

CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

Where to allocate as the Fed hesitates

Bottom line up top

Cause for pause: Economy grows, inflation slows. Equity and fixed income markets rallied in the wake of last week's U.S. Federal Reserve decision to keep its benchmark fed funds rate unchanged for the second meeting in a row. The S&P 500 Index gained nearly 3% on Wednesday and Thursday combined, while U.S. Treasury yields declined by an average of 12 basis points (bps) across all maturities. After months of hoping the Fed would fast forward to rate cuts, investors now seem content as the central bank keeps its finger on the pause button.

That said, the Fed left the door open to another possible rate hike before year-end — a stance consistent with its progressively upgraded characterization of U.S. economic growth, from “moderate” to “solid” to “strong” in its past three policy statements. Third quarter GDP growth of nearly 5%, more than double the second quarter's 2.1% pace, undoubtedly informed the Fed's data-driven perspective. Meanwhile, inflation has slowed markedly from its 2022 peaks. But at 3.7%, the Core PCE Price Index is still too far above the Fed's 2% goal to rekindle hopes of an imminent pivot to rate cuts. Inflation remains squarely in the Fed's crosshairs, even as markets expect the inflation rate to fall to about 2.4% over the long term (Figure 1).

Dealing with the labor market wildcard. The U.S. monthly employment report is arguably the most closely watched of all economic data releases. It encompasses several key metrics on the health of the labor market, which in turn may signal trends in the broader economy and influence Fed policymaking. Among these metrics, job creation —



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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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measured by net new nonfarm payrolls added — has been difficult to forecast in recent months. It has either lagged or exceeded economists' projections by sizable margins and is often significantly revised after the fact. Unpredictable job numbers and other labor market indicators, especially wage growth and the labor force participation rate, can further complicate attempts to position portfolios in a Fed-driven environment. October's payrolls, released last Friday, fit this uncertain mold by surprising to the downside. In our view, this latest snapshot of the labor market is unlikely to change the Fed's approach.

FIGURE 1: TEMPERED INFLATION EXPECTATIONS ARE UNLIKELY TO SWAY FED FROM HIGHER-FOR-LONGER RATES

Benchmark U.S. Treasury yields (%)



Data source: Bloomberg, L.P., 01 Jan 2020 – 30 Sep 2023. Performance data shown represents past performance and does not predict or guarantee future results. "Market expectations of inflation over 10 years" measured by the 10-year TIPS breakeven rate.

Portfolio considerations

To add, or not to add — that is the question. Topping the list of investor FAQs in today's environment are two related topics: "Where do you see rates going in the near-to-medium term?" and "What's an appropriate level of duration for my portfolio?" It's an apt pairing of queries, as fixed-rate fixed income assets experience capital appreciation when yields fall, and capital depreciation when yields rise. Because yields have risen sharply over the past few quarters, bond math now favors adding duration to both taxable and tax-exempt fixed income allocations. Figure 2 illustrates this concept, showing the expected total return of various Treasury maturities over the next year under three scenarios: yields stay the same, rise by 100 bps or decline by 100 bps.

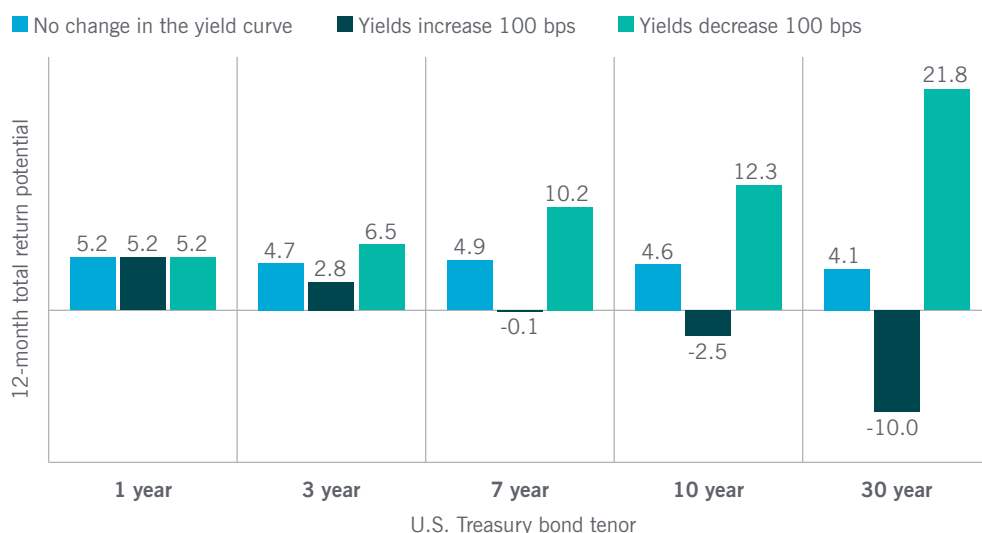
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We are finding attractive opportunities in securitized assets, preferred securities, investment grade corporate bonds and senior loans.

