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CIO Weekly Commentary
08 May 2023

CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

Fed ready to rein in but not reverse rates

Bottom line up top

Monetary policy certainty: asked and not answered. While "Who's going to win the Kentucky Derby?" can be answered in two minutes, the question of when the U.S. Federal Reserve will start cutting rates is a horse of a different color. True, the outcome of last week's Fed meeting — a 25 basis points (bps) rate hike — was the odds-on favorite. But the meeting came amid the fallout of another U.S. regional bank failure, and the Fed's lack of clarity on a pause, let alone a pivot, rained on the optimistic stock market's parade. Fed Chair Jerome Powell alluded to a possible pause in the historic rate hiking cycle but pointedly bypassed opportunities to get more specific. And, while the quick acquisition of the most recently failed bank's assets was a silver lining, anxiety over the looming U.S. debt ceiling negotiations magnified existing concern about the overall health of the U.S. financial system.

Investors should be careful what they wish for. Consensus expectations call for interest rate cuts by the end of 2023, but we expect rates to remain higher for longer. A Fed pivot may sound like a tailwind for risk assets, but such a shift won't occur in a vacuum. In fact, what ultimately causes the Fed to cut — a slowing economy that devolves into a recession — is bound to be a negative for markets. Until then, continued tightness in the labor market, along with stubbornly sticky areas of inflation and a contentious political landscape in Washington, D.C., should cause volatility to pick up in the coming weeks.

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.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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Emerging ahead of the curve. Despite the challenges facing U.S. markets, we believe they're generally a relative safe haven compared to those of most other countries and regions. That said, we continue to see attractive pockets of investment opportunity outside the U.S., especially among certain emerging markets. We're focusing on countries that have maintained more restrictive monetary policies and where real rates have been positive in recent history (Figure 1). These conditions can help slow inflation and create room for larger (and more imminent) rate cuts than we expect in the U.S.

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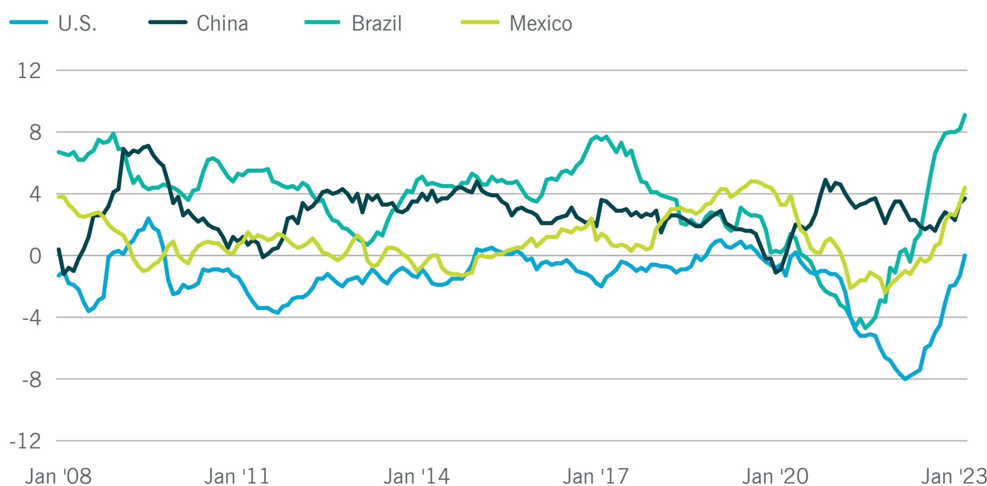
FIGURE 1: REAL RATES FAVOR EMERGING MARKETS

U.S. vs. China vs. Mexico vs. Brazil (%)



Data source: Bloomberg, L.P., Mar 2023. Real rates are calculated by subtracting the policy rate from the inflation rate of each country.

Portfolio considerations

In the first quarter, our Global Investment Committee upgraded its outlook on emerging markets equity and debt, a view we still hold. Last week's likely pause in Fed rate hikes could be a catalyst for further weakening of the U.S. dollar, which has already declined about 6% from its October 2022 high relative to EM currencies. This should be a boost for EM countries, making it easier for them to pay their dollar-denominated debt.

