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After a solid year for bonds, focus on income

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2019 was a very strong, yet unusual, year for fixed income markets. Declining rates and narrowing credit spreads propelled many fixed income sectors to double-digit returns. Given recent outperformance and the advancing credit cycle, we think investors should focus on well-diversified, income-producing portfolios. Consider broadly flexible strategies, such as core plus, core and diversified short-term bond, where active managers have latitude to navigate changing market conditions.

KEY TAKEAWAYS:

- Despite yield compression, professional managers can take advantage of a wide range of opportunities across and within sectors.
- Late cycle, we recommend using actively managed, broad, flexible fixed income strategies.
- We favor investment grade corporates, emerging markets debt, securitized sectors and preferred securities.

AN UNUSUALLY STRONG YEAR FOR BONDS

At the beginning of 2019, credit sector spreads had been widening sharply and many investors continued to predict additional rate hikes. But by year end, the picture had changed dramatically:

- Rather than hiking further, the Federal Reserve (Fed) cut rates three times, reducing the federal funds rate 0.75% over the year.
- Interest rates declined across the yield curve. The 10-year Treasury yield ended the year approximately 0.75% lower at 1.92%.
- Credit spreads narrowed, with recession, trade and geopolitical risks generally declining.

- The Bloomberg Barclays U.S. Aggregate Bond Index finished the year at a solid 8.72%. This was the highest total return for the asset class in past 10 years, and the first year it returned over 8% since 2002.

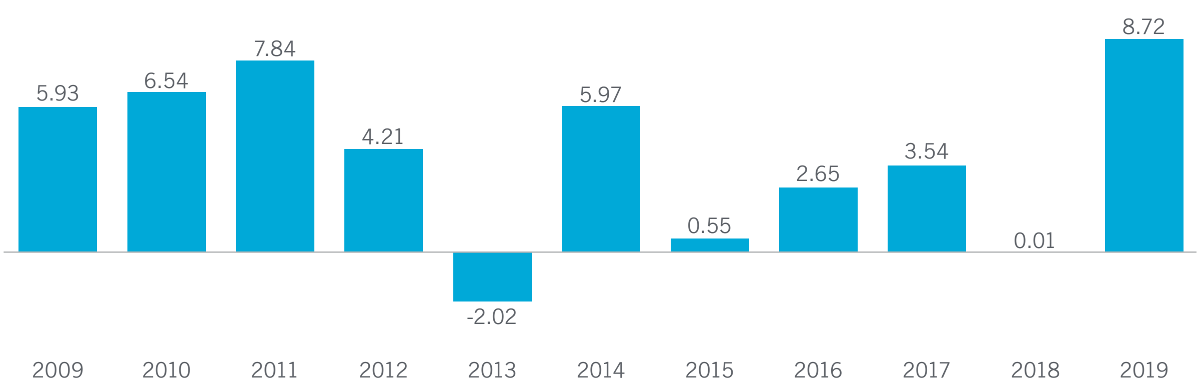
All sectors produced solid returns, with some of the more aggressive sectors — such as high yield, emerging markets, investment grade corporates and preferred securities — experiencing double-digit returns due to declining rates and sharply narrowing credit spreads. This strong, broad-based performance is unusual for the typically more subdued fixed income markets.

YIELDS ARE LOWER, BUT OPPORTUNITIES REMAIN

These dramatic changes over the course of the year have left credit spreads narrower and yields lower. That makes all asset classes more expensive with less room for further appreciation. We are clearly later in the economic cycle, but have not yet reached the end. We believe investors can still benefit from a well-diversified portfolio of nongovernment, income-generating securities.

