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Second quarter 2024 outlook

What makes rates move?

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The U.S. Federal Reserve appears ready to cut rates, but how and when rates move can be complex. Regardless of timing, higher starting yields mean more return potential, and declining rates may add price appreciation. We advocate a multisector approach that takes selective risk in credit sectors. Active management remains critical, as credit spreads are likely to widen in the coming months.

KEY TAKEAWAYS:

- We expect 50 basis points (bps) of Fed rate cuts this year.
- Higher starting yields mean more return potential, and declining rates may create additional price appreciation.
- We are finding attractive opportunities in preferred securities and in BB rated high yield and senior loans.

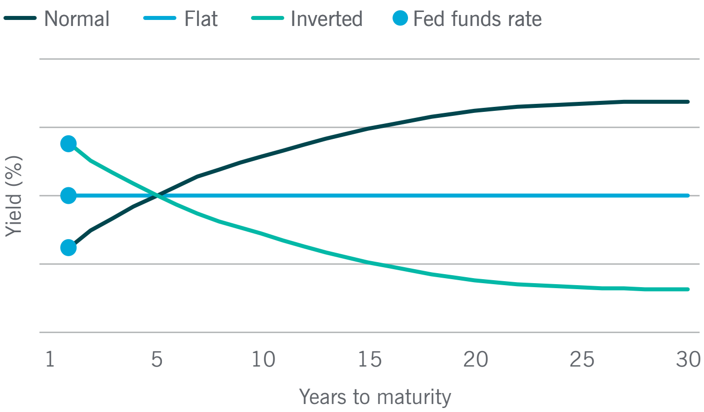
THE FED REMAINS ON TRACK FOR RATE CUTS

We forecast a slowdown in U.S. economic growth this year. Although disinflation should continue, we agree with the Fed's updated projections that inflation will ultimately prove stickier than previously expected. Despite the Fed's recent upgrades to growth and inflation projections, Chair Powell signaled at the March policy meeting that rates cuts remain likely this year. We currently anticipate 50 basis points (bps) of rate cuts in 2024.

INTEREST RATES REFLECT MORE THAN THE CENTRAL BANK POLICY RATE

The interest rate for each maturity point along the yield curve reflects the cost to borrow for that time period. A yield curve is normally upward sloping, but in certain environments it can be flat or inverted (Figure 1).

Figure 1: The yield curve describes the market yields of bonds at different maturities



This chart is a sample provided for illustrative purposes only.

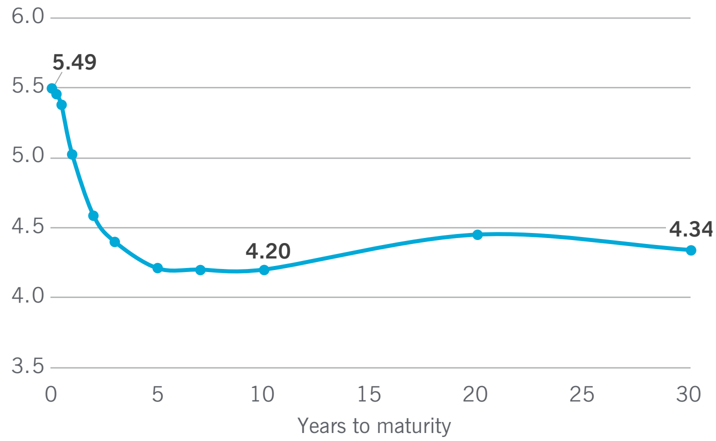
Since most fixed income assets have longer maturity profiles than cash, different factors influence rate levels along the full span of the yield curve.

Short rates are anchored by Fed policy. The policy rate marks the starting point for the yield curve, and changes in this rate impact the rest of the curve. The fed funds rate is currently 5.25-5.50%, and the yield curve is inverted at the short end (Figure 2). However, as the Fed begins cutting rates, we expect yields for maturities of 2 years and shorter to decline the most, which will eventually normalize the shape of the curve.

Longer-term rates are driven by multiple factors. The term premium is the additional compensation (in the form of a higher interest rate) that investors require for the risk of holding a longer-term asset. Additionally, if inflation is high or expected to rise, investors may demand a higher yield to compensate for inflation risk. Economic growth can create inflation, so we watch it carefully.

