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EQuilibrium

From stability to agility: nine implications for a new investment landscape

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In the post-great moderation world, institutional investors are facing a radically new environment. The underlying assumptions that have driven many investment strategies over the last 40 years must be reexamined. This paper explores nine implications that can help empower investors with the agility needed to navigate the uncertainties of the new economic environment.

HIGHLIGHTS

- Previously effective investment strategies may have limited utility in the new environment. A more rigorous approach to diversification and risk management is now essential.
- A considerably more dynamic approach to asset allocation is paramount. Country-specific risk profiles are changing and global investors should avoid taking on more risk than they need.
- Real assets should have a more prominent role in diversified portfolios. They are less susceptible to inflation, participate in secular growth trends and offer idiosyncratic risk exposure.

Nine considerations for investing in the new regime

Against a new macroeconomic backdrop, institutional investors are reassessing many of the well-established assumptions and practices that allowed their portfolios to flourish during the great moderation.

Dynamics within countries have shifted alongside an evolving interplay between fiscal and monetary policy. Dynamics between countries have also evolved as many prioritize national security and self-reliance over collaborative global economic growth. Investors are now confronted with major questions, such as the persistence of long-term inflation, whether risk-free assets exist, where to source diversification, and how to best harness expected returns across assets.

Highlighted in Nuveen's 2024 *EQuilibrium* survey, most institutional investors agree we have entered a period of elevated macroeconomic and geopolitical uncertainty. In response, they are exploring a variety of avenues to build more resilient portfolios and capitalize on new opportunities in the post-pandemic world.

While many institutional investors have coalesced around the idea that the new landscape will require a greater emphasis on risk management and a higher degree of strategic and tactical flexibility, there is no consensus on the asset classes and diversification strategies that will succeed in the new regime.

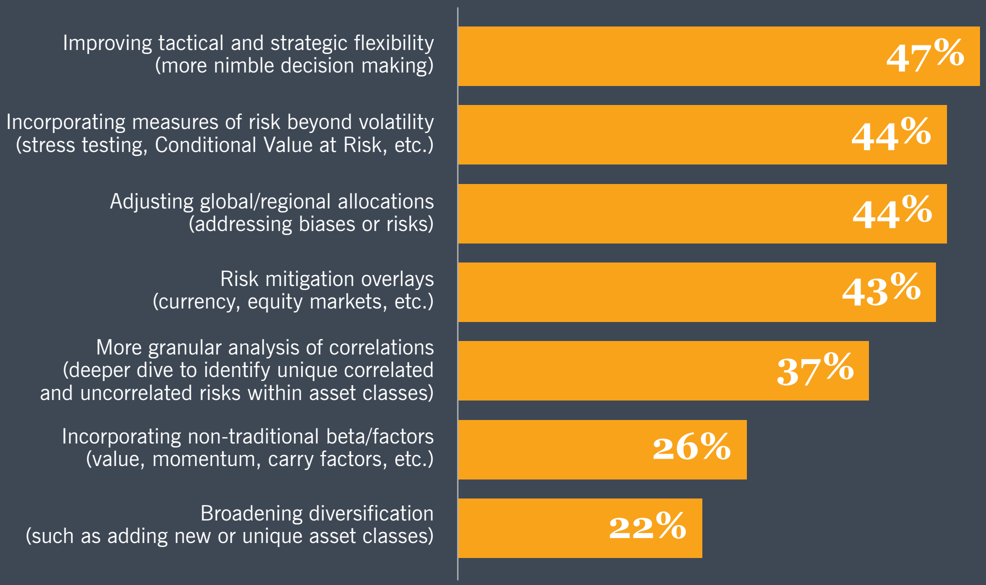
In this paper, we identify nine key themes investors should consider as they explore new ways to enhance the resilience and adaptability of their portfolios for a more uncertain investment landscape.

How investors are addressing resiliency in portfolios

Nearly half of institutional investors surveyed are focused on improving their flexibility and adjusting their regional allocations, but most are overlooking key strategies that we believe will lead to greater portfolio resilience, including broadening diversification and implementing a more granular analysis of correlations.

