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Don’t panic about rising rates

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Interest rates rose sharply and the yield curve steepened in the first quarter, resulting in negative returns for many bond sectors. While rising rates do cause bond prices to decline, higher yields may provide benefits to diversified portfolios over time. We continue to favor credit sectors in this environment, and active managers can take advantage of these opportunities to increase income and build return.

KEY TAKEAWAYS:

- While rising yields cause bond prices to fall in the short term, higher rates can be beneficial over the medium term.
- Higher yields create more income, and an improving economy generally benefits credit sectors.
- The steepening yield curve also creates opportunities for active managers to position along the yield curve to add incremental alpha.

INTEREST RATES ARE HIGHER

Good news abounded during the first quarter. Robust retail sales, stronger manufacturing data and surging commodity prices reflected the continued economic recovery. A second fiscal stimulus package and the anticipation of more bolstered consumer spending and confidence. COVID-19 case counts fell, a new vaccine was approved and vaccination programs rolled out.

While rates rose swiftly during the quarter, we don’t expect rates to rise significantly from here.

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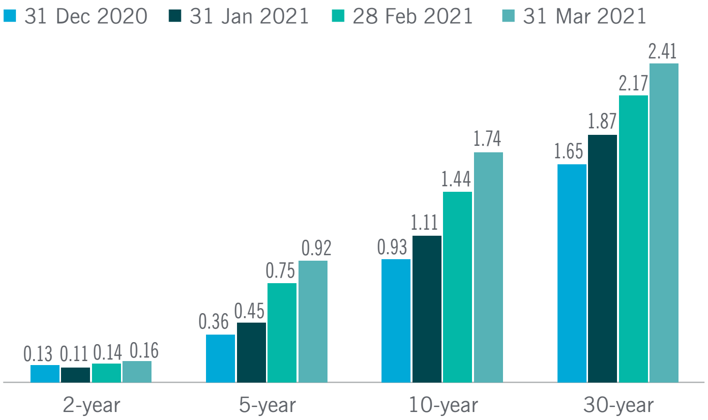
Figure 1: Treasury yields rose during the quarter

Treasury yields (%)



Data source: federalreserve.gov. **Past performance is no guarantee of future results.**

Interest rates rose as a result, with the 10-year Treasury yield ending the quarter at 1.74%. The yield curve steepened, as longer-term rates rose while shorter-term yields remained anchored.

While rates rose swiftly during the quarter, we don't expect rates to rise significantly from here. The optimism that propelled rates higher pulled forward increases that were already expected later this year. We estimate that the 10-year Treasury yield will increase to around 2.0% by year-end, modestly higher but not enough to derail growth.

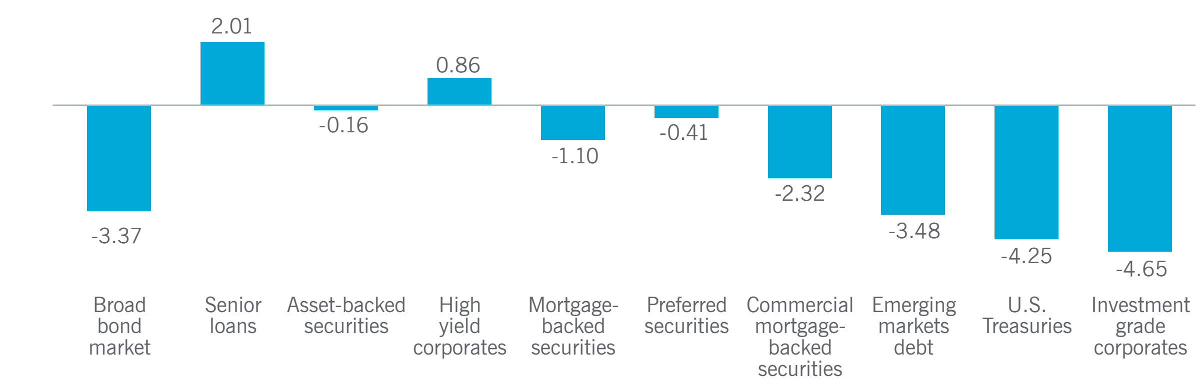
The Federal Reserve (Fed) has not yet signaled that this yield increase is worrisome, and we expect the Fed would respond if financial conditions became impaired. The market has pulled forward the timing of the first Fed hike from the end of 2023 to the end of 2022, recognizing the faster-than-expected recovery. However, we think the Fed is more likely to delay a hike until 2023.

