

## Fourth quarter 2024 outlook

# What goes up, must come down



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*With the U.S. Federal Reserve's first rate cut in September, we have moved from a very long cycle of higher rates toward a likely slow path of rate cuts. We anticipate a series of 25 basis point cuts over the remainder of 2024 and into 2025. In this environment, extending duration and maintaining allocations to higher yielding credit sectors – with an eye toward quality – may make sense.*

### KEY TAKEAWAYS:

- The Fed's current projections indicate that this cutting cycle may be slow and long, more like the 1995 and 2000 easing cycles.
- The basics of fixed income management still apply when positioning portfolios: build income, manage duration and pay attention to credit risk.
- We like well-diversified multisector and core plus bond strategies and see opportunities in preferred securities and higher quality, high yield corporate bonds.

### LONG AWAITED RATE CUTS HAVE BEGUN

At its September meeting, the Fed started the cycle of interest rate cuts by lowering the policy rate 50 basis points (bps) and setting up several more cuts for later this year. The Fed's current projections indicate that this cycle may be slow and long, more like the 1995 and 2000 easing cycles than more recent periods (Figure 1).

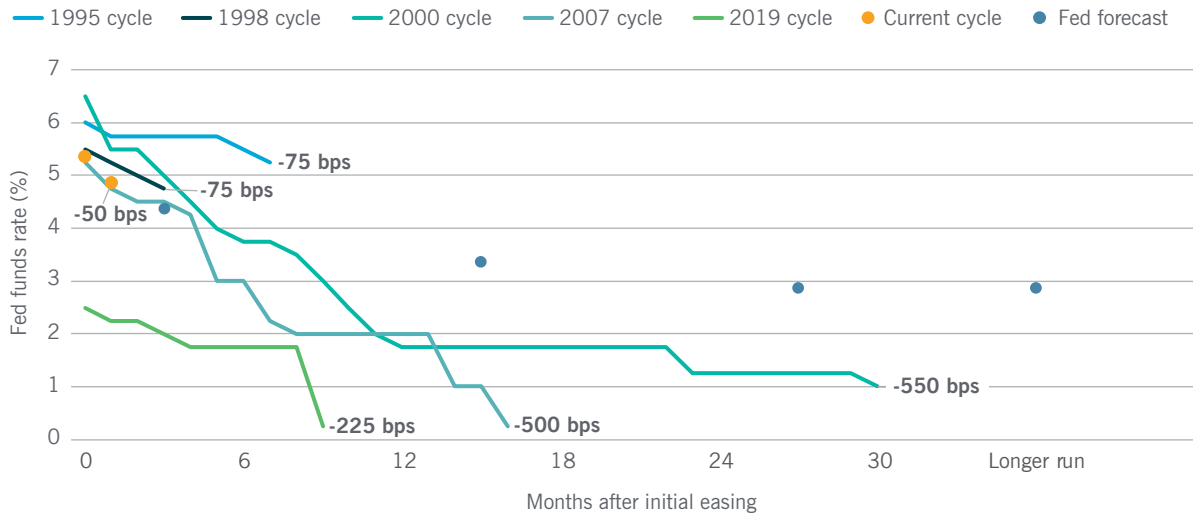


*This easing cycle may be slow and long, more like the 1995 and 2000 cycles.*

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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**Figure 1: The 2024 cutting cycle may be slow and long**



Data source: Bloomberg, L.P.; Federal Reserve Projection Materials. Fed funds rate and Fed forecasts as of 18 Sep 2024. Fed forecast represents the median forecast of each Federal Open Market Committee participant for the midpoint of the fed funds rate at year ends 2024, 2025, 2026 and longer run. Month 1 shows first rate increase. 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).

**NOT ALL INTEREST RATE CYCLES ARE THE SAME**

For an idea of how this cycle may play out, we look to prior cycles similar to the current environment (Figure 2). For example, Fed cuts in periods 1 and 3 were due more to a slowing economy than a crisis

situation. Conversely, cuts in more recent periods 4 and 5 were precipitated by extreme economic distress – the Great Financial Crisis and the global pandemic. Period 2 presented another crisis due to Russian and emerging markets debt market issues that caused hedge fund Long Term Capital to fail.