Figure 2: The Treasury yield curve is currently inverted

U.S. Treasury yield (%)



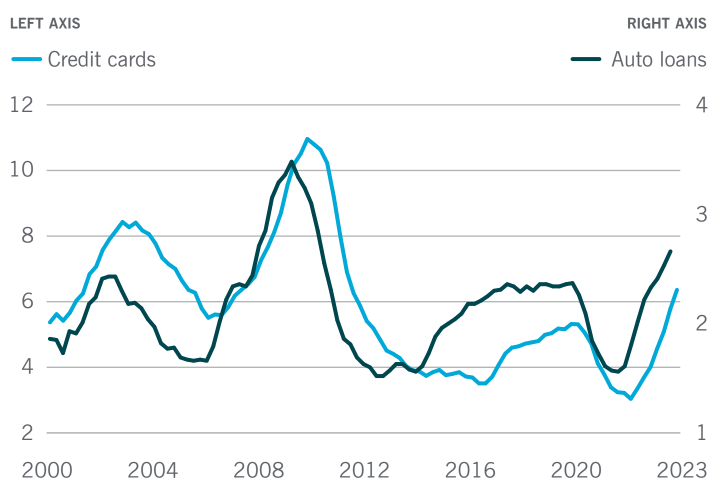
Data source: treasury.gov, 26 Mar 2024. **Performance data shown represents past performance and does not predict or guarantee future results.**

CONSUMER AND CORPORATE HEALTH HAVE WEAKENED SLIGHTLY

We believe U.S. GDP growth will slow this year, but not to recessionary levels. This should ultimately result in lower interest rates as the Fed cuts to support growth.

Figure 3: Consumer credit health has deteriorated, but not to recession levels

Delinquency rates (%)



Data source: Bloomberg, L.P., New York Federal Reserve, 31 Mar 2000 – 31 Dec 2023.

Consumer spending is a large part of the U.S. economy. Real consumer spending is running around 2% year-over-year, below its pre-Covid run rate of near 2.5%, and we anticipate a further slowdown. Consumer credit health has deteriorated over the last year, with some measures of delinquency rates now above pre-Covid levels. While mortgage delinquencies remain very low, credit card and auto loan delinquencies have risen. The phenomenon is relatively broad, with every age bucket experiencing higher rates than their 2019 averages.

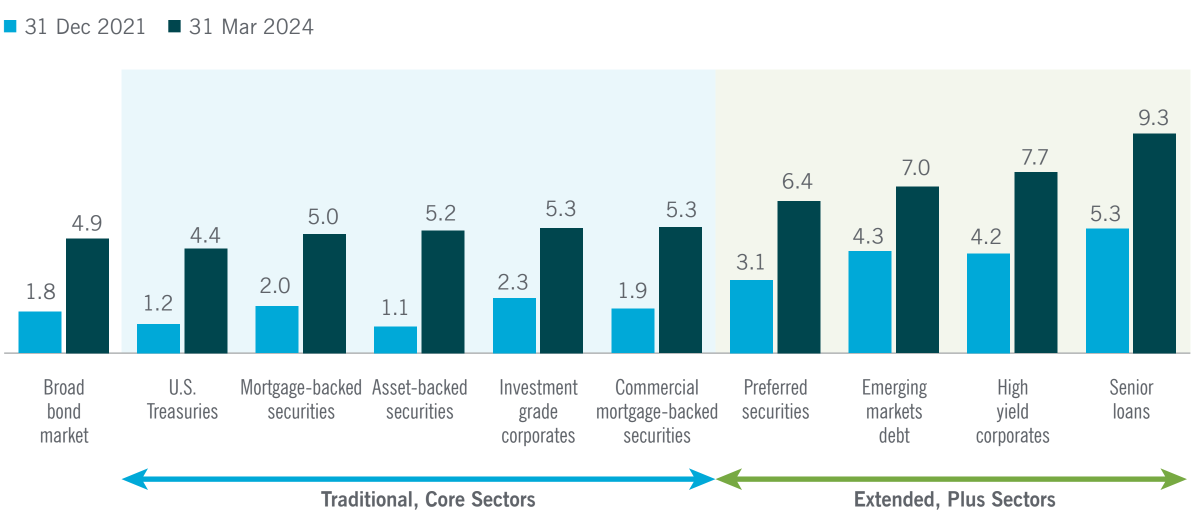
Corporate balance sheets have also weakened. Interest coverage ratios (ratio of earnings to interest expenses) have fallen across all ratings categories. However, in contrast to consumers, corporate balance sheets remains stronger overall than before Covid. Companies successfully extended the maturity of their debt during the period of low rates and have experienced resilient earnings. If rates remain somewhat elevated and growth slows, as we expect, corporate balance sheets will likely weaken. But we believe their strong starting position should alleviate broader downside risks.

STARTING YIELDS REMAIN ELEVATED

Despite slow economic growth, higher yields remain a bright spot. Over time, 100% of fixed income returns have been driven by income rather than price changes.[1] Across the spectrum, starting yields are currently much higher than in the past. This income component may steadily build total return over time as the interest rate environment adjusts. If rates decline, as we anticipate, fixed income returns may receive an additional boost.

