks, flipping the relationship and highlighting the importance of diversification.

We also maintain a constructive outlook on the European bank sector because these institutions are well capitalized on both an absolute basis and relative to their U.S. counterparts. Because European banks have a higher percentage of insured deposits than U.S. banks, we don't expect the same level of risk that we saw in the U.S.

In the long run, the level of regulatory oversight for all banks will likely increase. Banks will likely be forced to maintain higher levels of liquidity, and maybe even higher levels of capital. More regulatory requirements should improve and strengthen bank credit profiles, which would be good for credit investors.

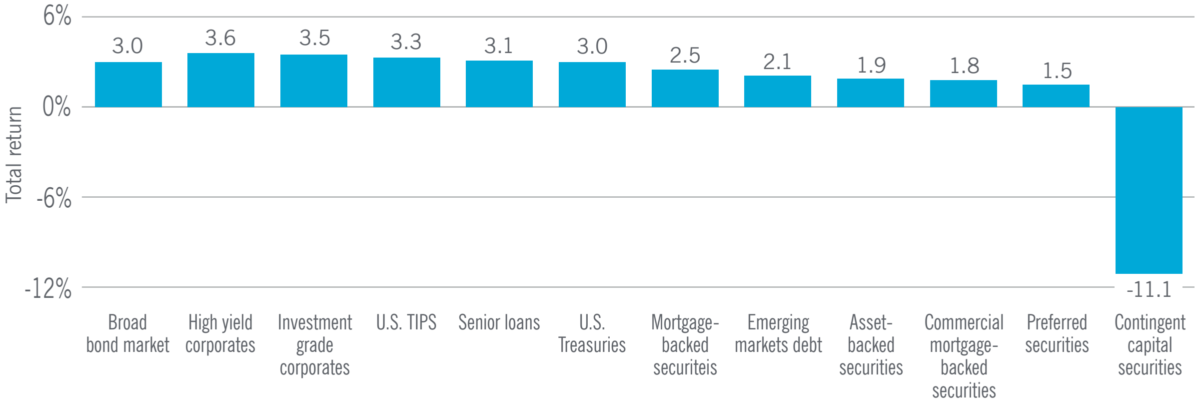
BOND RETURNS REMAIN POSITIVE

Although the bank headlines roiled the markets in late March, first quarter fixed income returns remained positive across most sectors — even the U.S. bank-heavy preferred sector. Only the contingent capital securities sector, which contains more than 90% European bank securities, ended the quarter with negative returns.

These positive returns reflect the combined benefits of declining market yields (when yields fall, bond prices increase) and higher income. The 10-year U.S. Treasury yield fell -0.40% during the quarter as risk averse investors flocked to U.S. Treasuries. The broad bond market, represented by the Bloomberg U.S. Aggregate Bond Index, now yields 4.40%. Over time, income has accounted for more than 95% of the bond market's return.[1] We believe this higher income makes bonds attractive.

Figure 2: Fixed income returns remained positive across most sectors

First quarter total returns (%)



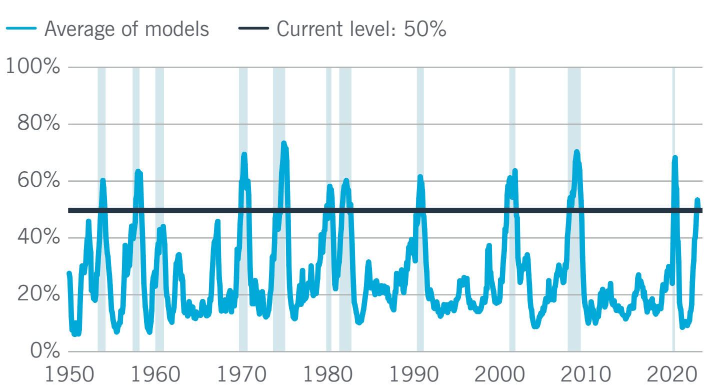
Data source: Morningstar Direct, 31 Mar 2023. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: broad bond market**: Bloomberg Aggregate Index; **high yield corporates:** Bloomberg U.S. HY 2% Issuer Capped Index; **investment grade corporates:** Bloomberg U.S. Investment Grade Corporate Index; **U.S. TIPS:** Bloomberg U.S. Treasury Inflation Protected Index; **senior loans:** Credit Suisse Leveraged Loan Index; **U.S. Treasuries:** Bloomberg U.S. Treasury Index; **mortgage-backed securities:** Bloomberg U.S. MBS Index; **emerging markets debt:** Bloomberg EM USD Aggregate Index; **asset-backed securities:** Bloomberg ABS Index; **commercial mortgage-backed securities:** Bloomberg CMBS Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **contingent capital securities:** ICE BofA USD Contingent Capital Index.