**Figure 2: Market conditions differed during periods of decreasing fed funds rates**

	Period 1	Period 2	Period 3	Period 4	Period 5	Today
	06 Jul 1995 – 1 Feb 1996	29 Sep 1998 – 18 Nov 1998	03 Jan 2001 – 26 Jun 2003	18 Sep 2007 – 17 Dec 2008	31 Jul 2019 – 17 Mar 2020	18 Sep 2024 – ?
Starting rate level	6.00%	5.50%	6.50%	5.25%	2.50%	5.38%
Number of cuts	3	3	12	8	4	?
Duration	7 months	10 months	30 months	16 months	9 months	?
Magnitude	0.75%	0.75%	5.50%	5.00%	2.25%	?
Starting credit spread	65 bps	123 bps	195 bps	155 bps	108 bps	94 bps
Other economic variables	<ul style="list-style-type: none"> <li>• Mid-cycle adjustment</li> <li>• Low inflation, high unemployment</li> </ul>	<ul style="list-style-type: none"> <li>• Long Term Capital fails due to Russian and emerging markets debt issues</li> </ul>	<ul style="list-style-type: none"> <li>• End of business cycle</li> <li>• Measured pace of easing</li> </ul>	<ul style="list-style-type: none"> <li>• Extremely accommodative policy of the Great Financial Crisis</li> </ul>	<ul style="list-style-type: none"> <li>• Easing of policy</li> <li>• Pandemic policy response</li> </ul>	<ul style="list-style-type: none"> <li>• Soft landing?</li> </ul>

Data source: Bloomberg, L.P.; federalreserve.gov, Nuveen. Data shown applies to the time periods noted in the table. Starting credit spread levels are the yield difference between Bloomberg U.S. Corporate Investment Grade Bond Index and similar-duration Treasuries.

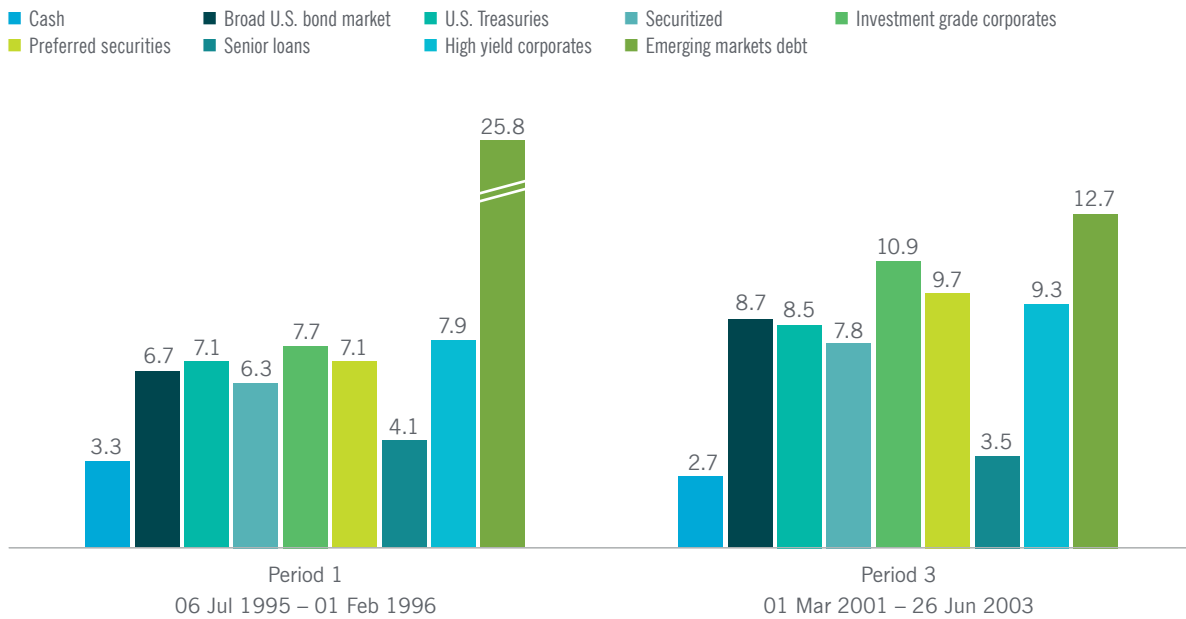
## HOW DID FIXED INCOME FARE?

