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CIO Weekly Commentary
08 April 2024

CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

A fixed income blend as themes converge

Bottom line up top

Great expectations meet immutable forces. The second quarter started with anticipation around momentous events in the U.S. across astronomy, sports … and, yes, even investing. Two headline-grabbing phenomena — a fresh batch of stronger-than-expected U.S. employment data and the women's 2024 NCAA basketball championship game — have already delivered the goods, while two others — the corresponding men's final matchup and a rare total solar eclipse visible across a swath of North America — are happening today.

Like fans who saw their brackets busted over the course of March Madness or sun gazers thwarted by cloud cover, investors counting on better progress in the fight against inflation and a quicker pivot to lower interest rates had to contend with further reality checks from the U.S. labor market last week. ADP private employment numbers, the JOLTS (Job Openings and Labor Turnover Survey) report and nonfarm payrolls data all revealed continued resilience. Even a deeper look at JOLTS data showing a higher rate of layoffs versus hires (Figure 1) was more a reversion to longer-term trends than a sign of labor market weakening.

Not surprisingly, equity and fixed income performance was mixed amid these persistent signals of strength. Early in the week, U.S. Treasury yields climbed to their highest levels since last November, while stocks called a timeout following what had been their best first-quarter return since 2019. By Friday, however, markets saw yields move a bit lower while stock prices edged higher.

Observable evidence supports sound conclusions. Our "higher for longer" rate hypothesis can be seen as a financial case study in Newton's first law of motion, which states that an object at rest (in this case, Federal Reserve rate policy) will remain at rest, and an object in motion (the resilient economy) will remain in motion, unless acted upon by an unbalanced force. For now, the

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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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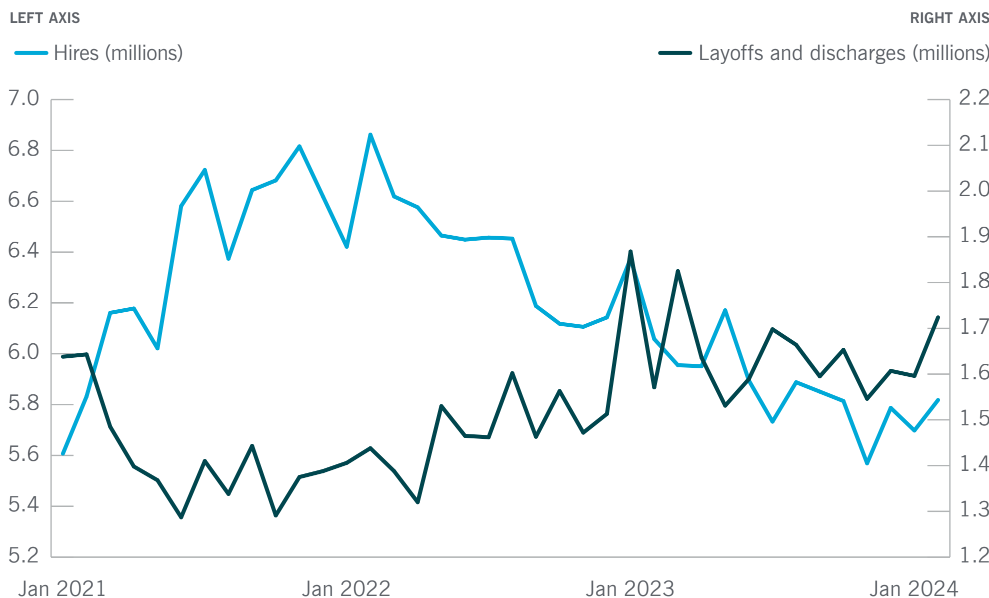
force of inflation appears to be in balance, not unbalanced, given the Fed's rate stance and U.S. economic strength. With this in mind, we continue to expect the Fed to wait until midyear (or possibly even a bit later) to make the first of what will likely be no more than three rate cuts in 2024. Against this backdrop, investors seeking to optimize income generation in their portfolios may want to take a fresh look at their asset allocations.

The inflation and growth backdrop suggests Fed interest rate cuts are at least a couple of months away.

FIGURE 1: LAYOFFS ARE INCREASING, BUT SO IS HIRING



Data sources: FactSet and the U.S. Bureau of Labor Statistics, seasonally adjusted data from Jan 2021 to Feb 2024.

