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Rethinking emerging markets hard currency

Katherine Renfrew
Head of Emerging Markets Corporates and Quasi-Sovereigns

John Espinosa
Head of Sovereigns

Melissa Zaccagnino
Associate Portfolio Manager, Emerging Markets Debt

Jeffrey Smith
Client Portfolio Manager, Emerging Markets Debt

Conventional thinking for emerging markets hard currency exposure is to manage sovereign bonds and corporate bonds in separate portfolios.

This paper challenges that idea. We believe investors should rethink current methods. We make the case that a hard currency portfolio with the ability to invest in both sovereigns and corporates improves the ability to:

- *best express country-level views*
- *manage active and downside risk*
- *more efficiently achieve risk-return objectives*

COUNTRY DYNAMICS ARE CRITICAL

Emerging markets (EM) offer a broad and diverse opportunity set, from well-established capital markets like Brazil and the large capital pools of Saudi Arabia, to the frontier markets of Ghana and crisis-stricken Ukraine. In the EM hard currency universe, exposure is available through sovereign obligations denominated in U.S. dollars or other

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developed market currencies, through government-related agencies (known as quasi-sovereigns) or through corporate issuers domiciled in or focused on emerging markets.

Regardless of the sector or the form, country risk is typically the dominant risk that emerging market investors need to assess correctly. Sovereign risks range from benign regulation to political issues to capital controls or even expropriation risks, varying widely among emerging markets.

One of the best illustrations of the diversity of emerging debt markets is reflected in the dispersion of returns. Data from the last ten calendar years shows this in figure 1. Every year has a marked difference in performance between the best and worst performing countries. In 2024, for example, the best performing country achieved returns of 118%, while the worst performer declined almost 6% — a range of 124 percentage points. The average returns of the top five and bottom five show a similar pattern, with the range for 2024 over 80 percentage points. Furthermore, the data shows that large differences in country returns are a consistent issue each year in emerging markets debt.

This dispersion demonstrates that country selection will have a significant influence on portfolio results. Determining how best to position an EM debt portfolio's country exposure requires a comprehensive understanding of country risk.

Country performance dynamics are largely a function of a country's economic growth drivers, inflation dynamics, terms of trade and levels of sovereign indebtedness. Investors need to evaluate sovereign fiscal and monetary policies, capital markets liquidity, import and export activity, currency dynamics and foreign exchange reserve level. Beyond financial indicators, such as credit spreads and credit ratings, qualitative aspects also need to be considered. These include the integrity of social institutions, political structure, governance norms, rule of law through legislation and adequate creditor rights in bankruptcy or reasonable minority shareholder protections.

These factors affect a country's risk profile and return potential. As such, sovereign risk factors are typically the main drivers of debt performance, particularly over longer time horizons.

Figure 1: Emerging markets debt returns

	2015	2016	2017	2018	2019	2020	2021	2022*	2023	2024
Best country	41.8%	41.2%	57.1%	14.0%	31.7%	17.3%	48.0%	6.9%	116.5%	118.4%
Top 5 average	24.7%	34.0%	30.0%	4.4%	27.6%	14.6%	22.4%	3.3%	73.8%	79.5%
JPM EMBI-GD	1.2%	10.2%	10.3%	-4.3%	15.0%	5.3%	-1.8%	-17.8%	11.1%	6.5%
Bottom 5 average	-13.4%	-8.8%	3.0%	-15.7%	-13.4%	-39.6%	-20.5%	-52.6%	-8.8%	-2.8%
Worst country	-19.5%	-36.3%	0.5%	-24.8%	-36.5%	-74.6%	-29.7%	-76.5%	-34.3%	-5.7%

JPMorgan EMBI Global Diversified Index returns. Source: Morningstar Direct, JPMorgan. Rolling 3-year correlations. Source: Morningstar Direct, JPMorgan. Rolling 3-year correlations. Best, Worst. 2024: Lebanon, Venezuela. 2023: El Salvador, Bolivia. 2022: Iraq, Ukraine. 2021: Zambia, El Salvador. 2020: Uruguay, Lebanon. 2019: Ukraine, Lebanon. 2018: Mozambique, Zambia. 2017: Belize, Bolivia. 2016: Ecuador, Belize. 2015: Ukraine, Zambia. Performance data shown represents past performance and does not predict or guarantee future results.