Figure 1: A remarkable recovery for bonds

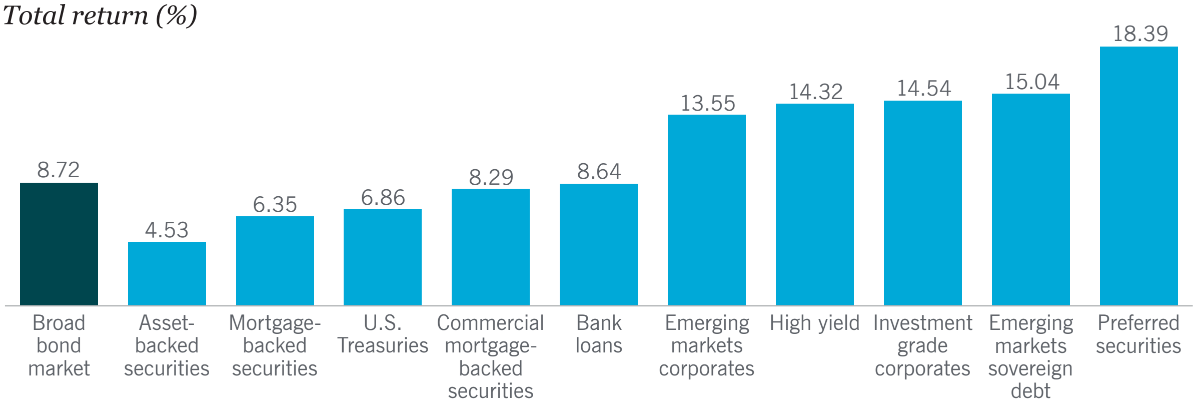
Total return (%)



Source: Morningstar, 31 Dec 2019. **Past performance is no guarantee of future results.** Representative index: Bloomberg Barclays U.S. Aggregate Bond Index. **It is not possible to invest directly in an index.**

Figure 2: All major fixed income sectors experienced strong returns

Total return (%)



Source: Morningstar, 01 Jan 2019 – 31 Dec 2019. **Past performance is no guarantee of future results. Representative indexes: broad bond market**: Bloomberg Barclays U.S. Aggregate Index; **asset-backed securities:** Bloomberg Barclays U.S. Asset-Backed Securities (ABS) Index; **mortgage-backed securities:** Bloomberg Barclays U.S. Mortgage-Backed Securities (MBS) Index; **U.S. Treasuries:** Bloomberg Barclays U.S. Treasury Index; **commercial mortgage-backed securities:** Bloomberg Barclays U.S. Commercial Mortgage-Backed Securities (CMBS) Index; **bank loans:** S&P/LSTA Leverage Loan Index; **emerging markets corporates**: JPMorgan CEMBI Diversified Index; **high yield corporates:** Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index; **investment grade corporates:** Bloomberg Barclays U.S. Corporate Bond Index; **emerging markets sovereigns**: JPMorgan EMBI Global Diversified Index; **preferred securities:** ICE BofA Merrill Lynch U.S. All Capital Securities Index **It is not possible to invest directly in an index.**

Despite the compression in yields, professional managers can still take advantage of a wide range of opportunities across and within sectors. For example, emerging markets bonds still offer approximately 3% more yield than U.S. Treasuries. Adding some of these higher yielding sectors to a well-balanced portfolio can help maintain income potential without excessively elevating overall portfolio risks.

ACTIVELY MANAGED STRATEGIES BALANCE SOURCES OF INCOME

In these late cycle environments, we recommend using actively managed, broad, flexible fixed income strategies. Core plus, core and diversified short-term bond strategies allow active managers to combine fixed income sectors into a single portfolio while balancing overall risks through several approaches:

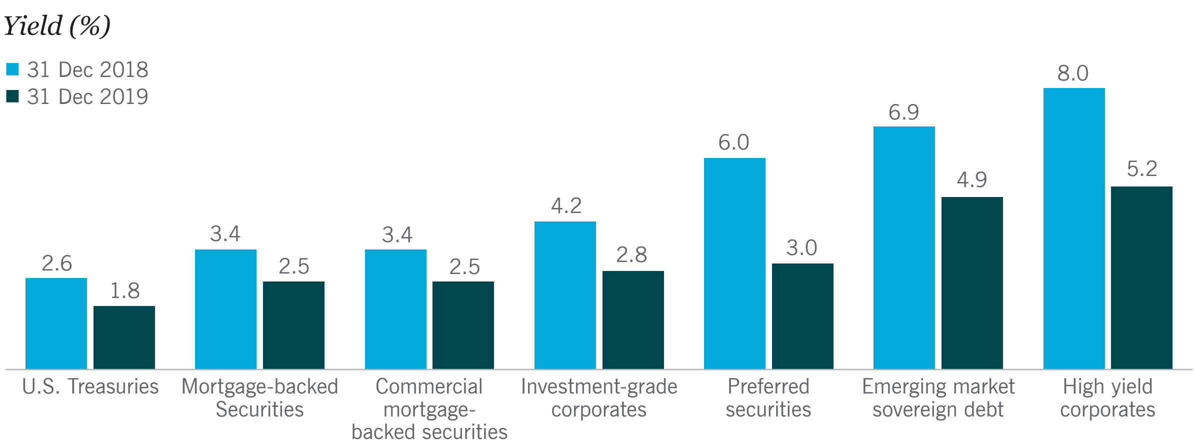
Actively adjusting sector allocations. While yields are lower across most sectors, valuations change over time. An active manager has the ability to quickly take advantage of opportunities. For example, while many of our portfolios had moderate allocations to high yield corporates one year ago, we've now reduced high yield corporate exposure in favor of higher quality sectors. Entrusting sector allocation decisions to dedicated fixed income professionals can help reduce investors' concerns. It also helps ensure that higher yielding sectors are added back to portfolios appropriately.