WHEN YIELDS RISE, BOND PRICES FALL

Not surprisingly, this rather sharp increase in rates meant negative returns for many segments of the fixed income market. Sectors with more sensitivity to changes in interest rates, as measured by their duration, fell the most. Only senior loans, which are predominantly floating-rate securities, and high yield bonds showed positive returns over the quarter.

Figure 2: Sectors with the longest durations fared worst

Total return (%)



Duration (yrs)	6.4	0.3	2.1	3.9	4.1	4.8	5.2	6.7	6.8	8.5

Data source: Bloomberg, L.P., Morningstar Direct, Credit Suisse, 01 Jan 2021 – 31 Mar 2021. **Past performance is no guarantee of future results. Representative indexes: broad bond market:** Bloomberg Barclays Aggregate Index; **U.S. Treasuries:** Bloomberg Barclays U.S. Treasury Index; **mortgage-backed securities:** Bloomberg Barclays U.S. Mortgage-Backed Securities Index; **asset-backed securities:** Bloomberg Barclays Asset-Backed Securities Index; **commercial mortgage-backed securities:** Bloomberg Barclays Commercial Mortgage-Backed Securities Index; **investment grade corporates:** Bloomberg Barclays U.S. Investment Grade Corporate Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **high yield corporates:** Bloomberg Barclays U.S. HY 2% Issuer Capped Index; **senior loans:** Credit Suisse Leveraged Loan Index; **emerging markets debt:** Bloomberg Barclays EM USD Aggregate Index.

RISING RATES ARE NOT ALL BAD

While rising yields cause bond prices to fall in the short term, higher rates can be beneficial over the medium term. Active managers are well-suited to take advantage of the benefits higher yields can bring as they adapt portfolio strategy to changing market conditions.

More income

A fixed income security's yield comprises the risk-free rate (the Treasury rate of a similar duration) plus the credit spread (compensation for the risk of that security). Therefore, rising Treasury rates can increase the yield of fixed income assets.

The yields of common fixed income sectors have generally increased year-to-date as base Treasury rates have increased. Since more than 93% of fixed income returns come from income rather than price changes, these higher yields help increase total return potential over time.[1] They also help offset the negative impact of rising rates.

Active managers can blend higher income sectors with lower-risk, higher-quality sectors to help capture income opportunities while managing risks.

Improved economic conditions benefit many fixed income sectors

When interest rates are rising, it generally means that the economy is improving. Demand for credit increases as business activity expands, creating a higher cost for borrowing money.

Improving economic activity is a positive for many fixed income issuers. Consumers are buying more goods and services supplied by the companies issuing the bonds. Homeowners are better able to pay their mortgages and credit card bills, which support mortgage-backed and asset-backed securities, respectively. Bond defaults decrease as borrowers are better able to make coupon payments and return principal.

These conditions lead to declining credit risk, which reduces the credit spread and increases bond prices over time. Active managers can use bottom-up credit research to uncover companies and securities best positioned to benefit from an improving economy.

Steeper yield curve provides opportunities for active managers

Over the first quarter, longer-term rates rose more than shorter-term rates, which remain anchored by Fed policy. The steepening yield curve creates opportunities for active managers to position along the yield curve to add incremental alpha.