*2022 Excludes Russia which exited the benchmark. All periods prior to 2024 exclude Venezuela

BROADENING THE OPPORTUNITY SET

The ability to express country conviction through corporates as well as sovereigns gives investors additional levers for generating strong risk-adjusted returns compared with a sovereign-only portfolio (which restricts the intra-country lever largely to curve positioning). Furthermore, broadening the opportunity set to include corporate bonds provides greater scope for diversification and managing duration and quality risks.

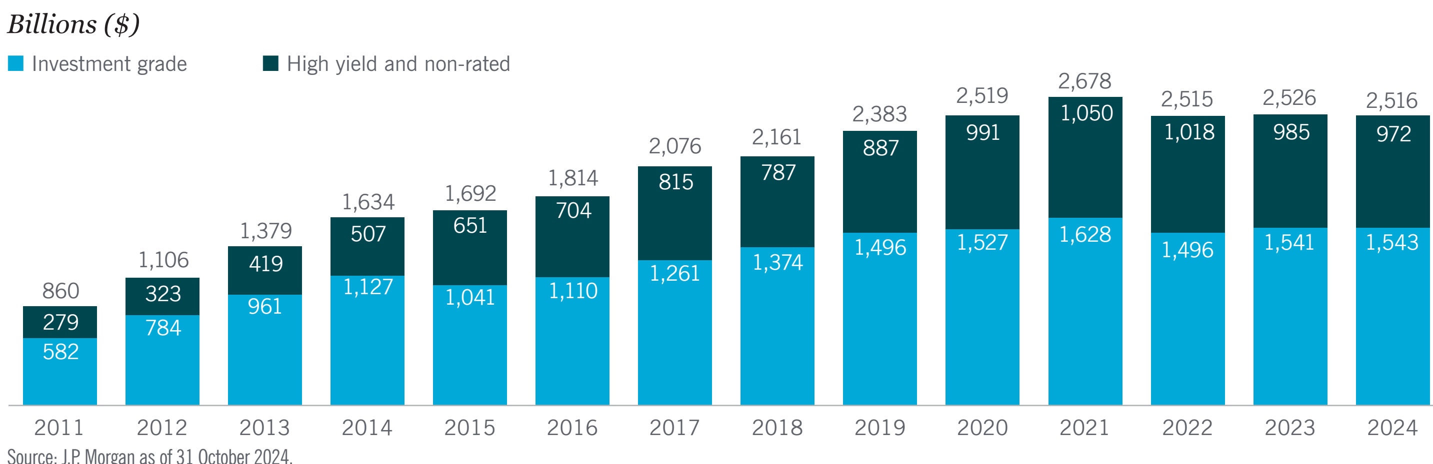
As figure 2 shows, after crossing the $1tn landmark in 2012, emerging markets corporate external bond stock surpassed $2tn in 2017, reaching $2.5tn by end 2024. This is significantly larger than emerging markets external sovereign debt market ($1.5tn) and the U.S. high yield bond market ($1.5tn).[1]

An additional feature of the corporate market that is significantly less common in sovereign debt markets is the prevalence of debut quasi-sovereign and corporate issuers. Debut corporate issuers are coming to the market and issuing debt (see fig. 3), which is expanding the opportunity set and offering diversification and yield. This trend is expected to continue. In 2025, EM corporates are anticipated to issue $383 billion — nearly twice the amount of hard currency sovereign issues.[2]

Investors taking a sovereign-only focus guided by the widely used JPMorgan Emerging Market Bond Index (EMBI) are already likely to have some corporate exposure, although it may be classified under a different label. The EMBI has a significant proportion of corporate debt through the nearly 20% allocation to quasi-sovereigns, which is defined as being fully owned by the national government. It covers bonds valued at around $339 billion from 27 different countries (see fig. 4), and only a small portion (1% of quasi-sovereigns) are guaranteed.