FIGURE 1: **In what ways are you addressing resiliency in your portfolio?**

Select all that apply, 800 respondents



Source: Nuveen, 2024 *EQuilibrium* Survey

DEFINING THE GREAT MODERATION

Period from the early 1980s through 2020 marked by the following characteristics in many developed economies:

- **Declining short- and long-term interest rates**
- **Disinflation**
- **Stable economic growth**
- **Reduced business cycle volatility**
- **Increasing global trade**
- **Tighter dispersion around economic forecasts**

1

Reframe resiliency after decades of distortion

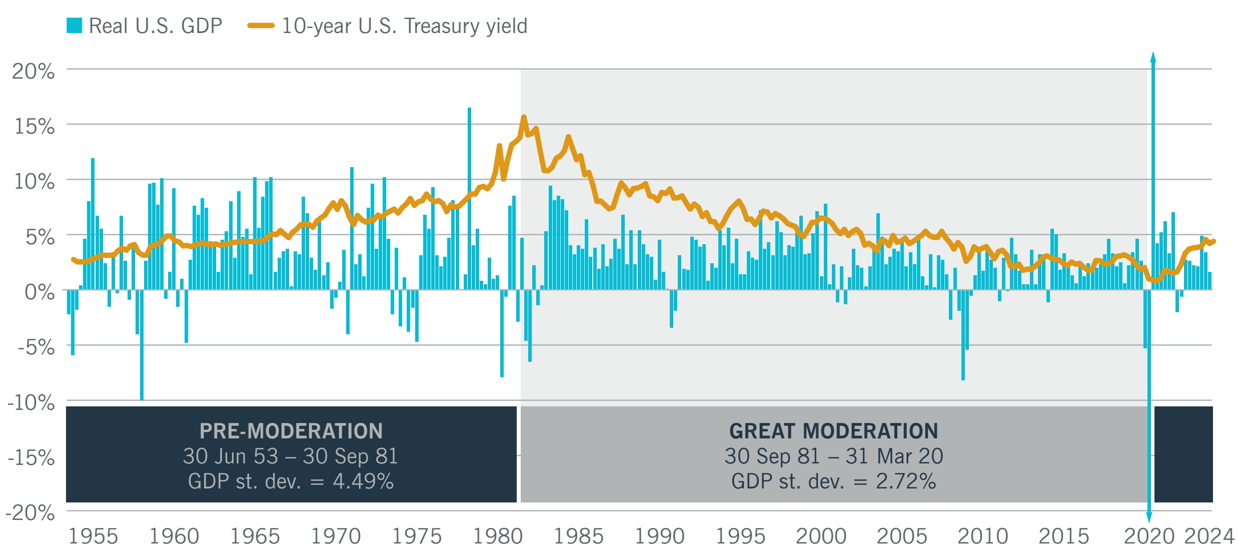
Fueled by well-defined and independent monetary policy, expanding globalization and an extended period of relative geopolitical stability, the great moderation was defined by suppressed macroeconomic uncertainty, low and stable inflation, a long-term decline in interest rates and reduced business cycle volatility. This backdrop, particularly in the post-global financial crisis (GFC) era, afforded investors, companies, governments and banks the opportunity to leverage low rates in pursuit of higher asset prices through activities at both the company level (e.g., debt-financed share buybacks) and the policy level (e.g., quantitative easing).

The global pandemic marked a dramatic conclusion to the great moderation. Central banks and governments coordinated stimulus to counter the economic consequences of political and societal reactions to the health crisis. Those stimulative efforts created rippling side-effects, many of which central bankers and legislators are trying to cure with policy decisions that have been at odds with one another. The inherent instability that comes with the current magnitude of fiscal and monetary intervention has propelled us into a post-moderation regime.

Not only are realized GDP growth and inflation more volatile than during the great moderation, the dispersion of economic forecasts has also greatly widened. The current degree of monetary and fiscal policy intervention has disrupted the historical relationship between interest rates and the real economy. Paradoxically, the very policies that are intended to promote stability are in fact creating more instability. Higher expected economic volatility appears here to stay and is likely to translate into greater capital markets volatility, leading to higher interest rates than what most modern investors have come to expect.

