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First quarter 2025 outlook

Fixed income prepares for a shiny new year

Anders Persson
CIO of Global Fixed Income

Tony Rodriguez
Head of Fixed Income Strategy

Bonds finished 2024 with positive returns, and we believe fixed income assets can continue to shine. Solid economic growth, sticky inflation and a slow pace of U.S. Federal Reserve rate cuts should keep shorter-term yields elevated. And relatively stable longer-term rates mean higher yields can help build portfolio income and return potential. In this environment, we like well-diversified multisector and core plus bond strategies in particular.

KEY TAKEAWAYS:

- Due to continued growth and sticky inflation, we expect a more patient Fed to deliver two more 25 basis point rate cuts this year.
- Yields remain at their highest levels in more than 15 years, and higher starting yields may lead to strong return profiles and continued income opportunities.
- We like well-diversified multisector and core plus bond strategies and see opportunities in the preferred market and in mid- to high-quality high yield and senior loans.

A SOLID YEAR FOR BONDS

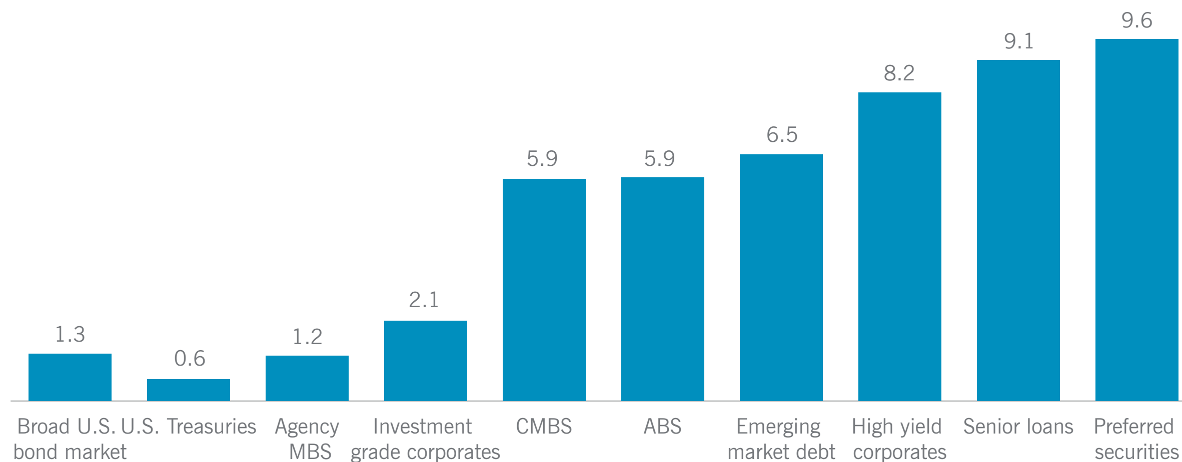
Throughout 2024, short-term rates declined as the Fed eased, but intermediate- to longer-term rates rose as the market interpreted economic data. The 10-year Treasury yield, for example, climbed nearly 70 basis points (bps) to end at 4.58%. Yet even with the significant rate changes, all major sectors posted positive returns. Traditional, investment grade sectors experienced low single digit returns and the more aggressive credit sectors saw high single digit returns. Preferred securities topped out at 9.6%. All in all, it was a pretty good year for bonds.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

NOT FDIC INSURED | NO BANK GUARANTEE | MAY LOSE VALUE

Figure 1: Fixed income posted attractive annual returns

2024 total return (%)



Data source: Morningstar Direct, 31 Dec 2024. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: broad U.S. bond market:** Bloomberg U.S. Aggregate Index; **U.S. Treasuries:** Bloomberg U.S. Treasury Index; **agency mortgage-backed securities (MBS):** Bloomberg U.S. Mortgage-Backed Securities Index; **investment grade corporates:** Bloomberg U.S. Corporate Investment Grade Index; **asset-backed securities (ABS):** ICE BofA AA-BBB U.S. Fixed Rate ABS Index; **commercial mortgage-backed securities (CMBS):** ICE BofA AA-BBB U.S. Fixed Rate CMBS Index; **senior loans:** Credit Suisse Leveraged Loan Index; **emerging markets debt:** JPM EMBI Global Diversified Index; **high yield corporates:** Bloomberg U.S. Corporate High Yield 2% Issuer Capped Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index.