Since bond prices move in the opposite direction to interest rates, major bond sectors experienced positive returns in prior falling rate periods (Figure 3). Not surprisingly, the longer-duration investment grade corporate sector performed better, while

the short-term, floating-rate loan segment fared worse. Outsized performance of emerging markets debt during 1995-1996 was partly due to a high concentration among a small number of Latin American countries. Importantly, all major sectors outperformed cash.

**Figure 3: Major bond sectors experienced positive returns in prior falling rate periods**

*Sector returns during select falling rate periods (%)*



Data source: Morningstar Direct. Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: cash: ICE BofA U.S. 3-month Treasury Bill Index; broad U.S. bond market: Bloomberg U.S. Aggregate Bond Index; U.S. Treasuries: Bloomberg U.S. Treasury Index; securitized: Bloomberg U.S. Securitized Index; investment grade corporates: Bloomberg U.S. Investment Grade Corporate Index; preferred securities: ICE BofA Fixed Rate Preferred Securities Index; senior loans: Credit Suisse Leveraged Loan Index; high yield corporates: Bloomberg U.S. HY 2% Issuer Capped Index; emerging markets debt: Bloomberg Emerging Markets USD Aggregate Index.

## POSITIONING PORTFOLIOS IN TODAY'S MARKET

How should investors be thinking about portfolios in the current cycle? The basics of fixed income management still apply: build income, manage duration and pay attention to credit risk.

**Emphasize diversified sources of portfolio income.** Income has been the primary driver of fixed income returns over time.<sup>1</sup> Since interest rates are relatively high, bonds currently offer generous yields. However, emphasizing sectors that may maintain higher income levels as rates slowly decline may help build total return.

*We like the higher-quality credit sectors with more income potential, such as investment grade corporates, preferred securities and higher-rated segments of high yield corporates. As the economy slows, allocating across fixed income sectors may further diversify specific portfolio risks.*



*We like the higher-quality credit sectors with more income potential.*

**Lengthen portfolio duration.** While many investors have been heavily weighted in cash, we think extending portfolio duration makes sense as rates fall. Increasing a portfolio’s duration, a common measure of a fixed income investment’s sensitivity to interest rate changes, helps improve price appreciation as rates decline.

*We advocate moving toward the intermediate-term duration segment of the market. This allows the portfolio to benefit more from falling rates than cash or shorter-term investments without subjecting it to the relatively volatile swings of long-term investments.*



*Credit spreads are currently fairly narrow, and we believe spreads can remain reasonable for some time.*

**Balance credit risk.** Credit spreads are the difference between the yield of a riskless U.S. Treasury bond and a security with credit risk, such as a corporate bond. At their essence, credit spreads represent a risk premium. During periods of economic contraction that cause rates to fall,

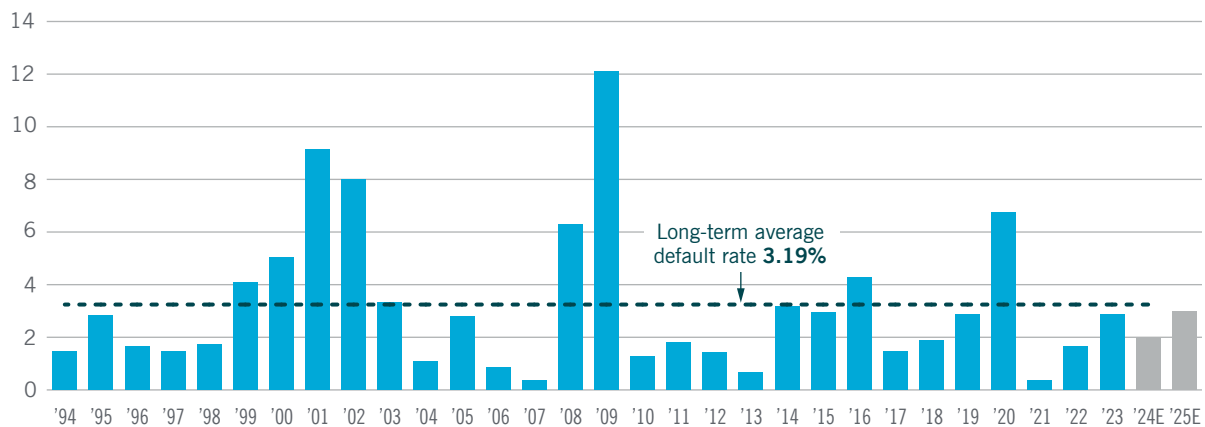
market risk premiums typically rise. This widening of credit spreads negatively impacts bond returns, potentially offsetting some of the benefit of falling rates on asset prices.