Figure 3: Fixed income sectors offer income potential

	Yield-to-worst (%)		
	31 Dec 2020	31 Mar 2021	**Change**
Broad bond market	1.12	1.61	**0.49**
Asset-backed securities	0.45	0.56	**0.11**
U.S. Treasuries	0.57	1.00	**0.43**
Commercial mortgage-backed securities	1.28	1.71	**0.43**
Mortgage-backed securities	1.25	1.82	**0.57**
Investment grade corporates	1.74	2.28	**0.54**
Preferred securities	2.40	2.87	**0.47**
Emerging markets debt	3.50	4.01	**0.51**
High yield corporates	4.20	4.24	**0.04**
Senior loans	5.10	4.88	**-0.22**

Data source: Bloomberg, L. P., Credit Suisse. **Past performance is no guarantee of future results. Representative indexes: broad bond market:** Bloomberg Barclays Aggregate Index; **U.S. Treasuries:** Bloomberg Barclays U.S. Treasury Index; **mortgage-backed securities:** Bloomberg Barclays U.S. Mortgage-Backed Securities Index; **asset-backed securities:** Bloomberg Barclays Asset-Backed Securities Index; **commercial mortgage-backed securities:** Bloomberg Barclays Commercial Mortgage-Backed Securities Index; **investment grade corporates:** Bloomberg Barclays U.S. Investment Grade Corporate Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **high yield corporates:** Bloomberg Barclays U.S. HY 2% Issuer Capped Index; **senior loans:** Credit Suisse Leveraged Loan Index; **emerging markets debt:** Bloomberg Barclays Emerging Markets USD Aggregate Index.

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Active managers can buy longer-term bonds with higher yields, and may reduce the interest rate sensitivity of those bonds through offsetting positions. They can invest more in the types of companies that benefit from steeper yield curves, such as banks. Banks invest their assets in longer-term securities and pay interest based on shorter-term rates, capturing the difference as profit. Active managers can also position portfolios to benefit from changes in the shape of the yield curve. For example, if they anticipate more steepening, they may underweight longer-maturity securities.

CREDIT SECTORS HAVE HISTORICALLY OUTPERFORMED FOLLOWING PERIODS OF RISING RATES

In this environment of rising rates, we continue to favor diversified exposure to credit sectors across our portfolios. These sectors have higher income potential and greater overall sensitivity to improving economic conditions. Both these factors can help offset the negative impact of rising rates and build total return potential.

Looking back historically, we found two previous periods where real rates rose similarly to the first quarter: the Taper Tantrum of 2013 and the COVID-19 crisis of 2020. Following these events, credit sectors, such as investment grade corporates, high yield corporates, preferred securities and emerging markets debt, significantly outperformed higher-quality sectors like U.S. Treasuries and mortgage-backed securities.

While certain credit sectors have higher risk, judicious addition to diversified portfolios using active management can help offset the impact of rising rates.

DIVERSIFIED, ACTIVELY MANAGED PORTFOLIOS CAN ADJUST TO HIGHER RATES

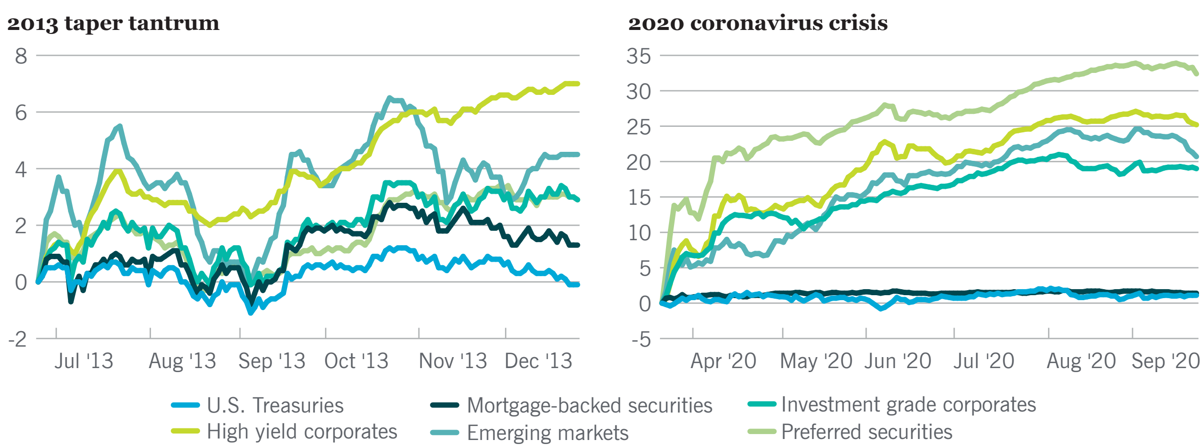
Active managers have the expertise, resources and access to credit research to benefit from a higher-rate environment. During these periods of rate changes, they reposition portfolios to take advantage of the higher yields and emerging opportunities created by economic recovery.

