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Third quarter 2025 outlook

Bond markets lean into income as growth moderates

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As global trade tensions persist and economic growth moderates, fixed income markets face both challenges and opportunities. While tariff-related uncertainty continues to weigh on growth prospects, historically attractive yield levels across fixed income sectors offer compelling entry points for investors. The U.S. Federal Reserve and other global central banks are poised to implement rate cuts, creating a supportive environment for fixed income returns despite ongoing market volatility.

KEY TAKEAWAYS:

- Global growth is slowing due to trade tensions and tariff uncertainty, though a U.S. recession remains unlikely with resilient labor markets and healthy balance sheets.
- Central banks globally are shifting toward monetary easing, with the Fed expected to deliver two cuts by year-end 2025.
- High starting yields provide attractive income potential, with higher-quality spread sectors offering better resilience in a slowing economy.

TARIFFS WILL LIKELY SLOW GLOBAL GROWTH

Global trade tensions remain at the forefront of market concerns, driven by the evolving tariff landscape. While current tariff levels have moderated from President Trump's initial announcement, shifts in negotiations and types of goods affected have created uncertainty for businesses and consumers alike. This unease appears to be weighing as heavily on global growth prospects as the direct economic impact of the tariffs themselves. Continued geopolitical tensions in the Middle East only compound the issue.

U.S. economic activity contracted in the first quarter, with GDP declining -0.5% annualized quarter-over-quarter. This headline weakness primarily reflects distortions in trade patterns. Businesses and consumers accelerated import orders to get ahead of impending tariffs, resulting in a significant negative contribution from net exports. While this trade-related decline is expected to normalize in subsequent quarters, broader economic headwinds are emerging. As tariff effects ripple through the economy, key growth components including consumer spending, business investment and inventory levels are all likely to face mounting pressure.

Our revised U.S. GDP growth forecast stands at 1.0% for the year. This reflects a modest uptick from our previous estimate due to softening tariff rhetoric during the quarter, yet remains well below pre-tariff projections. While the tariff outlook has improved, the anticipated implementation of a broad-based 10% tariff is expected to create significant economic headwinds. This pattern of downward revision extends globally, with growth forecasts being trimmed across major economies (Figure 1). The eurozone and China are not immune to these pressures, with growth rates expected to moderate to 0.8% and 4.0%, respectively. However, these projections carry substantial uncertainty, as shifts in trade policy could materially impact growth trajectories in either direction, underscoring the fluid nature of the current economic environment.

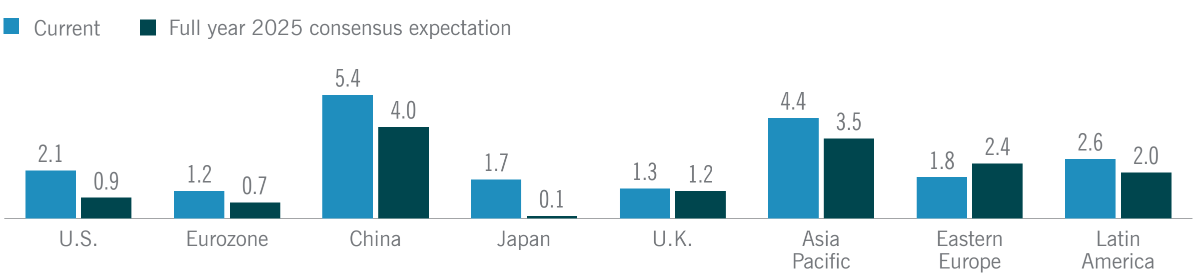
The U.S. labor market is showing signs of slowing as jobless claims have moved higher. Inflation dynamics present a nuanced picture, with only modest overall increases, partly attributed to temporary price pressures from pre-tariff inventory building. Although sticky inflation components, particularly housing costs, have retreated to post-pandemic lows, we anticipate an uptick in inflationary pressures driven by tariff implementation. Our revised forecast projects core inflation to reach approximately 3.0% this year. This is a more moderate increase than previously expected, reflecting the recent easing in tariff tensions, though still notably higher than our pre-tariff baseline.