Balancing sources of income. A wide range of bonds with exposure to different risk factors may create a more attractive portfolio risk profile. For example:

- Company fundamentals affect investment grade and high yield bonds.
- Foreign country interest rates and economic environments drive non-U.S. bond returns.
- Equity market returns influence high yield and preferred securities.
- Real estate market conditions affect commercial mortgage-backed securities.

With access to a broader playing field, an active manager can diversify sources of yield to balance higher quality income sources – such as high quality corporate bonds, mortgage-backed securities and asset-backed securities – with higher yielding sectors like emerging markets debt. As valuations change, the manager adjusts the proportion of higher quality to higher yield securities to suit current market conditions. This can help mitigate portfolio risk.

Figure 3: Higher yielding sectors may help preserve income potential



Source: Bloomberg, L.P., JPMorgan. **Representative indexes: U.S. Treasuries:** Bloomberg Barclays U.S. Treasury Index; **mortgage-backed securities:** Bloomberg Barclays U.S. Mortgage-Backed Securities (MBS) Index; **commercial mortgage-backed securities:** Bloomberg Barclays U.S. Commercial Mortgage-Backed Securities (CMBS) Index; **investment grade corporates:** Bloomberg Barclays U.S. Corporate Bond Index; **broad bond market:** Bloomberg Barclays U.S. Aggregate Index; **preferred securities:** ICE BofA Merrill Lynch U.S. All Capital Securities Index; **emerging markets sovereigns**: JPMorgan EMBI Global Diversified Index; **high yield corporates:** Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index. **It is not possible to invest directly in an index.**

Adding attractive bottom-up research ideas. While a sector as a whole may be richly valued, subsectors, industries or individual securities may provide higher yields or better return prospects. Bottom-up fundamental research may allow professional portfolio managers to uncover these opportunities. Adding these elements to the portfolio may incrementally increase yield while keeping overall portfolio risks balanced.

OUTLOOK: MODEST GROWTH, STABLE RATES AND LOWER RETURNS

We believe three themes will drive the fixed income markets.

Modest global growth

The U.S. economy continued to grow at a modest pace in the fourth quarter. Consumer spending supported growth while business spending remained disappointing. Consumers benefited from a strong labor market, high savings rate, strong equity returns and low financing costs. Businesses remained cautious, given trade uncertainty and geopolitical risks. Global growth stabilized as trade tensions eased, Brexit risk declined and China's manufacturing sector improved.

We expect the U.S. economy to grow approximately 2% in 2020 with global growth at 3% — similar to last year with potential for some modest upside. The global manufacturing sector appears to have bottomed, which is supporting risk sentiment. However, trade policy uncertainty is likely to re-emerge and geopolitical risks remain high, which could potentially moderate risk appetite and increase volatility.

The Fed's 2019 rate cuts and low long-term interest rates should keep financial conditions stable and support the housing market. We expect consumer spending to remain firm, while inflation is likely to stay below 2%.

The Fed appears to have paused

The Fed cut the fed funds rates for the third time in October, but maintained the 1.50% to 1.75% range at its December meeting. Financial markets responded positively, with tightening credit spreads, rallying equity markets and declining volatility.

The Fed communicated in December that monetary policy is appropriate to sustain expanding economic activity and signaled that it expects to leave rates unchanged in 2020. It also indicated that it would continue monitoring incoming information, including global developments and muted inflation pressures. We believe the Fed will likely remain on the sidelines for the upcoming months as it assesses the impact of mid-cycle cuts. Since it has communicated a "wait and see" approach, the hurdle to move rates in either direction is very high. The market is pricing in roughly one cut in 2020.