LOOKING AHEAD TO 2025

As we move forward, we see several trends supporting the investment landscape.

The global economy remains solid

While the U.S. economy is showing signs of slowing, we anticipate a soft landing with no recession through 2025. We expect U.S. growth around 2.0% with a slowing labor market. Europe appears poised for modest growth with some dispersion between its constituents. China's economy faces downside risks due to potential trade restrictions, while emerging markets countries with stable economic and political backdrops should be well-positioned for growth.

Inflation slowly moderates

We expect U.S. inflation to moderate but remain above the Fed's 2% target through much of the new year. Higher unemployment and slowing growth should ease some inflationary pressures, but the likelihood of further tax cuts and looser fiscal policy could act as a counterbalance. We expect inflation could remain somewhat sticky as these forces compete. We expect similar dynamics in Europe and the UK, with inflation set to improve further but remain above central banks' targets.

The new administration brings uncertainty

The Trump administration presents fiscal and regulatory uncertainty for economies and financial markets globally. We expect the Tax Cuts and Jobs Act to be nearly fully renewed with risks skewed toward additional tax cuts. We anticipate potential tax cuts should provide a small fiscal boost in 2026-27 but also pressure wider fiscal deficits, potentially keeping longer-term rates higher. Proposed tariffs could drive prices higher, lead to retaliation from other countries and create appreciation in the U.S. dollar, which would likely be a medium-term drag on growth.

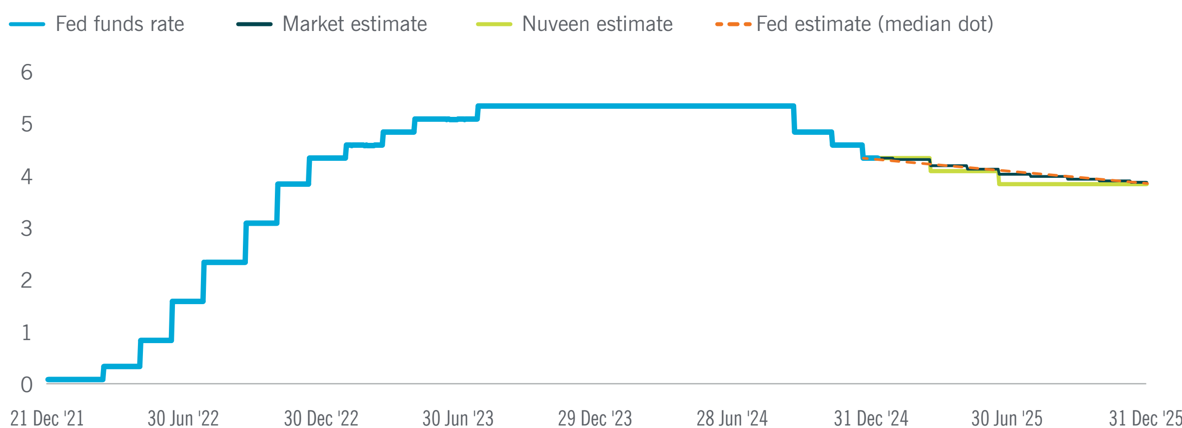
Monetary policy eases slowly

Due to continued growth and sticky inflation, we expect the Fed to continue normalizing monetary policy at a measured pace. We forecast two more 25 basis point rate cuts in 2025. By the end of 2025, the fed funds rate is projected to reach approximately 4.0%. The Fed will remain data dependent, and 2025 cuts will be more gradual if growth or inflation is more resilient than our base case, or if fiscal policy becomes materially more stimulative.

The European Central Bank is aligned as it continues to exit restrictive policy rates. However, Japan is expected to extend its tightening campaign in 2025. As a result, we expect higher short-term rates in general through 2025.

Figure 2: Higher short-term rates are likely through 2025

Fed funds rate (%)



Data source: Bloomberg, L.P., 31 Dec 2024.

Long-term interest rates remain relatively stable

Longer-term U.S. Treasury rates are expected to remain anchored based on economic and labor data trends, despite moderating inflation. We anticipate the 10-year Treasury yield will settle around 4.5% by year-end 2025, presenting opportunities to lock in attractive yields and earn income.