Credit spreads are currently fairly narrow versus historical levels. We believe spreads can remain reasonable for some time because we are not in recession and corporate fundamentals remain solid. Other factors should reduce the amount of spread widening. Consider the high yield corporate market, for example:

- Defaults are historically low and projected to remain low (Figure 4).
- The high yield asset class is skewed toward higher quality, with nearly half of the outstanding debt rated BB and only about 12% rated CCC.<sup>2</sup> High yield bond issuers have strong balance sheets even as we head into a potentially more challenging economic environment.
- Falling rates may benefit companies, both in terms of cost and business model considerations. Lower interest rate expenses help the weakest borrowers, which are more likely to default. Banks experience increased margins as declining short rates reduce the interest rates they credit their customers.

**Figure 4: Defaults are expected to remain near long-term average levels**

*High yield corporate bond par-weighted default rates (%)*



Data source: JPMorgan, 31 Aug 2024.

*Because spreads are tight and credit risk naturally increases as the economy slows, we like maintaining an up-in-quality bias. For example, stick to the less volatile investment grade corporate industries and emphasize the higher quality BB- and B- rated high yield corporate segments.*

**Employ multisector strategies.** By allocating to strategies that use a wide range of sectors, investors may take advantage of relative value opportunities. Additionally, multisector strategies tend to have high correlations to the bond market and low correlations to equities, making them useful for offsetting stock market volatility.

- **Multisector bond strategies.** The additional yield potential can help keep income levels high. In general, such strategies 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 strategies.** The ability to actively adjust allocations to lower-quality segments may boost yield while balancing overall risk. These strategies 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 strategies.** These strategies invest broadly across bond market sectors, including U.S. Treasuries, securitized sectors and investment grade corporates. They tend to have the highest correlation to the bond market, helping balance the risks of equity allocations.

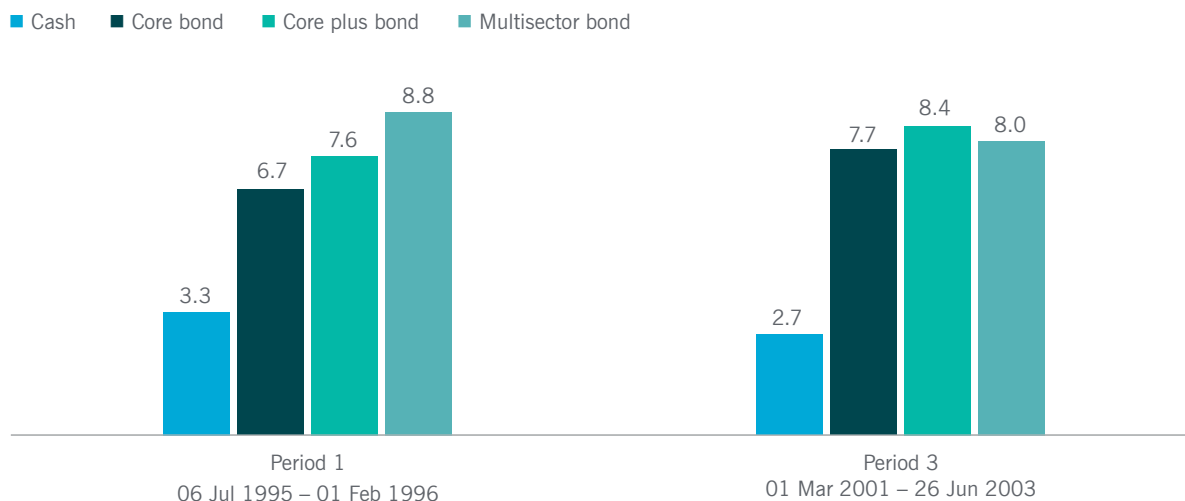
These strategies fared differently during previous Fed cutting cycles, but they all significantly outperformed cash (Figure 5).