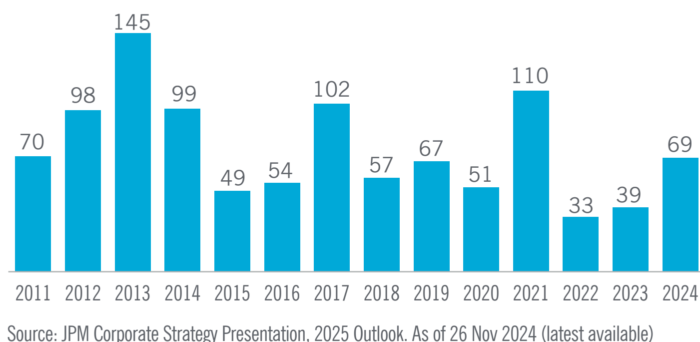
Figure 2: The growth of opportunities in EM corporate hard currency

Billions ($)



Source: J.P. Morgan as of 31 October 2024.

Figure 3: Debut EM corporates issuers



Source: JPM Corporate Strategy Presentation, 2025 Outlook. As of 26 Nov 2024 (latest available)

Figure 4: Investment characteristics of EM hard currency debt

Sector	Market cap $ (using broad index)	Investment grade %	Avg. rating	Duration (years)	No. of countries	No. of issuers
Sovereign (EMBI)	$1.268tn	34.8%	BB+	6.65	72	79
Quasi (EMBI)	$0.291tn	71.2%	BBB+	5.99	27	83
Corporates (CEMBI)	$1.166tn	57.9%	BBB-	4.13	63	748

Source: JPM as of 31 Dec 2024

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While JPMorgan uses a strict 100%-owned rule to classify an issuer as a quasi-sovereign, there are a vast number of issuers that fall somewhere between the private sector and partially owned sovereigns. Strictly limiting an investment universe to EMBI-eligible sovereigns and quasi-sovereigns removes an important lever for generating risk-adjusted returns.

A further consideration is when quasi-sovereign entities issue public equity, making them ineligible for the larger EMBI index. This can result in unnecessary or disadvantageous portfolio turnover. In May 2019, for example, oil producer Saudi Aramco was 100% state-owned when it launched its initial hard currency debt issuance, making it eligible for the EMBI. Sovereign investors already knew that the bulk of Saudi's economic strength is derived from ample low-cost, high-quality fossil fuel reserves, exclusively managed by Aramco, and its dominance within OPEC and global oil markets. However, after an IPO in January 2020, 3% of the company's equity was listed on exchanges, and the debt was subsequently moved to the JPMorgan Corporate Emerging Markets Index (CEMBI).

Including corporates provides investors with more and potentially higher return options that can either complement or substitute sovereign exposure.

This illustrates the somewhat blurred lines between the level of government support and ownership, underpinning why investors should cast a wider net in the hard currency universe. Other examples of quasi sovereigns that have moved from the EMBI to the CEMBI are Indian Railway Finance Corporation, Kazakhstan's KazMunayGas and Abu Dhabi National Energy Company. This overlap also demonstrates the importance of understanding both the corporate and sovereign angles when it comes to debt issuance.

By rethinking emerging market hard currency to include sovereign, corporates and partially owned quasi-sovereigns, investors have many more ways to express investment conviction and manage portfolios. Following a strict index inclusion rule, may lead to investors missing out on some of the more dynamic or strategically important economic entities within emerging economies.

ADDING CORPORATES, MANAGING RISK

Corporates can play a significant role in managing a hard currency portfolio's downside risk and active risk, which allows investors to capture alpha more efficiently.

Sovereign-only portfolios will generally have to take more active country risk to outperform the benchmark given the wide dispersion in returns previously mentioned. A narrow opportunity set limited to sovereigns could lead to underweight positions for countries with below-average yields but are fundamentally sound. A broader opportunity set that includes corporates provides investors with more and potentially higher return options that can either complement or substitute sovereign exposure.

Chile, for example, has one of the soundest credit fundamentals in Latin America and boasts one of the more stable credit ratings among emerging markets with an A2, A and A- credit rating profile from Moody's, S&P and Fitch, respectively. Thanks to Chile's solid fundamental backdrop and improved institutional development, its corporate and quasi-sovereign market has flourished, offering a robust and diverse set of issuers across a number of sectors and credit rating profiles. By looking beyond the sovereign debt, investors can tap into the stability that Chile's macroeconomic environment presents while also being appropriately compensated with compelling yield and spread opportunities.