Investors should use caution when relying on forecasts derived from relationships that were dependent on the conditions that existed during the great moderation — conditions that are highly unlikely to repeat. Going forward, the post-moderation era will likely mean that the very strategies that were laggards during the era of loose money — value investing, long volatility, floating rate securities, commodities and other real assets — will all play a more constructive role in diversified portfolios.

FIGURE 2: **Economic volatility unleashed, market volatility to follow**



Source: Bloomberg quarterly data of US Real GDP (QoQ % SAAR) and US Treasury Yield Curve Rate Constant Maturity (10 year) from Jun 30, 1953 through Mar 31, 2024.

2

Beware the declining utility of global cap-weighted allocations

Investors are keenly aware of the growing role geopolitics are playing in driving risk, as evidenced in our *EQuilibrium* survey results. While geopolitics have always been part of global investors' calculus, conflict in the Middle East and Europe combined with global information wars, especially between the U.S. and China, have propagated a deeper sense of uncertainty, particularly when set against a trend of de-globalization.

The current geopolitical landscape will create tailwinds for some countries, while others will face significant headwinds. Therefore, the dispersion of market returns across different countries and regions is likely to widen. More generally, the peace dividend investors enjoyed for decades, however difficult to estimate, is unquestionably in decline as nation states are shifting their priorities from collaborative economic growth and embracing global citizenry to national security and self-sufficiency.

From a portfolio construction perspective, global market capitalization-weighted indices will likely be suboptimal vehicles to achieve geographic diversification in the new environment. Instead, investors can more effectively build their geographic allocations by placing a greater weight on the economic forces that drive a country's or region's market risks and return. This approach recognizes that a country's economy and capital markets are not one and the same and enables a direct link between allocations and the total portfolio objective. Incorporating geopolitical factors such as rule of law, military prowess, strong property rights, access to innovation, advanced financial markets, capitalistic tendencies and plentiful natural resources will further aid fine-tuning geographic allocations.

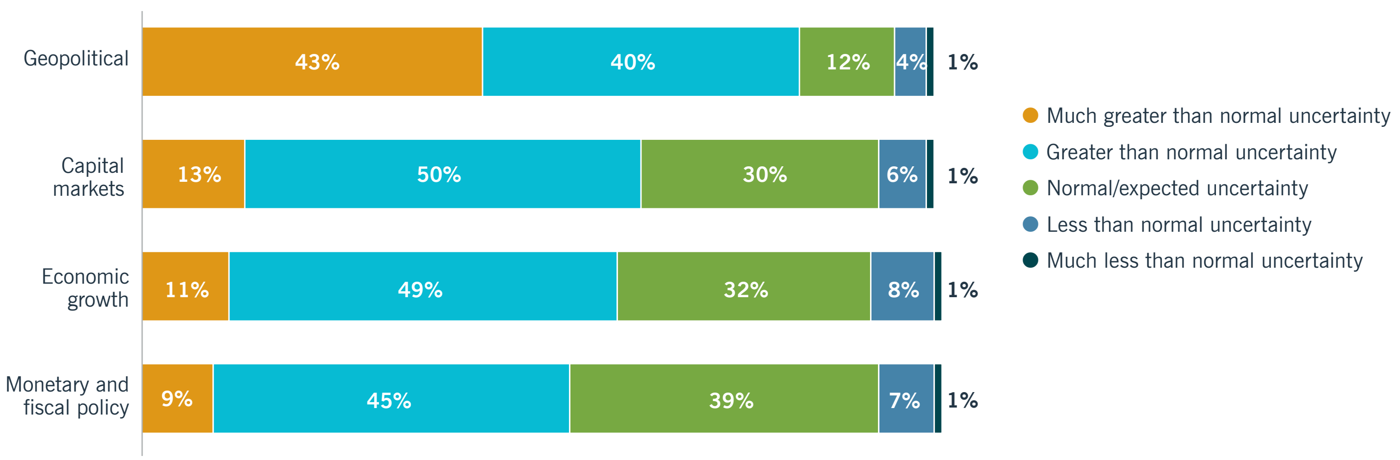
44%

of investors surveyed are focusing on adjusting their global/regional allocations to enhance portfolio resiliency

Source: Nuveen, 2024 *EQuilibrium* survey

FIGURE 3: **Geopolitics rise to the top of the risk ladder**

Taking into consideration the current environment, please rate your organization's general views about uncertainty in the following areas. (800 respondents)



Source: Nuveen, 2024 *EQuilibrium* survey. Data may not sum to 100% due to rounding.