For example, the 10-year Treasury would return +4.6% over the next year if its yield remained the same. If the 10-year yield were to rise by 100 bps (as it essentially has done year-to-date), the return would be -2.5%. And if the yield were to drop by 100 bps, the return would be +12.3%. We think today's elevated yields could decline over the next year, which would result in healthy capital appreciation.

FIGURE 2: WITH TREASURY YIELDS LIKELY TO DECLINE, BOND MATH FAVORS OWNING DURATION

Potential investment returns for Treasury tenors over the next year (%)



Data sources: Bloomberg, L.P., 25 Oct 2023. Performance data shown represents past performance and does not predict or guarantee future results. Total return potential includes roll, price change and coupon return.

Up in quality, up in duration. Within the taxable fixed income space, investors also receive a spread over Treasuries, meaning returns over the next year should be affected by any movement in spreads. We believe that any spread widening caused by a potential economic slowdown will be limited, as consumer balance sheets remain strong and business investment solid.

Additionally, corporate default rates are still below their historical average, which supports selectively taking on credit risk. We are finding attractive opportunities in securitized assets, preferred securities, investment grade corporate bonds and senior loans. With regard to investment grade corporates, their relatively longer durations offer compelling return potential if yields decline as we expect, and can be an effective way to add duration to a portfolio while seeking to minimize credit risk. As for senior loans, we emphasize an up-in-quality approach, as the lowest-rated segments may struggle if yields rise, while the asset

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class as a whole stands to benefit if rates remain higher for longer. And because senior loans are a floating-rate asset class, they may provide some protection if we are wrong about yields declining.

Choosing municipals needn't be a taxing allocation decision.

On the tax-exempt side, AAA rated municipal bonds currently pay taxable-equivalent yields that are higher than Treasury yields across all maturities, starting at the 32% tax bracket. The AAA rated muni curve is significantly steeper than the Treasury curve, favoring an overweight duration allocation in portfolios. High yield municipals also merit consideration, given their strong underlying fundamentals and our view that credit spreads will remain stable in the medium term.

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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. Equity investing involves risk. Investments are also subject to political, currency and regulatory risks. These risks may be magnified in emerging markets. Diversification is a technique to help reduce risk. There is no guarantee that diversification will protect against a loss of income. As an asset class, real assets are less developed, more illiquid, and less transparent compared to traditional asset classes. Investments will be subject to

risks generally associated with the ownership of real estate-related assets and foreign investing, including changes in economic conditions, currency values, environmental risks, the cost of and ability to obtain insurance, and risks related to leasing of properties. Alternative investments are not appropriate for all investors and should not constitute an entire investment program. Investors may lose all or substantially all of the capital invested. The historical returns achieved by alternative asset vehicles is not a prediction of future performance or a guarantee of future results, and there can be no assurance that comparable returns will be achieved by any strategy.

Investing in municipal bonds involves risks such as interest rate risk, credit risk and market risk. The value of the portfolio will fluctuate based on the value of the underlying securities. There are special risks associated with investments in high yield bonds, hedging activities and the potential use of leverage. Portfolios that include lower rated municipal bonds, commonly referred to as “high yield” or “junk” bonds, which are considered to be speculative, the credit and investment risk is heightened for the portfolio. Bond insurance guarantees only the payment of principal and interest on the bond when due, and not the value of the bonds themselves, which will fluctuate with the bond market and the financial success of the issuer and the insurer. No representation is made as to an insurer's ability to meet their commitments.

This information should not replace an investor's consultation with a financial professional regarding their tax situation. Nuveen is not a tax advisor. Investors should contact a tax professional regarding the appropriateness of tax-exempt investments in their portfolio. If sold prior to maturity, municipal securities are subject to gain/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on the state of residence. Income from municipal bonds held by a portfolio could be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

Debt or fixed income securities are subject to market risk, credit risk, interest rate risk, call risk, tax risk, political and economic risk, and income risk. As interest rates rise, bond prices fall. Credit risk refers to an issuer's ability to make interest payments when due. Below investment grade or high yield debt securities are subject to liquidity risk and heightened credit risk. Non-U.S. investments involve risks such as currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. These risks are magnified in emerging markets. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

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