While Chile has been relatively stable, Turkiye, on the other hand, has experienced many different economic regimes. It has recently returned to orthodoxy, but some of its previous, less conventional economic practices have made investors wary, particularly those focused on sovereign and quasi-sovereign bonds. But as figure 5 shows, Turkiye offers a wide array of

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Figure 5: Turkiye investment continuum reflects country complexity premium requiring specialization

	Turkiye Government	Turkish Wealth Fund	Export Credit Bank of Turkiye	Turkiye Vakiflar Bankasi	Ford Otosan	Ulker Biskuvi	TurkCell Iletisim Hizmetleri	Limak Cemento	Eregli Demir ve Celik Fabrikalari
Issuer description	Sovereign government of Turkiye.	Invests in financial services, transportation and logistics, energy, technology, telecom, agriculture and real estate. Serving domestic customers.	Offers export loans, receivable insurance and derivative products while serving a domestic customer base.	Offers deposits as well as corporate retail and investment banking services. Lending services and asset management services.	Manufactures and distributes Ford model trucks, autos, buses, trailers and pickups. Leading manufacturer/ exporter of commercial vehicles in Turkey.	Produces biscuits, cakes, wafers, chocolate. Exports throughout Turkiye, Europe, North America, Africa and Asia.	Converged communication and technology services with regional assets and global services.	Cement and cement-based product manufacturer with distribution throughout Turkiye.	Manufactures steel used in automotive, pipe, home appliance and machinery. Markets in Europe, US, Japan.
Sector	Sovereign	Quasi-Sovereign	Quasi-Sovereign	Partial Quasi-Sovereign	Corporate	Corporate	Corporate	Corporate	Corporate
Industry	Government	Govt-related	Govt-related (Bank)	Govt-related (Bank)	Auto manufacturing	Food products	Wireless	Building materials	Metals and mining
In EMBI	Yes	Yes	Yes	No	No	No	No	No	No
In CEMBI	No	No	No	Yes	Yes	Yes	Yes	Yes	Yes
Quality	BB-	BB-	BB-	B+	BB	BB	BB-	B	B+

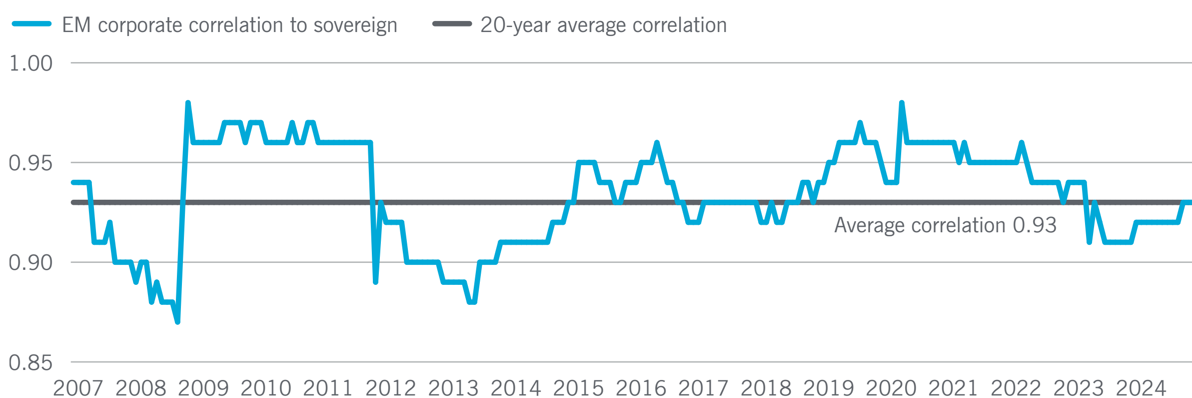
Source: Nuveen, Bloomberg

corporate issues that are additional levers for investors depending on the current economic backdrop. Exporters, for example, can potentially benefit from a depreciating currency through lower input costs at home and higher prices for the products they export (when adjusted for the home currency). Many Turkish corporates and private banks successfully navigated past cycles of economic turmoil, and this should continue to give investors confidence when policy positions change. The ability to invest in these types of issuers are important levers to help manage country exposure and the portfolio's risk profile. Many corporates, but not all, provide additional yield and income compared with their external sovereign bonds, which can further enhance diversification and returns for investors.