A U.S. RECESSION REMAINS UNLIKELY

Despite the cooling economy, our analysis suggests that the probability of a U.S. recession this year remains low. While our forecasting models have adjusted to reflect evolving tariff developments, the current recession risk assessment has returned to levels observed prior to the early April tariff announcements (Figure 2).

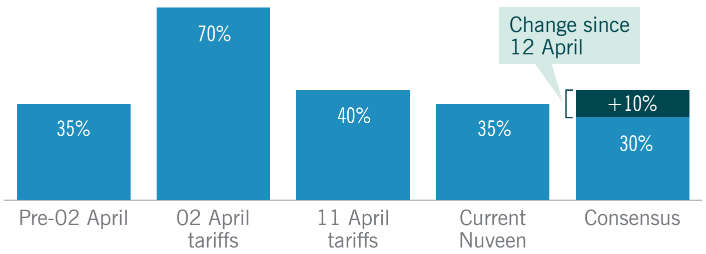
Figure 1: Global growth is expected to broadly decelerate

Growth rate (%)



Data source: Bloomberg, L.P., Bureau of Economic Analysis, Economic and Social Research Institute, 16 Jun 2025. Current represents the year-over-year growth rate as of 16 Jun 2025.

Figure 2: Probability of a recession has evolved amid tariff noise



Data source: Bloomberg, L.P., Nuveen, 16 Jun 2025.

CENTRAL BANKS ARE EXPECTED TO REDUCE POLICY RATES

The U.S. Federal Reserve remains on pause, while signaling potential rate cuts later this year. However, the continued uncertainty around U.S. macroeconomic and fiscal policy has complicated the Fed's path forward. The tariff situation presents the Fed with countervailing forces: While near-term inflation risks could delay monetary easing, the broader economic slowdown these tariffs may trigger is likely to ultimately overshadow inflation concerns and prompt Fed action.

The Fed is likely to maintain its watchful stance until the full impact of policy and tariff changes materializes in economic data before initiating further easing measures. Our baseline forecast anticipates two cuts of 25 basis points (bps) each in the latter half of the year, followed by a few more cuts in 2026, depending on inflation and growth trajectories. This easing cycle would bring the fed funds rate to a target range of 3.75%-4.00% by year-end.

Around the globe, other central banks have already begun to reduce rates. For example, the European Central Bank may be nearing the end of its rate cutting cycle with its eighth 25 bps cut in June. Central banks in Mexico and Poland cut rates by 50 bps in May, while Australia, New Zealand, Indonesia, South Korea, South Africa and Czechia cut rates by 25 bps.

The European Central Bank is expected to deliver one additional rate cut this year, though anticipated fiscal stimulus measures have diminished the urgency for aggressive monetary intervention. Meanwhile, Chinese authorities are likely to maintain their fiscal support initiatives, while keeping monetary policy relatively stable.

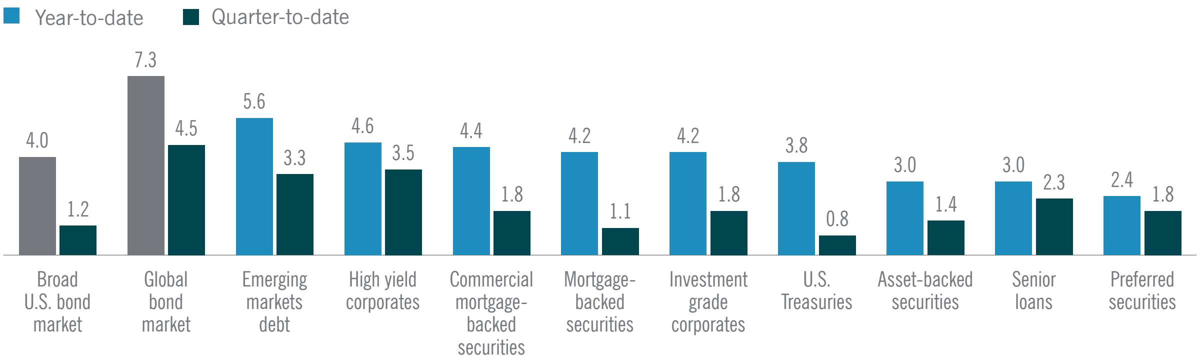
RATES ARE LIKELY TO DECLINE MODESTLY

Interest rate dynamics have shown significant volatility, reflecting both Fed policy at the short end and broader growth and inflation expectations at longer maturities. The first quarter saw rates decline across the yield curve, benefiting fixed income returns broadly.