3

Respect the limits of central banks' power to control inflation

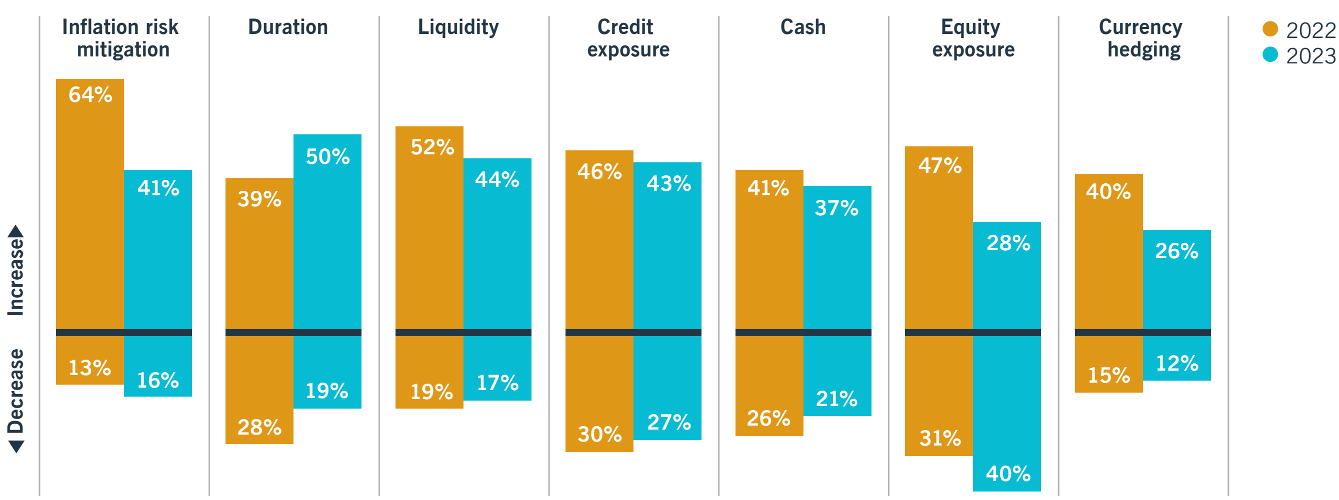
While the outlook for inflation is still on the minds of investors, it is no longer their predominant concern. The percentage of respondents who reported that they plan on increasing inflation risk-mitigating strategies declined substantially over the past year, from 64% in 2022 to 41% in 2023. This steep decline suggests that *EQuilibrium* respondents — like many investors headed into 2024 — either 1) had already adjusted portfolios with no further action warranted; 2) felt optimistic about the ability of central banks to rein in inflation; 3) were displaying some element of recency bias or 4) some combination of the above.

The widespread belief that monetary policy alone can manage and contain inflation remains. While it may be effective in the short-term, investors should be mindful that inflation is not solely a function of central bank behavior over the long term. Four structural trends will impede global central banks from achieving their low targeted rates of inflation:

1. **De-globalization:** Between the early 1970s and the global financial crisis of 2007–2009, global trade relative to world GDP rose almost 2.5x as the world embraced multi-lateral trade agreements, the rise of less advanced nations and the economic benefits of global production. It is no coincidence that this period of globalization overlapped with the great moderation. After peaking with the GFC, global trade has been declining.[1] Political ideologies, onshoring supply chains and a focus on national security are accelerating de-globalization.
2. **Energy transition:** Energy is the ultimate factor of production and a cost required for all goods and services. Many manufacturing processes and services are optimized on fossil fuel consumption, but the transition to a green economy will require new energy infrastructure and technology. Growing demand for industrial materials, rare earth metals and other commodities will ultimately create new commodity-based dependencies. As capital expenditure is diverted from old to new energy, current supply capacity will shrink.
3. **Aging demographics:** The working-age population relative to the total population in both advanced and emerging economies is poised to decline significantly. These increasing dependency ratios, which are reflective of decreasing labor supply, should lead to higher wages, all else equal. As we discuss next, technology-driven productivity increases can mitigate the inflationary impact of rising dependency ratios, but the extent to which this will happen is a major question.
4. **Deficit spending:** Most countries are running government budget deficits, in some cases very sizable ones that are exacerbated by off-balance sheet and future obligations. Almost all forecasts call for deeper deficits, reflecting limited political appetite to reduce spending, raise taxes or address entitlements. This is an intrinsically inflationary backdrop.

