

Third quarter 2023 outlook

Waiting for the rate cycle to turn



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The Fed's hiking cycle is nearly complete and recession expectations have largely been delayed to 2024. While it is tempting for investors to sit in still high yielding cash, we favor adding duration due to the higher yields of longer-term securities and their ability to benefit from any future rate cuts. We advocate a diversified multisector approach, focused on higher-quality credits across sectors. Active management remains critical, as credit spreads will likely widen in the coming months.

KEY TAKEAWAYS:

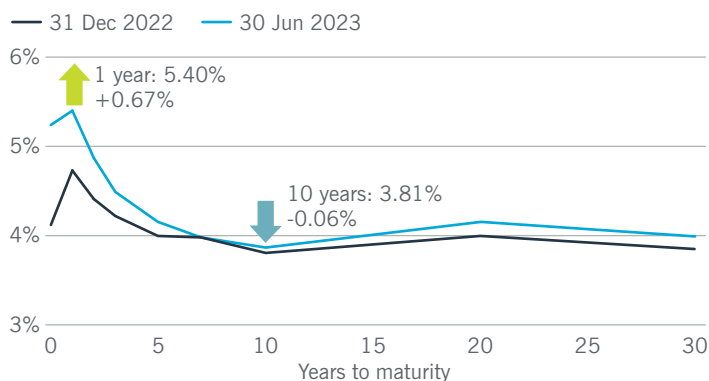
- Fixed income sectors have posted positive returns year to date, with the higher yielding sectors generally leading the pack.
- The advantage of cash over intermediate-term bonds has historically disappeared at the end of the hiking cycle.
- We favor credit sectors, and are finding opportunities in preferreds and BB rated high yield bonds and senior loans.

SHORT RATES CONTINUE CLIMBING

The yield on cash investments spiked this year, as U.S. Federal Reserve rate hikes drove the shortest-term rates higher (Figure 1). Conversely, intermediate- to longer-term yields have remained steady because they are influenced more by investor expectations of economic growth and inflation. As inflation faded and thoughts turned to recession, intermediate- to longer-term yields declined slightly. Looking forward, we expect yields to decline from here and forecast the 10-year Treasury yield to end the year at 3.25%.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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Figure 1: Short rates have risen the most*U.S. Treasury yield*

Data source: treasury.gov. Performance data shown represents past performance and does not predict or guarantee future results.

THE FED RATE HIKE CYCLE IS NEARLY COMPLETE

While markets are currently pricing only one additional Fed hike this year, we think a second hike is very possible. Despite recent improvement, inflation remains too high. Goods inflation has returned to normal, but housing and other core services remain too hot (Figure 2). We believe monetary policy tightening has not reduced inflation as much as the Fed expected, supporting our call for more hikes.

We forecast core inflation to be around 4% and 3% at the end of 2023 and 2024, respectively. We'll be watching the core services inflation excluding housing, which is the biggest driver of headline prices.

HOLDING CASH HAS A COST

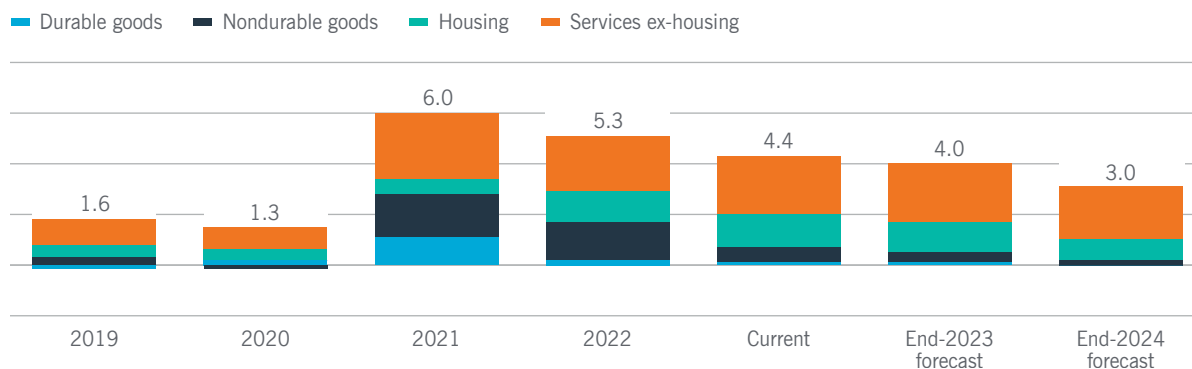
With short-term yields so high, it may be tempting to maintain larger cash allocations. But the advantage of cash over intermediate-term bonds has historically disappeared at the end of the hiking cycle (Figure 3). Higher yields add total return potential in a stable-to-declining rate environment.

In the months surrounding the end of Fed rate hiking cycles, the broad bond market has historically returned 5.5% on average versus 2.1% for 2-year Treasuries. This return advantage generally continued after the cycle ended. Therefore, we think it makes sense to reduce short-duration positions and move closer to neutral in the current environment.