However, the yield curve steepened during the second quarter, as longer-term rates increased, largely in response to anticipated growth in the U.S. fiscal deficit due to the tax and spending legislation under congressional consideration. This rate movement suppressed quarterly returns in higher-quality, rate-sensitive sectors, including U.S. Treasuries, mortgage-backed securities and investment grade corporates. Higher yielding segments demonstrated greater resilience. Both quarter- and year-to-date returns remain positive across major fixed income sectors.

Our forward outlook anticipates a decline in shorter-term rates as the Fed resumes its easing cycle later this year. We project the 10-year U.S. Treasury yield to settle at 4.25% by year-end 2025, though heightened policy uncertainty has widened our forecast range. The anticipated economic deceleration typically exerts downward pressure on longer-term rates, potentially benefiting bond prices through the inverse relationship between yields and valuations. This dynamic historically positions fixed income as a more resilient asset class during economic downturns compared to equities.

Figure 3: Bond market total returns remain positive



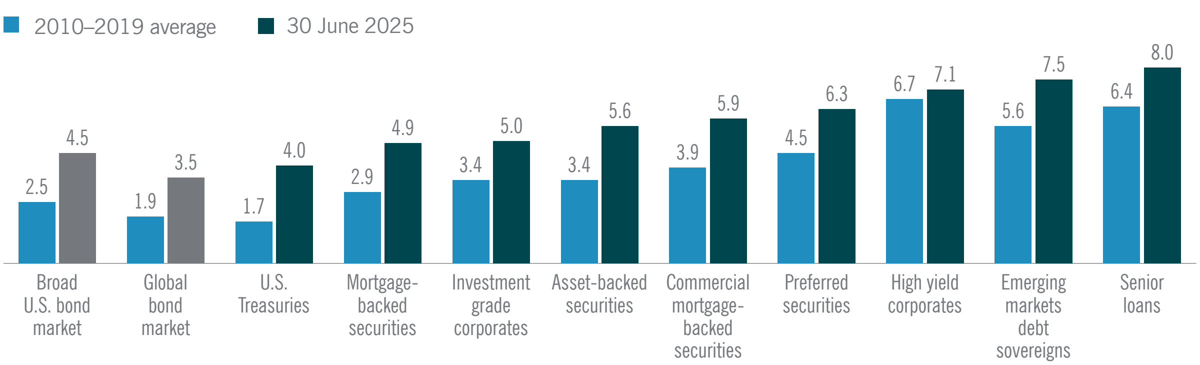
Data source: Morningstar Direct, 30 Jun 2025. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: broad U.S. bond market:** Bloomberg U.S. Aggregate Index; **global bond market:** Bloomberg Global Aggregate Index; **emerging markets debt:** JPM EMBI Global Diversified; **commercial mortgage-backed securities (CMBS):** ICE BofA AA-BBB U.S. Fixed Rate CMBS; **asset-backed securities (ABS):** ICE BofA AA-BBB US Fixed Rate ABS; **high yield corporates:** Bloomberg U.S. Corporate High Yield 2% Issuer Capped Index; **mortgage-backed securities (MBS):** Bloomberg U.S. Mortgage-Backed Securities Index; **investment grade corporates:** Bloomberg U.S. Corporate Investment Grade Index; **U.S. Treasuries:** Bloomberg U.S. Treasury Index; **senior loans:** S&P UBS Leveraged Loan Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index.

HIGH STARTING YIELDS HELP BUILD TOTAL RETURN

The current environment of historically elevated yields offers compelling income opportunities, presenting investors with what we consider the most attractive fixed income entry point in decades. This timing is particularly significant given that income has historically constituted the predominant component of fixed income total returns. As the global economy moderates, these substantial starting yields should continue to drive steady returns. While cash yields will likely decline with anticipated Fed rate cuts, strategic positioning across fixed income sectors can help maintain attractive portfolio income levels.