THE ODDS OF A RECESSION THIS YEAR ARE ELEVATED

The projected path of the Fed's "dot plot" of individual members' interest rate expectations indicates a recession. Similarly, the average of our models points to a 50% chance of U.S. recession within the next year, a level that has historically predicted an economic downturn. However, we continue to believe that any recession will be moderate in nature and relatively short lived.

Figure 3: Models point toward an economic downturn

Implied probability of a U.S. recession within the next 12 months



Data source: Nuveen, Bloomberg, L.P., Conference Board, Federal Reserve, Institute for Supply Management, Bureau of Labor Statistics and Department of Labor, 01 Jan 1950 – 31 Mar 2023. Shaded areas indicate recessions.

CONSIDER ACTIVELY MANAGED CORE AND MULTISECTOR PORTFOLIOS

The increased risk in the bank sector highlights the importance of a well-diversified, actively managed portfolio. Active managers employ intensive, bottom-up fundamental credit research to help identify opportunities, while broad diversification reduces the impact of any single sector or industry on overall returns. Active managers also adapt portfolios to the changing interest rate and economic environment.

Consider these ideas for fixed income allocations:

Short-term bond funds. The lower duration profile reduces the impact of rate changes on portfolio returns while still benefiting from a wide array of sectors. These funds typically combine higher-quality, short-duration sectors — like U.S. Treasuries, asset-backed securities and mortgage-backed securities — with smaller amounts of higher yielding sectors, such as high yield corporates and emerging markets debt. Note that short-term bond fund yields are near the level of longer duration strategies, making them even more attractive.

Multisector bond funds. The additional yield potential can help build total return. The funds augment a base of diversified higher-quality sectors with larger allocations (typically up to 50%) to below investment grade securities. This approach offers more yield potential than core plus, in return for greater potential volatility.

Core plus funds. The ability to actively adjust allocations to lower-quality segments may increase yield while balancing overall risk. These funds combine a larger portion of higher-quality sectors — like U.S. Treasuries, mortgage-backed securities and investment grade corporates — with smaller allocations (typically up to 30%) to lower-quality sectors, such as high yield corporates, senior loans and emerging markets debt.

Core/core impact with small amounts of plus sector exposure. These funds focus on higher-quality sectors to maintain return profiles similar to the broad bond market with a low correlation to equities. Core strategies with the flexibility to add small amounts (0% to 10%) of lower-quality sectors can be particularly attractive. Core strategies with an impact investing mandate add the diversification of responsible investing themes.

OUTLOOK

We expect growth to moderate to a below-trend pace

The risk of recession later this year is heightened in the U.S. and Europe, though the magnitude of a downturn should be mild by historical standards. Job growth, which has remained strong, is likely to decelerate in the coming quarters. Inflation has likely peaked, but will likely remain "too high" relative to central banks' targets through the end of 2023. This should drag on consumer spending and prompt further central bank tightening.

We expect the Fed to hike rates by 25 bps once more before ending the tightening cycle by mid-year. The European Central Bank is also likely to continue raising rates, though the overall level in Europe should remain lower than in the U.S. In China, policymakers are likely to continue pivoting toward "reopening" and economic policy support.

We continue to favor spread sectors and credit risk in asset allocation, with an up-in-quality bias within asset classes. We believe credit spreads are likely to widen in the coming months, likely presenting more attractive entry points for risk taking. That said, attractive opportunities exist in the preferred market and in BB-rated high yield and senior loans. We do not see much further upside for long-end yields.

For more information, please visit us at nuveen.com.

Endnotes

1 Data source: Bloomberg, L.P. Since index inception (31 Jan 1976 – 31 Mar 2023), 99.4% of the Bloomberg U.S. Aggregate Bond Index's annualized total return was derived from coupon return (as opposed to price appreciation).

Sources

Inflation: U.S. Bureau of Labor Statistics Consumer Price Index for All Consumers. **Employment:** Bloomberg, L.P., Bureau of Labor Statistics, Nuveen. **Global debt and yields:** Bloomberg L.P.

nuveen
A TIAA Company

GWP-2826750PG-Q0323P 363508