During the quarter, longer-term U.S. Treasury yields rose by 15 to 25 basis points (bps) in response to easing trade tensions with China, an accommodative Fed and stabilizing U.S. and global growth data. The yield curve steepened as short-term rates fell, leading to the first positive 3-month to 10-year Treasury yield spread since May.

The rise in yields led to a modestly negative total return for the overall U.S. Treasury Index during the quarter and slightly reduced its full-year return to 6.86%.[1] The 10-year Treasury yield ended the quarter at 1.92%. Yields also rose globally, resulting in $11.3 trillion worth of global bonds trading with negative yields, a reduction of over $3 trillion during the fourth quarter.[2]

Global central banks generally followed the Fed's pause, with many noting the stabilization in global growth. The lone exception was Sweden's Riksbank, which hiked rates by 25 bps back to 0%. Confidence was buoyed by prospects of a U.S./China trade deal and some clarity surrounding Brexit.

Meanwhile, Japan announced fiscal stimulus of a similar scale to 2016, while German politics pushed the fiscal debate one inch away from the country's so-called Schwarze Null (black zero) policy that requires a balanced federal budget. As a result of a more positive backdrop, global bond yields bounced back off all-time lows, led by long

German Bunds, which moved back into positive territory. Investors scaled back expectations of a Bank of Japan rate cut, nudging 10-year Japanese government bonds back to the bank's long-term target of around 0.0%.

Going forward, we expect the Fed will keep rates steady, long-term rates will be range bound and global central banks will remain accommodative. We are managing portfolio durations short to near benchmark in most strategies. We estimate that the 10-year U.S. Treasury yield will likely stay between 1.50% and 2.00% over the next year.

Late cycle, defensive positioning

Despite the advancing cycle, corporate and consumer credit fundamentals remain healthy, supporting credit sectors. A resilient consumer will benefit mortgage-backed and consumer-related securitized assets, while solid growth and a steeper yield curve should support U.S. financial debt and preferred securities. A dovish Fed boosts liquidity conditions and risk sentiment, which supports emerging markets debt and foreign currencies. Individual credit selection remains key in these later stages of the credit cycle.

We remain biased toward "late-cycle, defensive positioning" while moderately favoring spread sectors. We expect continued volatility in rates and credit markets and believe valuations are stretched. We continue upgrading quality, increasing liquidity and maintaining a high level of diversification. The income advantage of spread sectors will likely drive performance, as we don't expect a significant improvement in valuations. We anticipate low- to mid-single-digit returns from a diversified portfolio.

OUR FAVORITE THINGS

Our more conservative positioning continues to favor higher quality credit sectors, such as investment grade corporates, select emerging markets and preferred securities. We have also been increasing portfolio diversification while maintaining income by adding to higher quality securitized sectors, such as mortgage-backed securities, asset-backed securities and commercial mortgage-backed securities.

Investment grade corporate bonds had modest returns for the quarter at 1.18%, but generated their best annual total return (14.54%) in a decade.[3] The sector again handily outperformed the Bloomberg Barclays Aggregate Bond Index, which returned 0.18% for the quarter and 8.72% for the year. Investment grade spreads finished the year at year-to-date tights (93 bps) as macroeconomic tail risks receded during the quarter.

Progress on the ongoing U.S./China and the U.S./Mexico/Canada (USMCA) trade agreements fueled a rally in risk assets. Geopolitical risks were further alleviated as the risk of a "hard Brexit" was reduced with the decisive Conservative Party victory in the U.K. election. Longer-dated securities outperformed short- and intermediate-term bonds. In 2019, leverage metrics improved for BBB-rated securities, while they continued to degrade for A-rated bonds, driving the outperformance of the BBB-rated segment. At the ratings level, BBB rated bonds returned 1.68% for the quarter, outperforming lower-beta A and AA rated bonds, which posted returns of 0.81% and 0.20%, respectively.[4]

We expect credit spreads to respond favorably in the near term to the de-escalation of macroeconomic tail risks. Continuation of accommodative monetary policy, a steady U.S. economy and strong expected foreign inflows seeking positive-yielding assets are supportive for a continued tightening of credit spreads. Strong technical dynamics are expected to continue with gross and net issuance expected to decline year-over-year.