As the political and economic environment changes over time so can the instruments investors use to express their country views – by dialing up or down sovereign and corporate exposure and rethinking the issuers within corporate allocations.

Correlation data supports the thesis that adding corporate bonds does not necessarily introduce more active risk, as measured by tracking error.

Figure 6: Correlation between EM corporates and EM sovereigns



EM corporates and EM sovereigns represented by JPMorgan CEMBI Diversified and JPMorgan EMBI Global Diversified, respectively. Source: Morningstar Direct, JPMorgan. Rolling 3-year correlations. Source: Morningstar Direct, JPMorgan. Rolling 3-year correlations.

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Figure 7: Ten-year tracking errors

eVestment categories and benchmarks		10-year tracking error using manager preferred benchmark
Global Emerging Markets Fixed Income, Hard currency	Median	2.01
	Bottom quartile (highest)	2.87
	Top quartile (lowest)	1.63
Hypothetical 60% sovereign/40% corporate portfolio		1.47
JPM CEMBI Diversified		3.68
JPM EMBI Global Diversified		0.00

Source: eVestment, Nuveen. Data to 31 Dec 2024. Hypothetical portfolio comprises 60% JPM EMBI-GD and 40% JPM CEMBI-D. The hypothetical example is shown for illustrative purposes only and does not represent the performance of any specific investment. **Past performance does not guarantee of future results.**

This is evident in the high correlation between the EMBI and CEMBI over time. As figure 6 shows, correlations between emerging markets corporate bonds and sovereign debt are high, at 0.93 over the last 20 years. Over this period, which includes the global financial crisis in 2008, the euro sovereign debt crisis in 2011, the 2020 pandemic and outbreak of war in Ukraine in 2022, correlations remained consistently high in the range of 0.87 and 0.98.

Similarly, a hypothetical portfolio that combines 40% corporate exposure and 60% sovereign exhibits a 10-year tracking error of just 1.47 against the JPM EMBI GD (fig. 7). That same 40/60 hypothetical portfolio would rank in the lowest quintile for tracking error among the eVestment Global Emerging Markets Hard Currency category, and its Sharpe ratio also improves significantly over a longer time period. For a ten-year period, the ratio was 0.21, a 40% increase on the JPM EMBI GD's figure of 0.15.[3]

A further consideration for investors is concentration risk. A portfolio that can invest in both corporates and sovereigns should also, in theory, be able to minimize risks compared with separately managed sovereign and corporate portfolios. For sovereign-focused portfolios, security selection decisions generally consist of curve positioning and, at best, a handful of quasi-sovereigns that may offer a modest spread pickup to their sovereign counterpart. The most substantial lever to drive returns is relative country weights versus the benchmark, i.e. country allocation.

FRAMING THE OPPORTUNITY SET

Country cohort classification

Steady
- Sound economic framework
- Strong buffers in place
- Manageable financing needs

Reformer
- Improving outlook
- Addressing key structural reforms
- Potential for improved GDP and investment climate

Laggard
- Deteriorating or uncertain outlook
- In need of structural reform
- Concerns regarding policy coherence

Frontier
- Up-and-coming markets
- Good potential growth stories
- Lower correlation

Crisis-laden
- Significant event risk
- Political, economic, structural instability
- Prognosis remains poor/highly uncertain

When faced with such a broad universe and diverse range of country dynamics, classifying emerging markets with similar risk characteristics can help frame investment decisions. This is particularly appropriate in our view when extending into quasi-sovereign risk or the corporate opportunity set.

When analyzing countries, Nuveen Emerging Markets Debt team evaluates a country's legal framework, government system, infrastructure and regulatory policies to classify the country as steady, reformer, laggard, frontier or crisis laden. This cohort classification, defined opposite, signals a view on the state of a country, and is used alongside technicals, valuations and security selection to help determine country exposure and how to best express country-level conviction through the eligible opportunity set.

