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Positioning fixed income for late-cycle trends

William (Bill) Martin
Head of Taxable Fixed Income

Tony Rodriguez
Head of Fixed Income Strategy

The Federal Reserve (Fed) has hiked rates for the ninth time, and the positive economic impact of the fiscal stimulus appears to be waning. Many investors are wondering if recession is imminent. We think global growth will slow in 2019, but we don't believe major developed countries will experience recession. We are clearly entering the later stages of the credit cycle, but opportunity remains across the global fixed income markets. Active managers can continue to uncover attractive investment ideas to add value. However, we think it is time to moderate credit risk.

KEY TAKEAWAYS

- We believe there is little chance the U.S. will go into recession before late 2020 given continued strength in consumer confidence and business activity, especially in the labor market.
- As the cycle nears its peak, we believe it is critical to choose mandates with broad sector diversification, flexibility and active management.
- We favor investment grade corporates, preferred securities, select high yield credits and U.S. dollar-based emerging market debt.

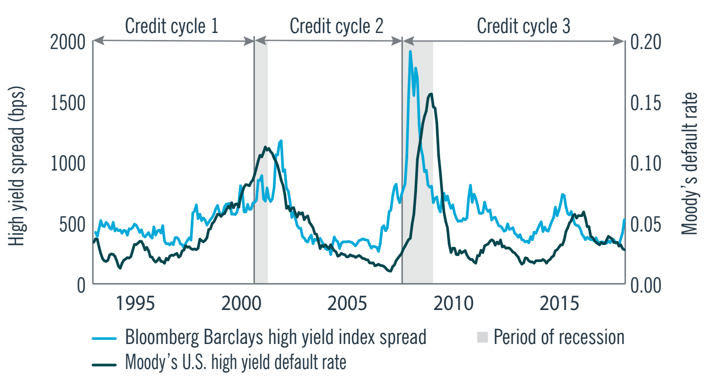
CREDIT CYCLE INFLUENCES THE BUSINESS CYCLE

The credit cycle tracks the expansion and contraction of access to credit over time. It influences the overall business cycle because access to credit affects a company's ability to invest and drive economic growth. Over time, performance of credit-oriented fixed income sectors such as investment grade corporates, high yield corporates and preferred securities is linked directly to the credit cycle.

We are in the midst of the third major credit cycle since the 1990s. It is easiest to identify cycles by observing credit spreads and default rates of high yield corporate bonds, which are more pronounced than those of investment grade corporates.

Recessionary periods have marked the turning points between cycles. Default rates peaked near the end of the recessionary period in both Cycle 2 and Cycle 3. Credit spreads peaked concurrent with the recession or afterward.

Exhibit 1: Recessions, not rate increases, mark the end of a credit cycle



Data source: Barclay's, Moody's, 31 Dec 1993 – 31Dec 2018. **Past performance is no guarantee of future results.** Indexes are unmanaged and unavailable for direct investment.

We think global growth will slow in 2019. But we believe there is little chance the U.S. will go into recession before late 2020 given continued strength in consumer confidence and business activity, especially in the labor market. While economic and earnings growth are slowing, we still believe U.S. GDP growth will be in the 2.0% to 2.5% range next year. Both trailing defaults and spreads are low relative to the ends of previous cycles, and defaults are projected to remain low. These factors suggest we have not yet reached the credit downturn phase.

FED UNLIKELY TO CAUSE RECESSION

If the Fed tightens monetary policy too much as growth slows, it can inadvertently tip the economy into a recession. We believe Fed policy will become more data dependent in 2019. We have already seen evidence of a more moderate tone at the December Federal Open Market Committee (FOMC) meeting.

The revised economic projections showed that the median FOMC member anticipates somewhat softer U.S. growth, and the expected maximum fed funds rate for the cycle dropped to 3.1% from 3.4%. This places it just above the Fed's 2.8% longer-run (or neutral) rate, the level at which it would neither stimulate nor depress the U.S. economy. All signs point to the Fed responding to slowing growth.

Inflation pressures remain muted, which should also help keep policy in check. While wage increases and other factors have caused inflation to creep upward over the past years, we do not anticipate the inflation rate to significantly exceed the Fed's target. In fact, inflation has actually declined sharply. As a result, the Fed reduced its inflation projections to 1.9% for 2018 and 2019 in December.

Exhibit 2: The Fed reduced its inflation projections

Fed's 5-year forward breakeven inflation rate

Data source: Bloomberg, L.P., 30 Sep 2016 – 31 Dec 2018. **Past performance is no guarantee of future results.** The Fed's five year forward breakeven inflation rate is a measure of the five year inflation expectations five years into the future that is considered by the Fed in its policy decision making.