Figure 4: Fixed income offers generous, historically high yields

Yield-to-worst (%)



Data source: Bloomberg, L.P., BofA, Standard & Poor's, 30 Jun 2025. **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; **global bond market:** Bloomberg Global Aggregate Index; **U.S. Treasuries:** Bloomberg U.S. Treasury Index; **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 US Fixed Rate ABS; **commercial mortgage-backed securities (CMBS):** ICE BofA AA-BBB U.S. Fixed Rate CMBS; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **high yield corporates:** Bloomberg U.S. Corporate High Yield 2% Issuer Capped Index; **emerging markets debt:** JPM EMBI Global Diversified; **senior loans:** S&P UBS Leveraged Loan Index.

WE FAVOR HIGHER-QUALITY ISSUES IN SPREAD SECTORS

Given the moderating economic environment, we continue to favor higher-yielding non-Treasury spread sectors, with an emphasis on higher-quality issues that historically demonstrate greater resilience during economic slowdowns. Several compelling opportunities have emerged across the fixed income landscape:

- **Securitized sectors** – including residential-mortgage backed, commercial mortgage-backed and asset-backed securities – may offer attractive valuations compared to other investment grade sectors, as well as lower exposure to tariffs. We continue to use our dedicated securitized research teams to uncover attractive opportunities in securities with higher yields and wider credit spreads that reside outside of the traditional Bloomberg Aggregate Index universe.
- **Preferred securities** offer attractive, tax-advantaged yields. Banks and insurance companies (the largest issuers of preferreds) continue to exhibit healthy underlying fundamentals and are less directly affected by the tariffs. The asset class has naturally lower interest rate sensitivity, which can help in a more volatile rate environment.
- **Collateralized loan obligations (CLOs)** present attractive yield opportunities that should maintain their substantial premium over cash rates, even as the Fed implements rate cuts. Their floating-rate structure means minimal interest rate sensitivity, offering natural protection against rate volatility in portfolio returns.
- **Emerging markets debt** currently offers attractive starting yields relative to similarly rated U.S. credit markets, while fundamental indicators suggest improving resilience. Through rigorous bottom-up analysis, we identify opportunities among issuers with robust credit profiles. The asset class's fundamental backdrop remains constructive, projected defaults are low and many countries have rebuilt their economic buffers. Emerging markets corporates also tend to have less leverage than developed markets issuers.

ACTIVE MANAGEMENT DRIVES SECTOR ALLOCATION

Multisector fixed income strategies offer an efficient vehicle for accessing our preferred sectors through professional active management. These portfolios provide dynamic allocation across fixed income sectors, with managers adjusting positioning in response to shifting economic conditions and market opportunities.

Multisector bond funds. Broadly diversified, multi-sector bonds across investment grade and high yield securities offering potential for high income and reduced interest rate sensitivity.

Core plus funds. Traditional U.S. fixed income with up to 30% in higher yielding plus bond sectors, which provide diversification and potential for additional return.

Core impact funds. Core U.S. fixed income focused on impact and ESG leadership with goal of providing favorable returns versus the broad bond market.

OUTLOOK

Market fluctuations may create strategic openings

While we've revised our U.S. economic growth forecast upward to 1.0% this year reflecting improved tariff rhetoric, this projection remains below pre-tariff disruption levels. We expect core inflation to reach approximately 3.0%, a more moderate increase than previously anticipated. These forecasts, however, remain highly dependent on the evolving tariff landscape, with potential for significant variation in growth outcomes depending on whether tariffs ease or intensify in coming months.

The Federal Reserve is likely to continue its easing cycle but at a decelerated pace. We anticipate two additional 25 bps reductions this year, bringing the policy rate to roughly 3.75%–4.00%. Similarly, the ECB is expected to implement one more rate cut before year-end. Fiscal stimulus measures in both economies will likely reduce pressure for further central bank rate cuts in 2026. Meanwhile, Chinese policymakers are expected to maintain fiscal support while avoiding substantial monetary easing.

In our investment approach, we maintain a modest preference for spread sectors and credit risk with an emphasis on higher-quality assets within each class. Credit spread volatility will likely persist in the coming months, potentially creating more favorable entry points for risk exposure. We project the 10-year Treasury yield will settle around 4.25% by year-end, reflecting decreased growth concerns alongside heightened risks of expanding fiscal deficits.

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

Endnotes

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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