It is worth noting that the classification is as much a qualitative evaluation as quantitative analysis. It is not static and can change depending on developments in a country. The framework allows for dynamic groupings of countries on similar trajectories that can cut across geographic regions, income levels and credit ratings, allowing for in-depth insight.

While this is a valuable lever, an over-emphasis on country weights can lead to substantial periods of underperformance even if only a few of those active positions go wrong, particularly among lower rated credits where default risk increases. Examples of this are portfolios that assumed a high recovery for Venezuela's defaulted debt in 2018 before sanctions were applied, portfolios that were bullish on Argentina ahead of President Macri's primary loss in 2019, and portfolios that underestimated the scale of the Russian invasion of Ukraine in early 2022 and the swift, coordinated Western response to isolate Russia from global markets. Those portfolios would have suffered significant drawdowns that could take many quarters or even years to recover from.

Separately, the aggregate risk profile for the two individual corporate and sovereign portfolios may be too concentrated in one particular country if the managers are taking on the same or similar active risks and are unaware of one another's positioning. This could present problems given the asset class's exposure to country-specific idiosyncratic risks as detailed above. It also places an extra burden on investors who may then need additional resources to oversee two separate portfolios and managers in the context of their wider investment portfolio.

Figure 8: EMBI issuer profile

	No. countries	Issuers	% EMBI
Steady	23	70	53.2
Reformer	13	29	22.2
Laggard	7	27	8.0
Frontier	22	25	12.9
Crisis-laden	7	11	3.7

Figure 9: CEMBI issuer profile

	No. countries	Issuers	% CEMBI
Steady	24	231	57.5
Reformer	9	70	16.1
Laggard	6	132	22.0
Frontier	7	11	4.1
Crisis-laden	1	2	0.3

Source: JPMorgan, Nuveen, as of 31 Dec 2024

ANALYZING THE OPPORTUNITY SET

Analyzing benchmark characteristics helps provide context to why investing in a country's corporate bonds can create compelling opportunity beyond sovereign and quasi-sovereigns.

Overlaying Nuveen's Emerging Markets Debt team's country cohort classification (see call-out box *Framing the opportunity set*) with the EMBI and CEMBI reveals the depth and breadth of opportunity. The EMBI steady bucket is 23 countries for a total of 70 issuers including the quasi-sovereigns (fig. 8). Extending the universe to corporates expands that opportunity set by one additional country and to over 300 issuers, allowing for a much more robust investible universe (fig. 9).

Similarly, sovereign reformers reflect only 13 countries and 29 issuers, while the corporate set is nine countries and 70 issuers. These two categories reflect over three-quarters of the CEMBI universe and provide ample opportunities for bonds in countries where the sovereign debt is typically much lower-yielding and less attractive relative than the broader EM opportunity set. Experienced investors in emerging economies understand the importance of diversification and often having multi-factoral risks can benefit portfolio returns.

DEEPER INVESTMENT INSIGHTS

The ability to use both sovereign and corporate bonds in the same emerging markets debt portfolio not only gives investors more tools with which to express investment conviction and help manage risks, it can also deepen the insights informing investment decisions.

A country's macroeconomic conditions — including levels of economic activity and inflation, and monetary and fiscal policy — set the tone for the business environment, while jurisdiction is paramount. A dedicated EM corporate team that is aware of how economic sectors and large companies are operating and competing in a global context can provide important insights that a purely sovereign approach may overlook. Bringing

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together insights at the sovereign and corporate level creates the potential for a competitive edge with a holistic approach to EM investing that has fewer blind spots.

Recent events in Panama are a good example of the synergies between corporate and sovereign analysis. In early 2024, Panama's credit trajectory was showing signs of deterioration. The government's closure of a mine operated by First Quantum added to those concerns, given the potential negative economic growth and fiscal implications. Complementing corporate analysis with sovereign analysis can refine and enhance investment views, such as the likelihood of the mine reopening and potential arbitration. As pressure on the sovereign increased and spreads widened substantially to reflect downgrade risk, Panama announced it would try to pivot to fund more in the local market, which was a significant shift from its historical reliance on the eurobond market. Corporate analysts could then assess how much capacity the local banking sector had and determine the viability of the sovereign's plans, leading to a more refined sovereign analysis.