High current yields present an attractive entry point

Across the fixed income spectrum, yields remain at their highest levels in more than 15 years. We think these elevated yields will persist with the slowing pace of Fed cuts and anticipated stable long-term interest rates. Since income has been the primary driver of fixed income returns over time,[1] higher starting yields may lead to strong return profiles and continued income opportunities.

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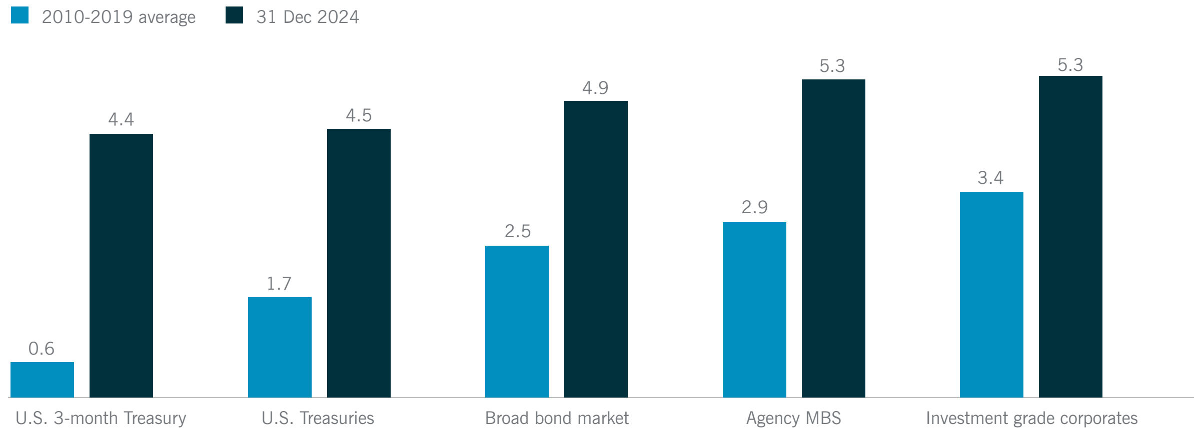
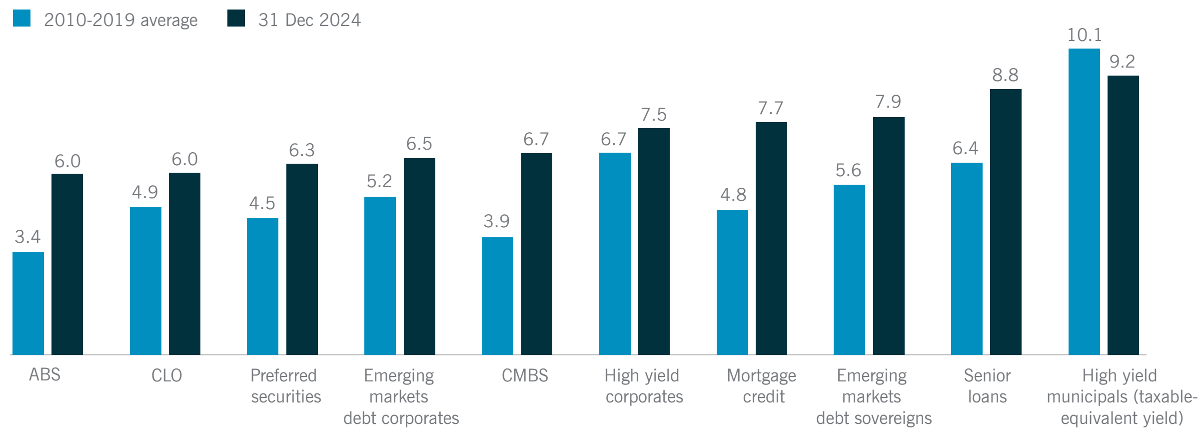
Figure 3: Yields are higher than historical averages for core sectors...