The Fed's policy actions have extended the credit cycle, as issuers have secured long-term debt financing and extended the duration of their liabilities at low all-in yields. Stable credit fundamentals should continue to support tight valuations, with BBB-rated issuers benefiting the most from further deleveraging. We will analyze the fourth quarter earnings releases closely to monitor the pace of deleveraging and for any indications of traditional late-cycle behavior that diverts cash from debt repayment to shareholder-friendly activities.

We remain focused on sector strategy and credit selection. Credit spreads are just 9 bps off the post-crisis tights of February 2018 and there is potential for increasing geopolitical risks and a reversal in risk appetite. We favor banks because they are strongly capitalized and communications due to their focus on improving balance sheets. We are selective in the chemicals, energy and retail sectors, which may be negatively impacted by an unexpected increase in volatility.

Emerging markets debt returned +2.09% for the quarter, reaching a total return of 13.11% for the year.[5] During the quarter, returns were choppy, primarily due to fluctuations in expectations for a U.S./China trade agreement. However, the year closed with a high degree of confidence that a phase-one agreement would be reached, leading to a strong rally in emerging markets assets.

> *The outlook for emerging markets leading into 2020 is much stronger than a few months ago."*

Within the broader asset class, emerging markets debt denominated in local currency performed best, as both major developed and emerging markets central banks maintained easing stances. U.S. dollar weakness allowed emerging markets currencies to contribute to returns. Emerging markets sovereigns and corporate debt also delivered positive returns as the beneficial effect of narrowing credit spreads offset any losses from higher U.S. Treasury rates. Within sovereigns, high yield outperformed investment grade as strong performance in Argentina and sub-Saharan Africa overcame weaknesses in Lebanon and Ecuador.[6] Technical factors were mixed, with mostly positive inflows offset by sizable issuance and refinancing during the quarter.

The outlook for emerging markets leading into 2020 is much stronger than a few months ago. While the Fed paused its easing cycle during the quarter, geopolitical risks have moderated as the U.S. and China make progress on a trade truce, a no-deal Brexit appears less likely and global growth shows signs of stabilization. Improved growth and trade should provide a positive tailwind for risk markets. These factors lead us to maintain a positive outlook for emerging markets debt, along with favorable valuations, stimulative monetary policies and increasing fiscal support across both developed and emerging markets.

While developed markets rates moved higher over the period, emerging markets yields and hard currency credit spreads remain attractive on a relative and historical basis. Furthermore, technicals appear more favorable, with modest net new issuance on the calendar for 2020. However, given tightened spreads compared to this time last year, differentiation and selection are increasingly important.

We expect local-currency-denominated emerging markets bonds to continue to perform well. Emerging markets central banks continue to have room to ease, with inflation not yet posing a threat and real yields remaining high. Emerging markets foreign currency may be a larger contributor to overall returns than duration if we see a stable to weakening U.S. dollar. Alternatively, sharply higher U.S. rates and a stronger dollar may pose challenges to our view.

Securitized sectors experienced lower returns this quarter with mortgage-backed securities (MBS) posting 0.71%[7] gains, commercial mortgage-backed securities (CMBS) -0.33%[8] and asset-backed securities (ABS) 0.39%.[9] We like these generally higher quality sectors for their ability to produce income and broaden portfolio diversification as the cycle progresses.

The mortgage market outperformed Treasuries, but lagged investment grade corporates despite higher rates and a steeper yield curve. After several months of elevated mortgage prepayment levels, prepayments declined more than expected toward the end of the year. This leads us to believe the worst of the mini refinance wave is over. Lower interest rates and increased household formation also remain supportive, while fair valuations make mortgages equally as attractive as investment grade corporate sectors. We generally favor agency MBS and prime jumbo non-agency MBS over non qualified MBS based on valuations and because they tend to have less dramatic prepayment behavior as rates decline.

Excess returns for ABS and CMBS versus Treasuries were basically flat during the fourth quarter. Rates moved higher due to a more constructive macro outlook, and spreads subsequently rallied late in the quarter against a backdrop of lower new issue supply in December. Both high quality and credit spread product benefited from tighter spreads by the end of the year. On balance, consumer and corporate credit continued to perform within the range of expectations, but with some pockets of deterioration especially in CLOs, which are collateralized by high yield leveraged loans.