For these reasons, a broadly diversified fixed income strategy with the flexibility to invest across high quality and higher yield sectors can make sense. Consider these types of portfolios for rising rates:

Short-term bond: Typically combine higher-quality, short-duration sectors, like U.S. Treasuries,

Figure 4: Credit sectors outperformed in the six months following a 45 bps rise in rates

Cumulative total return (%)



Data source: Bloomberg, L.P., 01 Jun 2013 – 31 Dec 2013 and 01 Mar 2020 – 30 Sep 2020 **Past performance is no guarantee of future results.** Charts illustrate six months following previous time periods where real rates rose over 45 bps over a 10-session period. **Representative indexes: U.S. Treasuries:** Bloomberg Barclays U.S. Treasury Index; **mortgage-backed securities:** Bloomberg Barclays U.S. Mortgage-Backed Securities Index; **investment grade corporates:** Bloomberg Barclays U.S. Corporate Investment Grade Index; **high yield corporates:** Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index; **emerging markets debt:** JPMorgan EMBI Global Total Return Index; **preferred securities:** ICE BofA All Capital Securities Index.

asset-backed securities and mortgage-backed securities, with smaller amounts of higher-yielding sectors, such as high yield corporates and emerging markets debt. Diversified short-term bond funds can reduce overall interest rate sensitivity while benefiting from a wide array of sectors.

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

Multisector bond. Augment a base of diversified higher-quality sectors with larger allocations (typically up to 50%) to below investment grade securities. Offer more yield potential than core plus, in return for greater potential volatility.

Core/core impact with limited plus sector exposure. Focus more on higher-quality sectors to maintain return profiles similar to the broad bond market and 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 in this low yield environment. Core strategies with an impact investing mandate add the additional diversification of responsible investing themes.

OUTLOOK

Optimistic growth expectations support credit sectors

The economic outlook improved significantly during the first quarter. Consensus forecasts for full-year U.S. growth have risen from less than 4% at the start of the year to around 6%, and will likely rise further. The combination of lower COVID-19 case growth, impressive progress on vaccinations, substantial fiscal stimulus and continued Fed accommodation has boosted optimism. Surveys of industrial activity have risen to multidecade highs, jobs growth has improved and consumer spending has accelerated.

We expect economic activity to progress even further in the months ahead. Vaccination rates should soon reach thresholds that enable broader economic normalization, and consumer balance sheets are strongly positioned for a robust consumption rebound. Inflation will likely rise significantly year-over-year as low readings from last spring impact the calculation, but levels should ultimately revert toward the Fed’s 2% target longer term.

Fiscal stimulus should remain supportive in the quarters ahead, albeit at a greatly reduced magnitude. The Fed will likely maintain its patient approach to policy for the near term, before gradually tapering asset purchases beginning a few quarters from now. Rate hikes are unlikely in the near term, given the still-persistent shortfall in employment, which we can expect for at least another year.

We expect long-end interest rates to rise further throughout this year, reflecting the potential for better growth and inflation. Accordingly, we maintain underweight in longer-duration market segments and prefer floating-rate securities such as senior loans. Given their full valuations, spread sectors are unlikely to see much further tightening, but they should benefit from higher yields, strong fundamentals and improved risk sentiment.

The strong macro backdrop should drive double-digit growth in corporate earnings and cash flow, along with significant declines in defaults and ratings downgrades. We remain overweight high yield and investment grade credit, emerging markets, preferred securities and structured products. We also continue our deep research on idiosyncratic stories to identify opportunities offering positive long-term growth prospects beyond the next few quarters.

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

Endnotes

Sources

1 Source: Bloomberg, L.P. Based on the percent of annualized total return derived from coupon return (as opposed to price appreciation) since index inception (01 Jan 1976) on the Bloomberg Barclays Aggregate Bond Index; returns from 31 Jan 1976 – 31 Mar 2021.

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