RECESSION RISKS REMAIN GLOBALLY

While we do not think the Fed will cause recession, we are carefully monitoring other risks. The slowdown of the Chinese economy and potential disruptions in economic growth caused by protectionist trade policy are both risks on our radar. China is slowing, but it has introduced monetary and fiscal stimulus to help support its economy. We should be seeing the effects of that effort more in 2019, which could produce upside surprises to growth in Asia, as well as with eurozone and emerging markets trade partners. We believe that ultimately there will be a moderation in the extreme nature of the rhetoric, and trade tensions will ease. However, this political factor remains a real risk. We are also keeping an eye on the tensions in Europe around Brexit and Italy, but we think these are less impactful in nature.

PORTFOLIOS ARE POSITIONED FOR A PEAKING CYCLE

Even though recession is not expected in the near future, the credit cycle is potentially peaking. As a result, we think it makes sense to upgrade portfolio quality, adjust industry mix and increase diversification and liquidity. As active managers, we implement these changes across our portfolios, adjusting the degree and magnitude by strategy.

As the cycle nears its peak, we believe it is critical to choose mandates with broad sector diversification, flexibility and active management, such as multisector, core plus or diversified short-term bond strategies.

OUTLOOK: MODERATING GROWTH AND MORE RATE UNCERTAINTY

We think three themes will drive the fixed income markets:

Moderating U.S. growth

U.S. economic activity slowed during the quarter, continuing to moderate toward trend with manufacturing and interest rate–sensitive sectors notably softer. Consumer spending remained firm, supported by strong employment, earnings and sentiment. Activity outside the U.S. was sluggish amid global trade tensions and a continued slowdown in China.

As the quarter progressed, however, a broad array of issues weighed on investor sentiment, including ongoing political discord, trade friction with China, the path and pace of Fed rate increases and the partial U.S. government shutdown. Oil prices dropped by more than 40% during the quarter after these same fears exacerbated concerns about oversupply and slowing demand. Financial conditions tightened as credit spreads widened, equity markets declined significantly and market volatility rose sharply.

We expect U.S. growth to stabilize near trend, with continued risks from geopolitical and trade developments and declining liquidity conditions, while support from a strong consumer continues. Inflation will likely remain subdued despite strong employment and recent wage gains.

Portfolios are adjusted as the credit cycle peaks

Upgrade portfolio quality	Adjust industry mix	Increase diversification
Improve credit quality across all sectors: • Maintain diversified income sources • Improve liquidity **Improve quality within rating tiers by:** • Selling appreciated bonds with more risk • Buying similarly rated bonds with stronger fundamentals to preserve income potential	**Manage industry exposure to:** • Reflect fundamental developments as the cycle matures • Ensure that yields offer adequate compensation for forward-looking risks **Continue to emphasize financials:** • Strong balance sheets, liquidity and positive credit conditions • Higher rates benefit earnings • Low event risk	**Maintain broad sector diversification across investment grade and below investment grade sectors** **Resize credit positions to reduce individual company risk**

Continued Fed uncertainty

Despite increased market volatility and tightening financial conditions, the Fed followed through on expectations and raised the federal funds rate in December for the fourth time in 2018, citing strong economic growth and job gains. Policymakers acknowledged some headwinds and lowered projections for gross domestic product (GDP) and inflation, while signaling the likelihood for fewer rate hikes in 2019.

However, investors priced in expectations for the Fed to reverse course and ease one year out, helping to drive an inversion at the front end of the Treasury yield curve. Lower yields across the rest of the curve caused further flattening, with the benchmark 10-year Treasury yield falling 36 basis points (bps) to 2.69% by the end of the quarter.

The Fed maintained its overall positive economic outlook, its bias for higher rates and its benign view of inflation. We think the Fed may move rates higher in 2019. However, with a policy rate hovering around neutral and the recent tightening of financial conditions, the Fed should be responsive to incoming information. We estimate that the 10-year U.S. Treasury yield will rise to around 3.00% by March 2019 and drift modestly higher in 2019 as a possible Fed hike moves rates toward the longer-run target rate.

Unclear global rate environment

Global developed market yields fell and yield curves flattened last quarter, driven by concerns about global growth and lower oil prices dampening inflation expectations. Global PMIs and export growth continued to decelerate as tighter financial conditions and trade tensions hurt economic confidence. Relative rate performance was mixed, with Canada outperforming and country-specific developments driving European rates. Brexit uncertainty lingered while Italian bonds outperformed, supported by a budget compromise. France underperformed on the back of yellow vest protests.

Global bond yields reflect a lower inflation outlook, heightened trade tension uncertainty and growing concerns around global growth. Although the market pricing of policy rate expectations has declined, some central banks continue to voice willingness to normalize monetary policies gradually. With the global central banks reducing their balance sheets, global liquidity should continue to tighten. The crosscurrents between those bond technicals and resulting tighter financial conditions should continue to influence bond market valuations. The U.S. dollar should remain stable, notwithstanding the concerns about financing U.S. fiscal and current account deficits, as it is supported by the relative outperformance of the U.S economy and attractive yields.