The combination of a benign macroeconomic backdrop, lower interest rates and lower new issue volume at the end of 2019 should give ABS a strong start this year. We expect this sentiment to continue for at least the initial months of the year. We think commercial real estate borrowers should find CMBS financing attractive in the persistently low-rate environment, especially for those seeking to lock in 10-year financing. This lower sustained capital cost may result in higher commercial real estate prices, supporting the sector. We will continue to look for opportunities in ABS and CMBS to capture attractive risk-adjusted returns, albeit with a more cautious approach in certain areas of the market.

Preferred and contingent capital (CoCo) securities also posted another solid quarter, returning 3.06%. Preferred credit spreads finished the quarter 44 bps lower at 172 bps.[10] Preferred securities benefited from continued strong underlying fundamentals and relatively modest supply during the period. We believe risk premiums are fair as preferred credit spreads remain approximately 30 bps wider than during the previously tight levels in late 2017.[11]

Contingent capital securities outperformed preferred securities for the quarter. U.S. $1000 par securities outperformed $25 par securities during the quarter. Despite redemption activity being rather balanced between $25 par and $1000 par preferreds, new issue supply was more concentrated in the $25 par market. For the full year, while all categories posted positive returns, $1000 par preferred performed best, followed closely by CoCos, and lastly by $25 par preferreds.

We still favor non-fixed rate coupon securities, as they can meaningfully reduce potential interest rate risk without sacrificing much return.

Fundamental credit metrics remain strong. U.S. bank balance sheets are incredibly resilient as confirmed by the 2019 Fed Stress Test results, while Bank of England stress test results released during the fourth quarter demonstrated the same for U.K. banks. Forward looking net supply for U.S. bank preferred securities is likely to be flat. While changes to bank capital buffer rules outside the U.S. may result in additional CoCo issuance, it is expected to be manageable and spread over several years.

We still favor non-fixed rate coupon securities, as they can meaningfully reduce potential interest rate risk without sacrificing much return. These coupon structures tend to be more defensive during rising rate environments compared to ordinary fixed-rate coupons. We also favor $1000 par securities because, on average, they are cheaper than $25 par securities and more $1000 par securities have non-fixed-rate coupons.

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

Endnotes

Sources

1 Data source: Bloomberg, L.P. Bloomberg Barclays U.S. Treasury Index.

2 Data source: Bloomberg, L.P.

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

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

5 Data source: Bloomberg, L.P. Bloomberg Barclays Emerging Markets USD Aggregate Index.

6 Data source: JPMorgan.

7 Data source: Bloomberg, L.P. Bloomberg Barclays U.S. MBS Index.

8 Data source: Bloomberg, L.P. Bloomberg Barclays Investment Grade CMBS Index.

9 Data source: Bloomberg, L.P. Bloomberg Barclays ABS Index.

10 Data source: BofA Merrill Lynch. 60% ICE BofAML U.S. All Capital Securities Index/40% ICE BofAML Contingent Capital Index. Spread is measured by option-adjusted spread.

11 Data source: BofA Merrill Lynch. ICE BofAML U.S. All Capital Securities 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. **Correlation** is a statistical measure of how two securities move in relation to each other. **Duration** is a measure of the sensitivity of the price of a fixed-income investment to a change in interest rates. **Option-adjusted spread (OAS)** is the yield spread added to a benchmark yield curve to discount a security's payments to match its market price, using a dynamic pricing model that accounts for embedded options. **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 Markets 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. Asset-Backed Securities Index** is the ABS component of the U.S. Aggregate index and includes credit and charge cards, autos and utilities. **Bloomberg Barclays U.S. Commercial Mortgage-Backed Securities Index** measures the performance of investment-grade commercial mortgage-backed securities, which are classes of securities that represent interests in pools of commercial mortgages. **Bloomberg Barclays U.S. Corporate Bond 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. **Bloomberg Barclays U.S. Mortgage-Backed Securities Index** covers agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). **Bloomberg Barclays U.S. Treasury Index** includes public obligations of the U.S. Treasury. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index. In addition, certain special issues, such as state and local government series bonds (SLGs), as well as U.S. Treasury TIPS, are excluded. STRIPS are excluded from the index because their inclusion would result in double-counting. The **ICE BofAML Contingent Capital Index** tracks the performance of investment grade and below investment grade contingent capital debt publicly issued in the major domestic and eurobond markets. **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. **S&P/LSTA U.S. Leveraged Loan 100 Index** is designed to reflect the performance of the largest facilities in the leveraged loan market.

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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