*By allocating to multisector strategies, investors may take advantage of relative value opportunities.*

**Figure 5: Bond investment strategies outperformed cash during falling rate periods**

Total return (%)



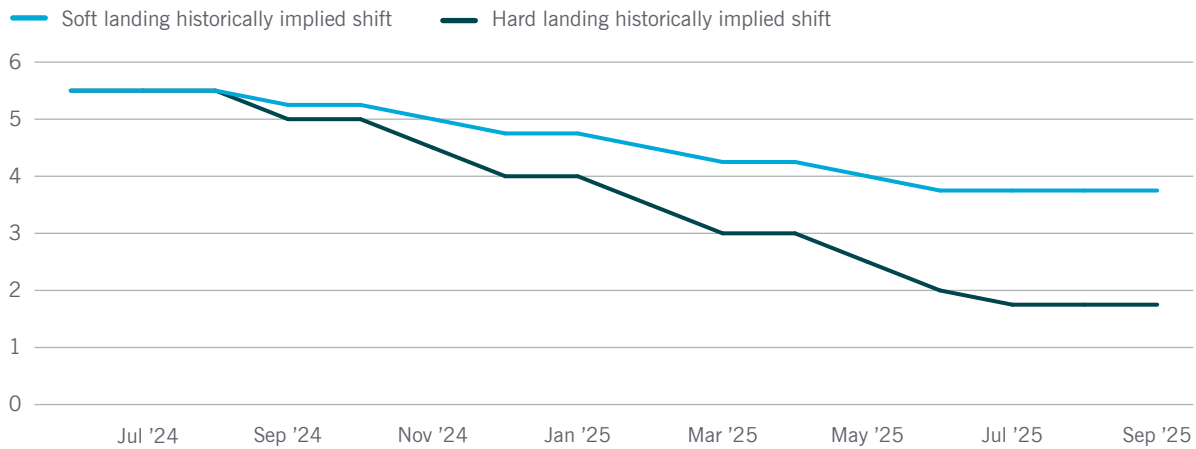
Data sources: Morningstar Direct. Based on Morningstar category averages; cash represented by the ICE BofA U.S. 3-month Treasury Bill Index. Performance data shown represents past performance and does not predict or guarantee future results.

## CASH YIELDS ARE SET TO DECLINE

While it may be tempting to wait, cash yields will likely decline meaningfully in either a soft or hard landing scenario. It is just a matter of how fast and how much. Repositioning portfolios into longer duration sectors now may add income and provide additional returns as rates fall.

**Figure 6: Fed rate cuts mean lower rates on cash regardless of the economic scenario**

*Fed funds target rate, upper bound (%)*



Data sources: Bloomberg, L.P., 26 Aug 2024. Historical shifts reflect cutting cycles from 30 Nov 1966 to present. The percent change of fed funds for each cutting cycle is computed. Separate averages are computed for cutting cycles that do not precede a recession and for those that do. They are designated soft and hard landing respectively. The average percentage change in either scenario is then applied to the current fed funds target rate. This example is for illustrative purposes only and not intended to predict or project investment results.

## OUTLOOK

### *We favor an up-in-quality bias*

U.S. economic growth should continue slowing to a below-trend pace. U.S. job growth is likely to moderate further and presents upside risks to the unemployment outlook. Inflation has peaked but should remain “too high” relative to central banks’ targets this year. Nevertheless, policy should remain focused on downside risks to growth rather than upside risks to inflation.

We expect the Fed to continue cutting interest rates 25 bps per meeting through mid-2025, bringing policy rates to the neutral level of 3.25%-3.50% by June. The European Central Bank is also set to cut rates further, and we forecast 125 bps of cuts through mid-2025. In China, policymakers will likely continue 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 should widen modestly in the coming months, likely presenting attractive entry points for risk taking. That said, we see attractive opportunities in the preferred market, in BB-rated high yield and senior loans, and in non-core asset-backed securities and commercial mortgage-backed securities. Emerging markets should benefit from a weaker dollar, central bank rate cuts and steady global growth. The recent rate rally has moved in line with our forecasts, and we expect long-end yields to be range bound over the coming months.

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**Endnotes**

- 1 From 31 Jan 1976 to 31 Aug 2024, 100% percent of annualized total return of the Bloomberg U.S. Aggregate Bond Index was derived from coupon return, as opposed to price appreciation.
- 2 Data source: Bloomberg, L.P., Bloomberg U.S. Corporate High Yield Index, 31 Aug 2024.

**Sources**

**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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