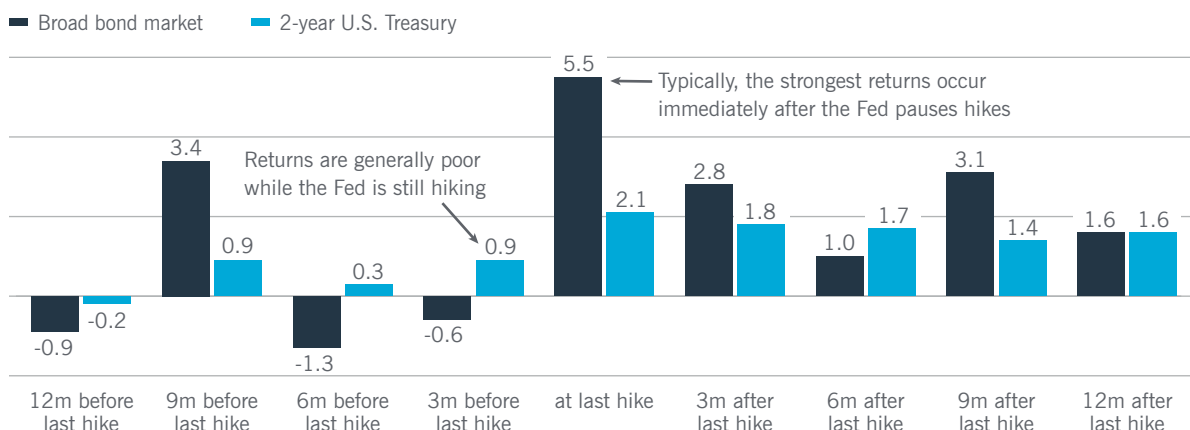
While cash yields rise along with rate hikes, they fall just as quickly once the Fed starts cutting. On the other hand, intermediate-term bonds may benefit from potential future rate declines because bond prices rise as interest rates fall.

FIXED INCOME RETURNS REMAIN STRONG DESPITE RISING RATES

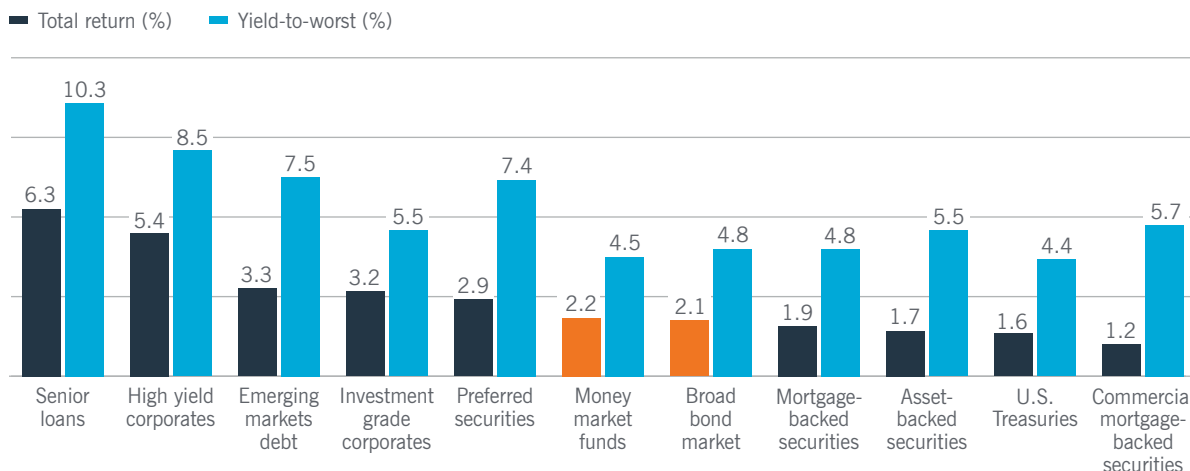
Due to their strong income component, fixed income sectors have posted positive returns year to date (Figure 4). Generally, the higher yielding sectors led the pack. The broad bond market finished similar to cash, as represented by money market funds, even though the rate cycle was not yet done.

Figure 2: Inflation remains too high for the Fed*Contribution to headline PCE inflation, year-over-year (%)*

Data source: Bloomberg, L.P., Haver Analytics, Bureau of Economic Analysis, 30 Apr 2023.

Figure 3: Higher yields add to total return potential with rates stable to declining*Average three-month total returns ahead of and after the last rate hike (%)*

Data source: Bloomberg, L.P., Nuveen. Performance data shown represents past performance and does not predict or guarantee future results. Average of performance over the last four Fed tightening cycles.

Figure 4: Higher yielding sectors have led performance so far this year

Data source: Morningstar Direct, 01 Jan 2023 – 30 Jun 2023. Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: senior loans: Credit Suisse Leveraged Loan Index; high yield corporates: Bloomberg U.S. HY 2% Issuer Capped Index; emerging markets debt: Bloomberg EM USD Aggregate Index; investment grade corporates: Bloomberg U.S. Investment Grade Corporate Index; preferred securities: ICE BofA U.S. All Capital Securities Index; money market funds: Morningstar US Fund Prime Money Fund Category Average; broad bond market: Bloomberg Aggregate Index; mortgage-backed securities: Bloomberg U.S. MBS Index; asset-backed securities: Bloomberg ABS Index; U.S. Treasuries: Bloomberg U.S. Treasury Index; U.S. TIPS: Bloomberg U.S. Treasury Inflation Protected Index; commercial mortgage-backed securities: Bloomberg CMBS Index.

CONSIDER ACTIVELY MANAGED, DIVERSIFIED MULTISECTOR PORTFOLIOS

As the rate cycle closes and the economy begins to slow, intensive, active managers employ intensive, bottom-up fundamental credit research to help identify opportunities. Broad diversification also reduces the impact of any single sector or industry on overall returns.

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 yields on short-term bond funds are now 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 continue moderating

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

We now expect the Fed to hike rates by 25 bps at least once more before ending the tightening cycle later this 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, which may present more attractive entry points for risk taking. That said, we currently see opportunities 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

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.

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