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BREAKING NEWS
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The Fed sounds more hawkish, but rate cuts remain in play

A surprising resurgence in U.S. inflation drove Fed Chair Powell's comments to be more hawkish than the March meeting, but he continued to signal that the central bank's next move is likely to be a rate cut.

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WHAT HAPPENED?

The U.S. Federal Reserve kept interest rates at 5.25% - 5.50%, remaining at their 23-year high. The policy statement included a new sentence, saying "in recent months, there has been a lack of further progress toward the Committee's 2 percent inflation objective." This hawkish addition acknowledged the recent uptick in inflation. But the rest of the statement continued to signal that the next move will likely be a rate cut once the FOMC has "gained greater confidence that inflation is moving sustainably toward 2 percent."

In his press conference, Chair Powell matched the tone of the policy statement, stating that recent inflation data "has been higher than expected" and that it "will take longer" to gain sufficient confidence about inflation to justify a rate cut.

However, Powell continued to signal a rate cut, even if it takes longer than previously expected to arrive. He explicitly said "it's unlikely that the next policy move will be a hike." Notwithstanding the recent hot U.S. inflation data, Powell said that "my expectation is that we will, over the course of this year, see inflation move back down."

While the changes to the statement and press conference were undoubtedly a hawkish shift compared to the prior Fed meeting in March, they were less hawkish than market pricing entering the meeting. U.S. Treasury yields fell between 2 and 5 basis points across maturities after the meeting, and spreads tightened throughout fixed income markets.

INCOMING INFLATION DATA HAVE SURPRISED TO THE UPSIDE

The biggest development since the January meeting has been the surprising resurgence in inflation. We had already penciled in an above-consensus pace of core inflation for this year, but we have been surprised by the magnitude and breadth of the recent acceleration.

For the first quarter overall, core PCE inflation rose at an annualized rate of +3.7% – the fastest pace since early last year and the biggest quarterly acceleration since early 2021. Disinflation in housing has stalled, while other core services has rebounded substantially and nearly returned to recent highs. Core goods prices have continued to drag down the overall numbers, but not enough to outweigh the dynamics in services.

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At the same time, the labor market has remained strong. Job creation has picked up to a one-year high of +276,000 per month, while the unemployment rate has remained below 4%. Wage inflation has been mixed, with the latest readings surprising to the upside and compounding the overheating signal from core services inflation. Nevertheless, leading indicators continue to point to a slowdown in wage inflation moving forward.

Although first quarter GDP was softer than expected, at +1.6% quarter-over-quarter annualized, underlying growth remains robust. Final sales to private domestic purchasers (a measure of underlying growth that strips out volatile elements) expanded +3.1% in the first quarter. That marked the third consecutive quarter of 3%-or-higher underlying growth, the best stretch since 2014 (excluding the immediate post-Covid period).

Non-U.S. economic news has been positive as well. Manufacturing and services PMIs have generally improved across developed and emerging markets, highlighted by a rebound in China. Inflation in most economies has slowed more than in the U.S., with European core prices rising +2.9% in the latest reading, a two-year low.

Looking ahead, we continue to anticipate a modest slowdown in U.S. and global growth this year. Loosening labor markets and softer wage inflation will eventually translate into further decelerations in price inflation. The path is likely to remain uneven, and we still expect core inflation to remain well above the Fed's 2% target into 2025.

WHAT DOES THIS MEAN FOR INVESTORS?

With anticipated rate cuts being pushed out later in 2024, investors are still benefiting from the highest starting yields in more than 15 years. This means yield income remains the primary contributor to fixed income total returns, helping offset any near-term price declines. Across most fixed income sectors, spreads are modestly tight versus history, but we're finding compelling opportunities in several areas, including securitized credit, preferreds, senior loans and municipals.

In securitized, consumer and commercial credit asset-backed securities (ABS) performance continues to show signs of stabilizing. Default rates are in line with pre-pandemic levels, yet yields are significantly higher. Commercial mortgage-backed securities (CMBS) offer substantial reward potential for investors willing to accept the risks and challenges facing office and retail properties. Delinquency rates for the lodging and retail sectors have improved markedly over the past two years.

In preferreds, spreads have already compressed by 50 basis points year-to-date, leading to some of the best returns within fixed income. We expect preferreds to continue to benefit from technical tailwinds, such as constrained supply amid low net issuance this year, as well as from sound underlying fundamentals for investment grade financial services companies. Preferreds also offer a compelling 7% yield.

The floating rate structure of senior loans tends to help them weather periods of higher interest rates. Currently, loans are yielding north of 9%, making them one of the highest-yielding investments in any asset class. Individual investor demand for loans was robust in the first quarter, with inflows at $2.8 billion — a trend we think will persist as investors continue to seek income while protecting against the risks of a delayed rate-cutting cycle. Within loans, we prefer higher-quality sectors and enterprise revenue business models. Larger issuers with strong free cash flows should be better at managing the elevated interest payments that come with higher-for-longer rates.

Today's elevated yields also offer an attractive entry point for municipal bonds. Investors in the highest tax brackets who choose high-quality, long-term municipals with maturities beyond 15 years can expect taxable-equivalent yields of around 6%, with even higher levels in states with income taxes.

In the below-investment grade space, high yield municipals yield 5.6%, resulting in a 9.5% taxable-equivalent yield. About 75% of the high yield municipal bond index is made up of higher-quality

BB-rated issues, and historical default rates for this segment is roughly equal those of BBB-rated corporates. Muni credit fundamentals remain healthy following three consecutive years of robust revenue and 2024 tax collections that are roughly 25% higher than prior peaks in 2019 and 2020. Rating agencies have agreed on credit strength, with upgrades outpacing downgrades by an approximately 4:1 ratio for three years in a row.

In equities, we favor the materials and energy sectors, and see opportunities in dividend payers. U.S. manufacturing activity is showing signs of bottoming out after contracting since September 2022. The materials sector has historically performed well when survey indicators trough and return to expansion.

We remain constructive on higher-quality, dividend growth-oriented stocks. In our view, dividend growth companies tend to be supported by positive fundamentals, sustainable growth potential, healthy balance sheets, ample free cash flow, stable profit margins and management teams committed to returning capital to shareholders. These favorable characteristics may contribute to key advantages, including income growth and a hedge against still-elevated inflation.

We remain cautious about the consumer discretionary sector. Although the resilient U.S. economy continues to defy expectations, any material changes to employment warrant close monitoring. Additionally, a recent report from the New York Federal Reserve showed that higher-for-longer interest rates and inflation are causing anxiety for consumers, with one in eight (the most in four years) expected to miss an upcoming minimum debt payment.

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

Endnotes

Sources

Federal Reserve Statement, May 2024.

Bloomberg, L.P.

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Investors should contact a tax advisor regarding the suitability 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.

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