Within EM equities, country selection and diversification are crucial. China is always subject to scrutiny because it makes up approximately one-third of the MSCI EM Index. Currently, we're cautiously optimistic on Chinese equities, in part due to a continuing pickup in domestic consumption of services, namely restaurants and leisure activities. In March, China's non-manufacturing PMI Index reached 58.2 — its highest level since May 2011. PMI levels above 50

indicate expansion. But the manufacturing sector has not fared as well amid slowing global demand for Chinese consumer goods. Additionally, China faces geopolitical and trade tensions with the U.S. The friction should not be ignored, although it is likely more "noise" than a serious impediment to China's medium-term growth trajectory.

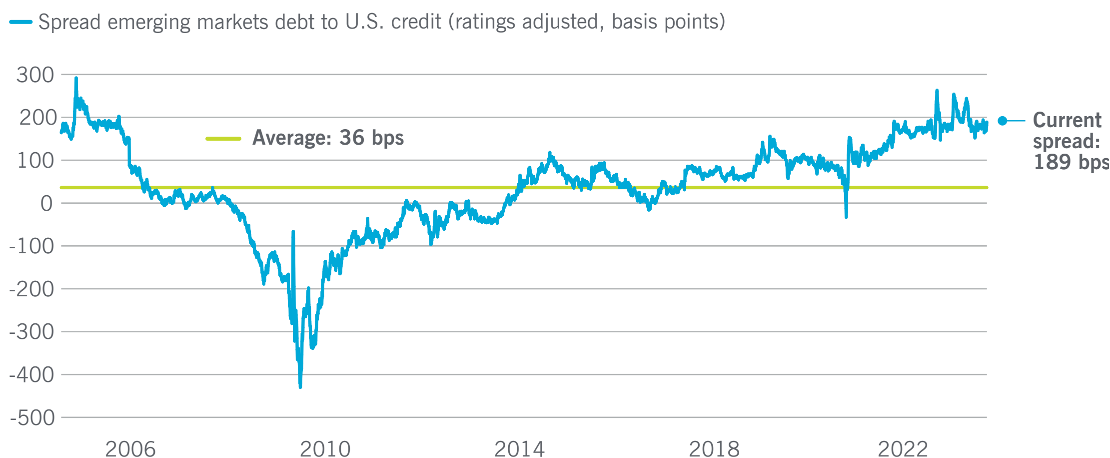
A pause in interest rate hikes by the Fed could be a catalyst for a weaker U.S. dollar.

Two EM equity markets we find attractive are Brazil and Mexico. In Brazil, consumer inflation continues to fall, to 4.65% in March compared to a peak of 12.1% in April 2022. The Brazilian central bank's key policy rate is 13.75%, a tad shy of its highest level in 15 years. With inflation rapidly cooling, policymakers may need to cut rates sooner rather than later — potentially sparking a strong equity market rally. Mexico's story is similar to Brazil's: high nominal and real rates, with decelerating inflation. With Mexico closely tied to the U.S., its central bank tends to change monetary policy according to Fed actions. This time, however, it may decide to cut much sooner than the Fed, especially with a real rate of 4.4%.

Country selection is also critical for EM debt, where we believe careful, patient investors may be rewarded. The asset class remains cheap compared to U.S. credit, with a current spread of 189 bps, more than five times wider than the long-term average of 36 bps (Figure 2). As with EM equities, prospective rate cuts could help drive strong total returns for EM fixed income. And market technicals remain supportive, with larger cash balances on the sidelines and the challenges facing distressed sovereign governments largely priced in.

FIGURE 2: EMERGING MARKETS HEADWINDS HAVE MODERATED

Emerging markets debt remains cheap relative to U.S. credit



Data sources: Bloomberg, L.P., JPMorgan, 31 Mar 2023. **Performance data shown represents past performance and does not predict or guarantee future results.** Spread of emerging markets debt to U.S. credit (ratings adjusted) is the credit spread of the JPMorgan Emerging Markets Bond Index minus Global Diversified (EMBI-GD) less the blended credit spread of a 50-50 mix of the Bloomberg U.S. High Yield Index and the Bloomberg U.S. Investment Grade Corporate Index.

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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Nuveen provides investment advisory services through its investment specialists.

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