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Fixed income markets may have changed, but the same lessons apply

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After several years of ultra-low yields and highly accommodative stances by policymakers globally, fixed income has seen significant shifts across all sectors, paving the way for a new-look market environment.

*“**In an ever-changing investing landscape,** market participants that keep in mind the lessons of previous cycles should be well-placed to navigate new markets.*

THE ‘NEW’ MARKET

Sticky Inflation and elevated interest rates have catalysed a significant shift in markets, pushing up borrowing costs, negatively impacting spreads for fixed income across sectors, and forcing investors to re-evaluate their portfolios.

The U.S. Federal Reserve (Fed) has increased interest rates from 0.25% to 5.50% since March 2022, the European Central Bank has hiked rates to 4% since July 2022 and the Bank of England has lifted rates from 0.25% to 5.25% since the start of 2022.

With cash yields the highest in decades, investors have naturally gravitated towards short-term instruments such as money markets and certificates of deposit. However, for investors with a long-term horizon, reinvestment risk – the risk that future cash flows are invested at lower prevailing rates – means that today’s returns on cash cannot simply be extrapolated into the future. Finding strategic and diversified income sources can help minimize reinvestment risk and maximize risk-adjusted returns over a market cycle.

DIVERSIFICATION REMAINS KEY

Diversification has proven to be essential for portfolio survival, and this is unlikely to change. Until 2022, the correlation traits of a traditional portfolio of 60% equity and 40% bonds benefited investors.

Data from Nuveen[1] shows that, prior to 2022, U.S. bonds had a slightly negative correlation to U.S. and non-U.S. stocks, exhibiting -0.10 for the former and -0.30 for non-U.S. stocks.

The correlation to equities is one aspect of diversification, though investors should remember that fixed income is a varied asset class, and not all sectors are equal. Diversification within fixed income allocations remains just as important when navigating challenging markets.

Considering the challenges investors face today: high inflation, recession fears and steady income generation, how could fixed income address these concerns?

Monetary policy has caused yield curves to invert in the U.S. and Europe, with investors struggling to find yield in the long end. A potential solution to this problem could be emerging market (EM) bonds. Inflation is decelerating in several EM economies, albeit in a stickier manner than preferred. Policy tightening appears to be nearing its end and while economic activity is slow, it remains in a supportive state. Many emerging market economies rely on commodities, thus adding a pro-inflation performance within a fixed income context. Within EM, we find corporate issuers with sound balance sheets and the ability to service their debt that offer attractive yields and potential for total return.

The likelihood and severity of a global recession has been the subject of intense debate among market participants. Despite recent optimism over the Fed's ability to engineer a soft landing, our view is that a recession in the world's largest economy, should it occur, would likely have an outsized impact on corporate borrowers as opposed to the U.S. consumer. This partially informs our preference for mortgage-backed securities, particularly mortgage credit over corporate bonds. Housing fundamentals are buoyed by continued house price appreciation while existing homeowners are locked-in to low payments post-COVID, creating a positive environment for the performance of these instruments on a risk-adjusted basis.

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Finally, the high-yield bond market looks well-positioned to cope with a slowing economy than previous cycles, with a historically high percentage (~50%) of BB rated bonds and a low percentage (~10%) of CCC rated issues[2]. Although defaults could increase towards historical averages due to prolonged tight monetary policy and credit conditions, most of the credit deterioration should occur in the lower quality segment of the market.

Technical factors remain supportive for the high-yield sector, with net new issuance still falling short of natural demand. The imbalance is driven by a combination of maturities and calls, tenders and the migration of certain issuers in the upper tier of the high-yield market into investment grade, so called "rising stars."

These sectors are only a portion of the broader fixed income asset class. There are several other levers that active managers can pull on to successfully navigate any market environment in pursuit of attractive risk-adjusted performance. Since the performance of fixed income sectors can vary meaningfully in different conditions, a focus on diversified sources of income and risk can positively influence long-term investment outcomes.

PATIENCE REMAINS A VIRTUE

In challenging markets, investors may be tempted to seek refuge in unproven strategies that may seem appealing at the time. Previous market cycles, however, have demonstrated the benefits of patience.

For instance, in the U.S., historically, bonds have generated strong returns on average immediately following the end of Fed hikes. The most attractive returns have typically occurred nine months after the terminal policy rate. While we advocate a balanced and flexible approach, the virtue of staying invested over a cycle and having a long-term investment horizon hold true regardless of style or approach.[3]

REMAIN ACTIVE

Active management across asset classes will remain an important tool for navigating challenging market conditions. With interest rates, inflation and a shifting geopolitical stage creating an unsettling environment, knowing when and where to enter or exit a position – and having the capability to do so – should prove valuable to investors.

Partnering with an investment manager that has a credible track record of managing flexible bond portfolios over a market cycle is one way of maintaining an active stance across fixed income sectors. Managers that can identify the opportunities and risks across fixed income sectors can serve investors well in challenging conditions.

NEW MARKET, SAME LESSONS

In an ever-changing investing landscape, market participants that keep in mind the lessons of previous cycles should be well-placed to navigate new markets. Partnering with a fixed income manager with breadth and expertise across fixed income sectors and a proven track record of navigating challenging markets utilizing a flexible approach can create resilient investment solutions for all stages of the economic cycle.

ABOUT NUVEEN

Nuveen, the investment manager of TIAA, offers a comprehensive range of outcome-focused investment solutions designed to serve the long-term financial goals of institutional and individual investors. Nuveen has $1.1 trillion in assets under management as of 30 June 2023, and operations in 27 countries. Its investment specialists offer deep expertise across a comprehensive range of traditional and alternative investments through a wide array of vehicles and customised strategies.

For more information, please visit nuveen.com.

Endnotes

1 The power of private real assets, Nuveen Real Assets, 2022.

2 Source: Bloomberg LP. As of 30 Jun 2023. Representative indices: **High yield corporates:** Bloomberg U.S. Corporate High Yield 2% Issuer Capped Index; **Senior loans:** Credit Suisse Leveraged Loan Index; **Emerging market debt:** Bloomberg Emerging Market Aggregate Index; **Preferred securities:** ICE BofA U.S. All Capital Securities Index; **Investment grade corporates:** Bloomberg U.S. Corporate Investment Grade Index.

3 Source: Bloomberg LP, Nuveen. Average of performance over the last four Fed tightening cycles. Agg Index is the Bloomberg U.S. Aggregate Index

A word on risk

All investments carry a certain degree of risk and there is no assurance that an investment will provide positive performance over any period of time. Investing in municipal bonds involves risks such as interest rate risk, credit risk and market risk, including the possible loss of principal. The value of the portfolio will fluctuate based on the value of the underlying securities. There are special risks associated with investments in high yield bonds, hedging activities and the potential use of leverage. Portfolios that include lower rated municipal bonds, commonly referred to as "high yield" or "junk" bonds, which are considered to be speculative, the credit and investment risk is heightened for the portfolio. Bond insurance guarantees only the payment of principal and interest on the bond when due, and not the value of the bonds themselves, which will fluctuate with the bond market and the financial success of the issuer and the insurer. No representation is made as to an insurer's ability to meet their commitments.

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