

## Preparing portfolios for late cycle: Part 3

# Diversifying fixed income portfolios



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*This year has provided a wake-up call to fixed income investors that, yes, interest rates can rise and they can rise quickly. While the sharp increase in Treasury yields dented total returns on diversified fixed income portfolios, we believe it will still be possible to earn good returns over the next few years. Searching for value has become more difficult, but solid economic fundamentals are supporting higher-income assets nearly a decade into the credit cycle.*

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## KEY POINTS

- Rising interest rates present a challenge to fixed income investors.
- Despite some economic divergence between the U.S. and the rest of the world, global growth appears healthy enough to sustain corporate profits growth and support credit markets.
- High yield bonds remain attractive as a source of income, but their spreads remain close to their narrowest levels of the decade.
- A combination of technical factors has conspired to keep global rates low, which we believe will support income-producing assets even in this late-cycle period.
- As we approach the end of the U.S. economic expansion and ongoing monetary policy tightening, we expect modestly higher credit spreads and a further flattening between short and longer-term rates.

## WHAT WE'RE WATCHING FOR IN THE TAXABLE FIXED INCOME MARKET

For years after the global financial crisis and 2008-09 recession, persistently low interest rates were the biggest challenge for fixed income investors. Low yields assure low returns on bonds held to maturity. And while active management through security selection and asset allocation can mitigate a challenging starting point, most investors have experienced lower returns on their bond portfolios than they received over the prior ten, twenty or thirty years.

Now, however, the landscape has shifted, and U.S. investors are confronting a new challenge: rising interest rates. While yields remain low on an absolute basis, their sharp increase in 2018 is a reminder that rates can move both up and down. And with the Federal Reserve seemingly intent on taking short-term rates higher over the next twelve months, we expect pressure on interest-rate sensitive bond prices to endure.

At the same time, U.S. corporate credit spreads have widened somewhat on waning demand from abroad and increases in new Treasury debt from the recent fiscal stimulus. Spread widening is quite typical for the final years of a credit cycle, as investors become risk averse and issuance remains robust. But we do not expect a spike in corporate yields relative to Treasury or a crisis akin to the one that preceded the previous recession.

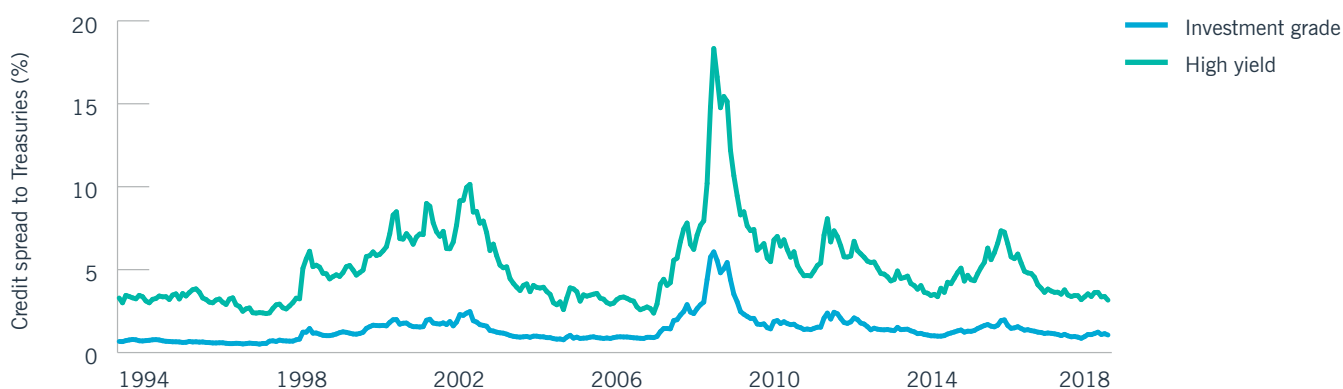
## MANAGING A FIXED INCOME PORTFOLIO IN LATE CYCLE

Our Nuveen Midyear Outlook noted that we have become more defensive in select areas of the market, particularly in places where we do not have to accept much lower returns to de-risk. We have already moderated credit risk in our fixed income portfolios, particularly in lower-rated, fixed-rate high yield. But we do not yet believe it is time to become ultra-defensive in portfolios by moving to a U.S. Treasury overweight or dramatically extending duration.

We can replace the lost income from the lower U.S. high yield allocation in a number of ways. Emerging markets (EM) U.S. dollar debt is, on average, rated higher than U.S. high yield, but is currently trading at wider spreads to Treasuries thanks to declining sentiment toward EM. Preferred securities and floating-rate loans are also attractive options, given the relative health of U.S. banks and their lower sensitivities to rising rates.

Most importantly, broadly diversified, core plus and multisector bond strategies allow active managers to take advantage of all the strategies mentioned, and more, that are designed to outperform the broader fixed income benchmarks amid changing market conditions.

### U.S. corporate credit spreads are at near-decade lows



Data source: Bloomberg, L.P., 01 Jan 1994 – 30 Sep 2018.

## PORTFOLIO POSITIONING

- Moderately reduce credit risk, particularly by lowering exposure to lower-rated high yield bonds.
- Being overly defensive — overweighting U.S. Treasuries, or dramatically extending duration — is not warranted at this point.
- Emerging markets U.S. dollar bonds, preferred securities and floating-rate loans may be attractive substitutes for a portion of high yield allocations.
- Broadly diversified core plus and multisector bond strategies offer the potential to outperform broad market indexes in the late cycle.

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