OUR FAVORITE THINGS

We believe that the U.S. economy is poised for relatively solid growth with low inflation and that the positive credit cycle will continue into 2019. We continue to favor higher income sectors, such as investment grade corporates, preferred securities, select high yield credits and U.S. dollar-based emerging market (EM) debt. However, we think it is time to moderate credit risk in portfolios, as we are clearly in the later stage of the credit cycle.

Investment grade corporate bonds were flat for the quarter with a -0.18% return underperforming the Bloomberg Barclays Aggregate Bond Index at 1.64%. Credit spreads moved continuously wider during the quarter, creating negative excess returns compared to Treasuries for the quarter and the year. Equity volatility increased as a result of trade policies, weakening global growth, lower oil prices and Fed fears. Following the downgrade of several large single-A rated issuers to BBB, the BBB-rated segment now accounts for slightly more than 50% of the index.

"Security selection will likely be the key performance driver."

Credit fundamentals should remain solid, but the leverage amassed through debt-funded merger and acquisition is approaching end-of-cycle levels. BBB-rated debt growth has exceeded that of all other rating categories. Many credits have communicated their intent to de-lever in 2019.

While we believe the credit cycle is not yet turning, volatility will likely remain elevated and markets choppy. We think selection will likely be the key performance driver. Technicals will likely be mildly positive as gross issuance is expected to be down 10%. However, after maturities, net issuance could be down as much as 30%. Trade policy with China remains one of the largest unknowns on specific industries and issuers. Overall, we look to become somewhat more defensive, upgrading quality and liquidity across our portfolios.

Preferred and contingent capital (CoCo) securities experienced negative returns of -3.62% over the quarter, as spreads widened 125 bps to end the year at 374 bps. While there was no material new issue supply during the quarter, geopolitical headlines (U.S. versus China, Brexit, the Fed), elevated market volatility, and significant tax-loss harvesting weighed on valuations. Non-U.S. paper materially outperformed U.S., primarily due to the CoCo segment.

$25 par value securities slightly underperformed $1000 par value securities, partly due to redemption activity. CoCo securities outperformed most other categories, despite continued Brexit headlines during the quarter. Italy reached an agreement with the EU regarding its budget, providing relief for another lingering concern.

Fundamental credit metrics remain strong. U.S. bank balance sheets are incredibly resilient as confirmed by the 2018 Fed Stress Test results, while EU and U.K. stress tests demonstrated essentially the same for non-U.S. banks. Flat or negative supply remains a supportive technical for U.S. bank preferred security valuations. We believe risk premiums have cheapened significantly and appear very compelling. However, the first quarter may be a bit volatile until geopolitical headlines are resolved, such as the U.S./China trade dispute and Brexit.

Despite our opinion that interest rates are more likely to be range bound, we still favor non-fixed rate coupon securities in case rates unexpectedly move higher. These coupons tend to be more defensive during rising rate environments versus ordinary fixed-rate coupons. We favor $1000 par securities because on average they are cheaper versus $25 par securities, and more $1000 par securities have non-fixed rate coupons.

High yield corporate bonds sold off sharply during the quarter, driven by concerns about growth, Fed rate hikes, declining oil prices, trade tensions and questions regarding the length of the credit cycle. The index returned -4.54% and its spread widened 210 bps during the quarter to end the year at 526 bps. Both high yield and leveraged loans saw large investor outflows, accelerating into year-end, which drove prices lower as the market searched for liquidity.

Nonetheless, credit fundamentals remain solid. Balance sheet leverage and coverage metrics remained consistent with mid-cycle expansion. Earnings continued to validate strong fundamentals, even as earnings growth rates moderated. Unlike selloffs early in the year, lower quality underperformed during the quarter due to credit worries and lower liquidity. CCC-rated bonds returned -9.3% and BB-rated bonds -2.9%. The positive technical factor of limited issuance was overwhelmed by large outflows from the sector.

The fundamental backdrop remains supportive, given continued economic growth, contained interest rate increases and moderate inflation. High yield companies continue to demonstrate discipline by extending the term of their debt and maintaining solid balance sheet and cash flow metrics. Default rates (excluding energy) are likely to remain below historical averages and the near-term likelihood of a recession remains low. Nonetheless, vigilant monitoring of credit risk is warranted due to market volatility, as well as macro and geopolitical factors such as trade friction and ongoing central bank actions.

