

CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

Extra credit may be a plus for portfolios

Bottom line up top

Markets may be pricing in the best of both worlds: a soft landing atop a solid foundation. Rejuvenated optimism for a soft economic landing has helped propel gains for most risk assets over the past several weeks. Disinflation continues at a measured pace, signaling that this week's Federal Reserve meeting may mark the final rate increase of the long tightening cycle. But while the end of the Fed's hiking campaign could boost markets further, the benefits might be short-lived. That's because interest rates will likely remain elevated even after the rate hikes stop, as the impact of hawkish monetary policy that began in 2022 has yet to come home to roost. These factors will eventually take their toll on economic growth, regardless of current market bullishness.

The collapse of real estate appears to be greatly exaggerated. One area of the economy investors aren't viewing through rose-colored glasses is real estate — historically considered a reliable prognosticator of economic contraction. Markets continue to expect a doomsday event for the sector, but so far it has remained relatively resilient amid steadily rising rates. June's data for U.S. building permits, housing starts and the National Association of Home Builders confidence index provided a glimpse into the state of the U.S. residential real estate market. Although some of this data came in below consensus expectations, the misses were mostly benign. Both single-family building permits and the NAHB index hit their highest levels in 12 months (Figure 1).

Commercial real estate can still yield benefits. Like the U.S. housing market, commercial real estate continues to weather headwinds reasonably well. The recent regional bank failures and ongoing challenges



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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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faced by the office sector has kept skittish investors from adding exposure to CRE. Yet the banking turmoil has remained contained, and there's been no widespread contagion of weakness from the office space to other CRE sectors. Additionally, while data from Fitch Ratings shows delinquency rates for commercial mortgage-backed securities have ticked up to near 2%, that's well below the 9% level reached during the Global Financial Crisis and the 5% mark we saw during the early stages of the Covid pandemic. Furthermore, the rise in delinquencies has been limited primarily to sectors such as office, lodging and retail, while delinquencies in sectors like apartments and industrial properties are within historical norms.

Despite negative headlines surrounding the office sector, we see compelling opportunities within real estate.

FIGURE 1: CONFIDENCE IN THE HOUSING MARKET CONTINUES TO IMPROVE

NAHB housing market index



Data source: FactSet and the National Association of Home Builders. Jul 2013 to Jun 2023.

Portfolio considerations

Against this backdrop of economic resilience, a likely stop to Fed rate hikes and little evidence of broadly deteriorating fundamentals, we believe commercial real estate — along with select “plus” fixed income credit sectors — warrant consideration for investors seeking higher yields and total returns. Fixed income credit exposure in particular has been a winning choice for investors year-to-date, with sectors such as high yield corporates and emerging markets debt outperforming broad investment grade benchmarks.

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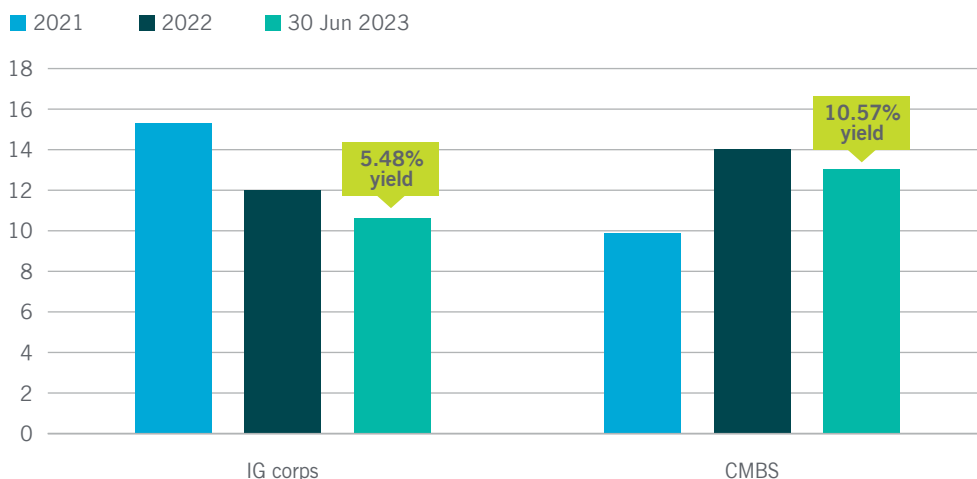
But not all credit sectors offer the same opportunities. We advocate a flexible and nimble approach to allocating among different areas of the global fixed income market. Beginning a couple of years ago, for example, we began to believe that investment grade bonds were starting to look slightly expensive given their tight spreads relative to Treasuries. Likewise, we felt agency mortgage-backed securities weren't offering high enough yields over Treasuries to compensate for their risks.

In contrast, we saw better opportunities developing in emerging markets debt, given still-supportive growth levels and, more recently, central bank moves to cut policy rates in China and (we anticipate) Brazil. Non-office commercial mortgage-backed securities have also become more compelling compared to investment grade bonds, as the sector has benefited from rigorous underwriting standards and improving loan-to-value ratios over the past decade. The CMBS asset class currently offers a highly attractive 10.6% yield and a spread of 450 basis points over Treasuries — its largest ever outside of a recession. Figure 2 shows how a hypothetical flexible fixed income portfolio could have adjusted allocations in light of these advantages, rotating out of investment grade corporate bonds and into CMBS.

We see value in taking on credit risk in fixed income, while also maintaining a flexible asset allocation approach.

FIGURE 2: THE BENEFITS OF FLEXIBILITY

Hypothetical allocation shifts in a fixed income portfolio (%)



Data source: Bloomberg L.P. Yields shown are yield-to-worst. Representative indexes: Investment grade corporates: CMBS: ICE BofA AA-BBB U.S. Fixed Rate CMBS Index. This represents hypothetical historical portfolio shifts across a broad fixed income allocation and is not intended to reflect any specific portfolio, product or service.

About Nuveen's Global Investment Committee

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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

For more information, please visit nuveen.com.

Endnotes

Sources

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

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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. Real estate investments are subject to various risks, including fluctuations in property values, higher expenses or lower income than expected, and potential environmental problems and liability. Debt or fixed income securities are subject to market risk, credit risk, interest rate risk, call risk, derivatives risk, dollar roll transaction risk and income risk. As interest rates rise, bond prices fall. Below investment grade or high yield debt securities are subject to liquidity risk and heightened credit risk. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. Asset-backed and mortgage-backed securities are subject to additional risks such as prepayment risk, liquidity risk, default risk and adverse economic developments.

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