Figure 4: Income potential may be enhanced by higher rates

Yield-to-worst (%)



Data sources: Bloomberg, L.P., Credit Suisse. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: broad bond market:** Bloomberg Aggregate Index; **U.S. Treasuries:** Bloomberg U.S. Treasury Index; **mortgage-backed securities:** Bloomberg U.S. MBS Index; **asset-backed securities:** Bloomberg ABS Bond Index; **investment grade corporates:** Bloomberg U.S. Investment Grade Corporate Index; **commercial mortgage-backed securities:** Bloomberg CMBS Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **emerging markets debt:** Bloomberg EM USD Aggregate Index; **high yield corporates:** Bloomberg U.S. HY 2% Issuer Capped Index; **senior loans:** Credit Suisse Leveraged Loan Index.

We think a diversified multisector approach, with a focus on select higher yielding credit sectors, may prepare a portfolio for the upcoming market environment.

HIGHER STARTING YIELDS HAVE REWARDED INVESTORS

Despite the anticipated eventual decline, interest rates have modestly increased year-to-date, with the 10-year Treasury yield up 32 bps. Plus sectors have outperformed core sectors due to their naturally lower duration profiles and higher starting yields. If rates do decline, the longer-duration core sectors may quickly catch up.

CONSIDER ACTIVELY MANAGED, DIVERSIFIED MULTISECTOR PORTFOLIOS

As we approach a period of likely declining interest rates, we advocate diversified multisector portfolios with longer duration profiles. The intensive, bottom-up fundamental credit research active managers employ can help avoid any problem situations as the economy begins to slow. Broad diversification also reduces the impact of any single sector or industry on overall returns.

Consider these ideas for fixed income allocations:

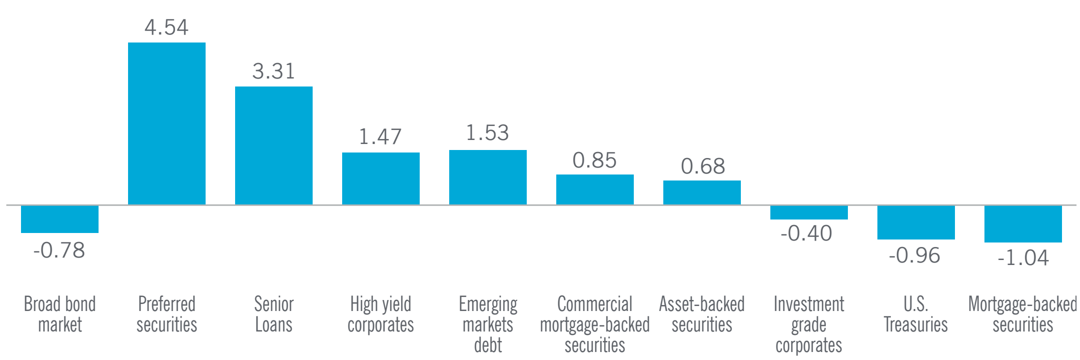
Multisector bond funds. The additional yield potential can help build total return. The funds augment a base of diversified higher-quality sectors with larger allocations (typically up to 50%) to below investment grade securities. This approach offers more yield potential than core plus in return for 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.

Figure 5: Fixed income returns remain strong

2024 total returns (%)



Effective duration (in yrs)	6.3	4.5	0.3	3.6	6.2	4.5	2.9	7.2	6.3	5.9

Data source: Morningstar Direct, Bloomberg, L.P., Credit Suisse. 31 Mar 2024. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: broad bond market:** Bloomberg Aggregate Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **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; **commercial mortgage-backed securities:** Bloomberg CMBS Index; **asset-backed securities:** Bloomberg ABS Index; **investment grade corporates:** Bloomberg U.S. Investment Grade Corporate Index; **U.S. Treasuries:** Bloomberg U.S. Treasury Index; **mortgage-backed securities:** Bloomberg U.S. MBS Index.

OUTLOOK

Recession risk has receded

We continue to expect growth to moderate to a below-trend pace. The risk of outright recession in developed markets has receded substantially. Job growth will likely resume its moderation moving forward. Inflation appears to have peaked but will likely remain higher than central banks' targets this year. Nevertheless, the policy focus is likely to shift away from too-high inflation and toward too-low growth.

We believe the Fed is finished hiking rates, and we anticipate 50 bps of rate cuts this year. The European Central Bank is also finished with its tightening cycle, and we expect a similar pivot toward cuts before mid-year. In China, policymakers are likely to continue with their fiscal policy support, though substantial monetary easing is unlikely.

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, presenting more attractive entry points for risk taking. That said, we see attractive opportunities in the preferred securities 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

1 As of 31 Mar 2024, 100% of annualized total return of the Bloomberg U.S. Aggregate Bond Index was derived from coupon return (as opposed to price appreciation) from 31 Jan 1976 to 31 Mar 2024.

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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