Valuations have shifted dramatically versus much of 2018 and offer increased opportunities in light of continued supportive fundamentals. Some companies and industries will face challenges in this environment, so issue selection is particularly important for identifying return opportunities and managing risk. The cheapening of lower-quality high yield has selectively created attractive opportunities, where credit work validates company fundamentals. But we remain cautious about macro risks.

Emerging market debt returned -0.18% for the quarter, struggling as growth fears fueled by trade tensions took their toll on commodity prices causing Middle Eastern and African oil and commodity-focused credits to underperform. Mexico saw renewed pressure as recently elected President AMLO canceled the Mexico City airport project, driving concerns over the administration's attitude toward investors.

Local currency–denominated EM bond markets outperformed, driven by outsized returns in Brazil, Argentina and Turkey. Yields were the primary contributor, as currency was a small detractor. Brazil rallied on the election of President Bolsonaro, which renewed optimism on pension reform. Meanwhile Argentina and Turkey continued to recover from stresses earlier in the year.

While EM valuations are looking more attractive, many countries still face a challenging environment of rising funding costs and weaker growth. Tighter fiscal and monetary policies, as well as ongoing trade tensions between the U.S. and China, pose further downside growth risks. Global liquidity conditions have tightened amid monetary policy normalization by major central banks.

As the developed market growth outlook moderates, the divergence between developed market and EM growth that opened up earlier in the year could start to reverse. Closing growth differentials and a slower expected pace of developed market monetary tightening may prove supportive for EM assets, but the overarching theme of uncertainty still justifies caution. Given this backdrop, select markets with strong fundamentals and sustainable policy responses may present opportunities.

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For more information, please contact your financial professional or visit us at nuveen.com.

Endnotes

Sources

1 Data source: Bloomberg, L.P. Bloomberg Barclays U.S. Investment Grade Corporate Index.

2 Data source: BofA Merrill Lynch. 60% ICE BofAML U.S. All Capital Securities Index/40% ICE BofAML Contingent Capital Index.

3 Data source: Bloomberg, L.P. Bloomberg Barclays High Yield 2% Issuer Capped Index.

4 Data source: Bloomberg, L.P. Bloomberg Barclays Emerging Market USD Aggregate Index.

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Glossary

A **basis point** is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% (0.0001). **Contingent convertibles (CoCos)** are similar to traditional convertible bonds in that there is a strike price, which is the cost of the stock when the bond converts into stock. Another threshold in addition to the strike price triggers the conversion when certain capital conditions are met. **Duration** is a measure of the sensitivity of the price of a fixed-income investment to a change in interest rates. **Yield curve** is a line graph that plots the interest rates of bonds with the same credit quality, but different maturity dates, on a specific date. **Yield spread** is the difference between the yields on two different debt instruments, usually of different credit quality. **Yield-to-worst** is the lowest yield of yield to maturity, yield to call, yield to put, and others. **Bloomberg Barclays Emerging Market USD Aggregate Index** includes USD-denominated debt from emerging markets around the world. **Bloomberg Barclays U.S. Aggregate Index** represents securities that are SEC-registered, taxable and dollar-denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass through securities, and asset-backed securities. **Bloomberg Barclays U.S. Investment Grade Corporate Index** is a broad-based benchmark that measures the investment grade, fixed rate, taxable corporate bond market. **Bloomberg Barclays U.S. High Yield 2% Issuer Capped Index** tracks the performance of U.S. non-investment-grade bonds and limits each issue to 2% of the index. **ICE BofA Merrill Lynch Contingent Capital Index** tracks the performance of all contingent capital debt publicly issued in the major domestic and eurobond markets, including investment grade and sub investment grade issues. **ICE BofA Merrill Lynch U.S. All Capital Securities Index** is a subset of the ICE BofA Merrill Lynch U.S. Corporate Index including all fixed-to-floating rate, perpetual callable and capital securities.

A word on risk

Investing involves risk; principal loss is possible. Debt or fixed income securities are subject to market risk, credit risk, interest rate risk, call risk, derivatives risk, dollar roll transaction risk, and income risk. As interest rates rise, bond prices fall. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity, and differing legal and accounting standards. These risks are magnified in emerging markets. Preferred securities are subordinate to bonds and other debt instruments in a company's capital structure and therefore are subject to greater credit risk. Certain types of preferred, hybrid or debt securities with special loss absorption provisions, such as contingent capital securities (CoCos), may be or become so subordinated that they present risks equivalent to, or in some cases even greater than, the same company's common stock. Asset-backed and mortgage-backed securities are subject to additional risks such as prepayment risk, liquidity risk, default risk and adverse economic developments. Non-investment-grade and unrated bonds with long maturities and durations carry heightened credit risk, liquidity risk, and potential for default.

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Nuveen | 730 Third Avenue | New York, NY 10017 | 212.490.9000 | nuveen.com

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