This highlights how understanding developments in the sovereign informs the outlook for a sector and, with that, specific issuers and credits.

Similarly, in-depth knowledge of the local banking sector can shape sovereign debt views. Signs of stress in the banking system, such as upticks in non-performing loans, could be early indicators of macroeconomic problems. It can also indicate whether macroeconomic policies are working. If, for example, a central bank is tightening, but industry analysis shows that credit is growing elsewhere in the financial sector, this would be an important datapoint on the efficacy of policy in the real economy and likely inform views on the sovereign.

The concept of a sovereign ceiling has a critical role when analyzing corporates. It is rare for a corporate to have a higher rating than the sovereign in which it is domiciled, which is known as piercing the sovereign ceiling. Even the best-run corporations are subject to downside risk if they are domiciled in a crisis-stricken country. And conversely, negative company-specific dynamics will likely take precedence, regardless of how well a country's economy is performing. This is why a holistic view of corporates, which encompasses not only country-level macro views but also company-specific analysis, is critical.

CONCLUSION

Rethinking emerging markets hard currency debt exposure opens up opportunities for investors. A portfolio that can invest in both corporate and sovereign issues can diversify active country exposures across the entire portfolio. It allows for the best expression of specific country risk through the selection of the underlying sovereign and/or corporate issues, while providing additional tools to manage upside and downside risks.

One portfolio with the ability to invest in both has more levers with which to achieve investment goals compared with separate sovereign and corporate portfolios. This more diversified portfolio can tap into a much broader opportunity set that captures the growth and development of emerging markets, with access to levers that can limit excessive market or default risk. With more sector options, investors can dynamically respond to changing fundamentals and relative value through adjustments to duration, credit and market risk. Such an investment approach, which encompasses both corporates and sovereigns in a hard currency portfolio, can enhance investment insights, better manage risk, and provide the potential to improve risk-adjusted returns over a market cycle.

For more information, please visit nuveen.com.

Endnotes

1 Source: JPMorgan, as at 31 Dec 2024.

2 Source: JPMorgan, as at 29 Apr 2025.

3 3 Source: Source: eVestment, Nuveen. Data to 31 Dec 2024. Hypothetical portfolio comprises 60% JPM EMBI-GD and 40% JPM CEMBI-D.

Sources

Gross Domestic Product: U.S. Department of Commerce; **Treasury Yields and Ratios:** Bloomberg (subscription required); **Municipal Bond Yields:** Municipal Market Data; **ICI Fund Flows:** http://www.ici.org/research/stats; **Municipal Issuance:** Seibert Research; **Defaults:** Municipals Weekly, Bank of America/Merrill Lynch Research, July 7, 2017; **State Revenues:** The Nelson A. Rockefeller Institute of Government, State Revenue Report, June 2017; **State Budget Reserves:** Pew Charitable Trust. **Global Growth:** International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD); **Standard & Poor's and Investortools:** http://www.invtools.com/; **Flow of Funds, The Federal Reserve Board:** http://www.federalreserve.gov/releases/Z1/Current/z1.pdf; **Payroll Data:** Bureau of Labor Statistics; **Bond Ratings:** Standard & Poor's, Moody's, Fitch; **New Money Project Financing:** The Bond Buyer; **Consumer Price Index:** http://www.bls.gov/cpi/ http://research.stlouisfed.org/fred2/series/CPIAUCNS; State of Connecticut Fiscal Year 2017 Comprehensive Annual Financial Report; State of Connecticut Annual Information Statement; State of California Official Statement dated March 6, 2018; Moody's Analytics, California, April 2, 2018; BLS.gov; State of California, Comprehensive Annual Financial Report, FYE June 30, 2017; New Fiscal Plan for Puerto Rico, Restoring Growth and Prosperity, April 2018; Puerto Rico's Financial Oversight and Management Board hearing on April 19, 2018; The Bond Buyer, Governor's opposition to Puerto Rico fiscal plan could end up in court, April 20, 2018

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One **basis point** equals .01%, or 100 basis points equal 1%. The **Municipal Market Data AAA scales** are compilations of the previous day's actual trades for AAA-rated insured bonds. The **personal consumption expenditures (PCE) deflator** indicates the average increase in prices for all domestic personal consumption.

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