Yield-to-worst (%)



...and extended plus sectors



Data sources: BofA, Bloomberg, L.P., Credit Suisse, 31 Dec 2024. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: 3-month Treasury:** U.S Treasury 3-Month yield; **U.S. Treasuries:** Bloomberg U.S. Treasury Index; **broad bond market:** Bloomberg U.S. Aggregate Index; **agency mortgage-backed securities (MBS):** Bloomberg U.S. Mortgage-Backed Securities Index; **investment grade corporates:** Bloomberg U.S. Corporate Investment Grade Index; **asset-backed securities (ABS):** ICE BofA AA-BBB U.S. Fixed Rate ABS Index; **collateralized loan obligations (CLO):** JPM CLO A Rated Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **emerging markets debt corporates:** JPM CEMBI Diversified Index; **commercial mortgage-backed securities (CMBS)**: ICE BofA AA-BBB U.S. Fixed Rate CMBS Index; **high yield corporates:** Bloomberg U.S. Corporate High Yield 2% Issuer Capped Index; **mortgage credit:** JPM CRT Mortgage Credit Reference Index (average shown from 2015 to 2019 due to data availability); **emerging markets debt sovereigns:** JPM EMBI Global Diversified Index; **senior loans:** Credit Suisse Leveraged Loan Index; **high yield municipals:** Bloomberg High Yield Municipal Bond Index. High yield municipal taxable-equivalent yield calculations use 37% federal income tax and 3.8% Medicare surtax rates.

Diversifying income portfolios is paramount

To take advantage of higher starting yields, we think it is important to build diversified income across the full spectrum of fixed income. Diversification across sectors, correlations and risk factors should help prepare for unexpected volatility.

We continue to maintain allocations to higher yielding credit sectors with an eye toward quality as the economy slows. With think most sectors are fully valued but reflect healthy growth, solid profitability and an outlook for low defaults. Strong consumer balance sheets and solid levels of business investment should keep corporate defaults low. Therefore, we balance credit risk with duration risk across our portfolios.

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As active managers, we can use our deep, bottom-up research capabilities to uncover what we believe are attractive opportunities within all segments of the bond market. In addition, active management may help position portfolios for bouts of volatility as new policies are implemented and the economy slows.

2025 FIXED INCOME INVESTMENT THEMES

As we build portfolios, we are incorporating these main themes:

1. **Higher current yields** present the best starting point in 15+ years.
2. **Higher-for-longer rates** offer continued income opportunities.
3. **Position for bouts of volatility** amid potential policy shifts and a slowing economy.
4. **Balance duration with credit risk** in multi-sector portfolios.

Consider these investment ideas

STRATEGY		THEME			
		1	2	3	4
Multisector bond	Broadly diversified, multisector bonds across investment grade and high yield securities offering potential for high income and reduced interest rate sensitivity	X	X	X	X
Core plus	Traditional U.S. fixed income with up to 30% in higher yielding plus bond sectors, which provide diversification and potential for additional return	X	X	X	X
Core impact	Core U.S. fixed income focused on impact and ESG leadership with goal of providing favorable returns versus the broad bond market	X	X	X	X
Senior loans	Below investment grade senior loan securities with the potential for reduced interest rate sensitivity and high income	X	X	X	
Preferred securities	Preferred and other income producing securities offering attractive income potential, qualified dividend income and risk/reward balance	X	X	X	
High yield municipal bonds	Non-investment grade and unrated municipal bonds with the potential for a high level of tax-exempt income and enhanced yield	X	X	X	

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OUTLOOK

We favor spread sectors and credit risk

We continue to expect growth to moderate to a below-trend pace. Job growth will likely moderate further in the months ahead, presenting upside risks to the unemployment outlook. Inflation has peaked but should remain too high relative to central banks' targets in 2025. 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, but at a slower pace. We forecast two more 25 bps cuts this year, taking the policy rate to around 3.75%-4.00%. The European Central Bank is set to cut rates further as well, and we forecast 100 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 in the coming months, likely presenting more attractive entry points for risk taking. That said, we see attractive opportunities in the preferred market and in mid- to high-quality high yield and senior loans. The recent shift in rates has moved in line with our forecasts, and we expect long-end yields to be rangebound over the coming months.

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

Endnotes

1 As of 31 Dec 2024, 100% of the annualized total return of the Bloomberg U.S. Aggregate Bond Index was derived from coupon return (as opposed to price appreciation from 31 Jan 1976 to 31 Dec 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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