Portfolio considerations

Investors looking to lock in attractive yields ahead of eventual rate cuts while also positioning their portfolios to benefit when those cuts occur have expressed growing interest in how best to blend taxable and municipal fixed income assets to pursue these goals.

Municipals: In it for the duration. Extending duration now should benefit investors later as interest rates decline, which we expect will happen in the second half of 2024. The municipal curve is currently much steeper than the U.S. Treasury curve, a relationship that favors adding duration in municipal holdings (Figure 2). Additionally, we see compelling value in lower-rated (BBB) investment grade munis, which are yielding 75 to 90 basis points more than their AAA muni counterparts across short- and long-term maturities.

Below-investment grade (high yield) municipals also offer opportunities in this regard, given their longer duration profile. High yield municipal fundamentals remain sound, helping foster strong demand for this segment of the market. In addition, the selling that typically occurs in the U.S. through mid-April to raise

funds for tax purposes is wrapping up. With that seasonal technical weakness poised to end, we believe investors interested in allocating to high yield munis may want to do so sooner rather than later.

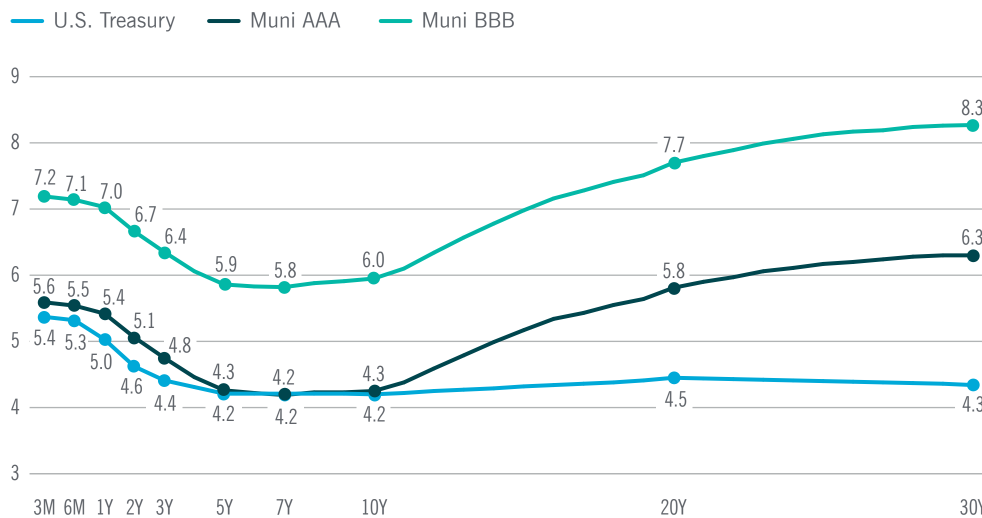
Taxable fixed income: Yes to yield. While the municipal curve favors adding duration, investors who are also concerned about sticky inflation and today's higher-for-longer rate environment may find that an allocation to senior loans is warranted. This below-investment grade, generally shorter-duration asset class is floating rate, with a compelling yield that currently exceeds 9%. What's more, with the U.S. economy having proved resilient in the face of prolonged inflation and tight monetary policy, the odds of a recession have fallen significantly, and we expect credit default rates to remain in line with their historical averages. In short, we believe senior loans offer a compelling risk/reward tradeoff.

Another sector to consider in a blend of municipal and taxable markets is preferred securities. Preferreds provide investment grade exposure with an attractive yield of approximately 6.5%, along with preferential tax treatment, as their qualified dividends are taxed at lower rates than ordinary income.

Municipal bonds (including high yield munis), senior loans and preferred securities could create a compelling blend of assets in a diversified fixed income portfolio.

FIGURE 2: EXTENDING DURATION MAY LEAD TO HIGHER TAX-EFFICIENT YIELDS

U.S. Treasuries versus AAA and BBB municipal yield curves (taxable-equivalent yield, %)



Data sources: Bloomberg, L.P., 31 May 2024. **Performance data shown represents past performance and does not predict or guarantee future results.** Municipal yields reflect general obligation (GO) securities. Taxable-equivalent yield (TEY) is the yield a taxable investment needs to possess (before taxes) for its yield to be equal to that of a tax-free municipal investment. The yields shown are based on the highest individual marginal federal tax rate of 37%, plus the 3.8% Medicare tax on investment income. Individual tax rates may vary. They do not take into account the effects of the federal alternative minimum tax (AMT) or capital gains taxes.

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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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