FIGURE 4: **Fewer investors are increasing inflation risk mitigating strategies**

In the next 12 months, indicate the directional changes you will be making in your portfolio(s) in the following areas. (800 respondents)



Source: Nuveen, 2024 *EQuilibrium* survey

4

Artificial intelligence is a double-edged sword when it comes to inflation

When considering the intersection of artificial intelligence (AI) and investment strategy, investors often focus narrowly on purchasing stocks of companies directly involved in developing AI models or the infrastructure supporting them. It is crucial, however, for asset allocators to adopt a broader, top-down perspective that encompasses AI's disruptive potential and its wide-reaching influence on growth and inflation, labor dynamics and everything in between. AI will influence asset allocation across several dimensions.

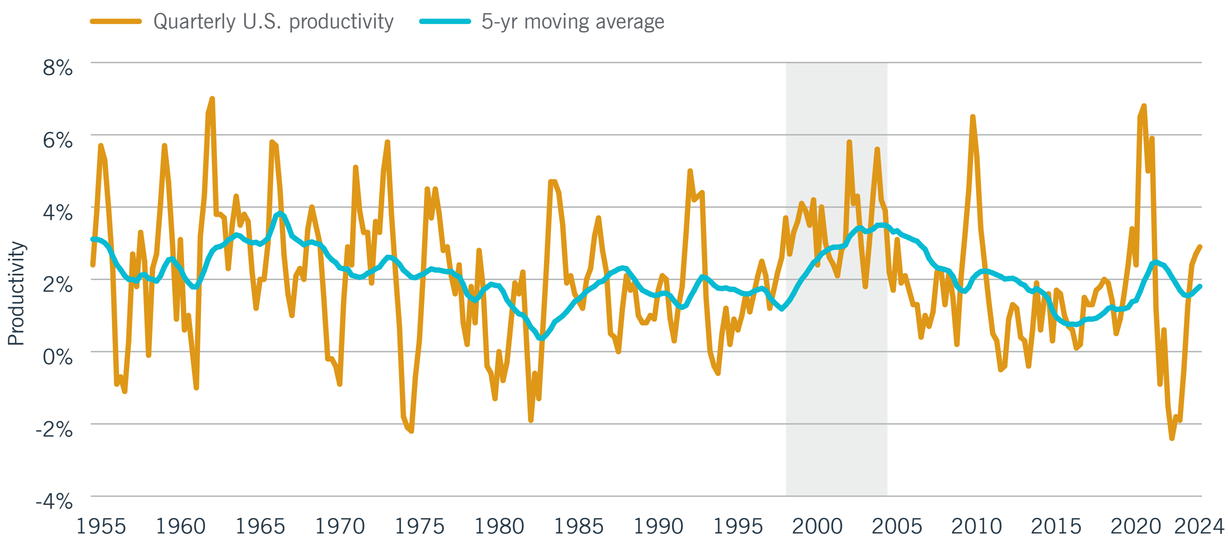
Whether it is electricity, transportation, cloud computing or AI, technological innovation increases growth. AI's growth impact, however, will not be uniform. Some sectors will be cannibalized while new ones emerge. Different countries will benefit to varying degrees depending on the current and future composition of their respective economies. As such, simply going long upstream AI software manufacturers may miss a much grander sphere of influence — and opportunity.

The productivity gains AI unleashes could fuel economic growth, as the Internet boom did almost three decades ago, and help counteract inflationary pressures. All else equal, increasing productivity should be met with higher real interest rates. That said, productivity growth is disinflationary as it increases the effective labor supply. Thus, productivity growth places less upward pressure on nominal rates than it does on real rates.

Despite AI's enormous potential as a productivity enhancer, investors should not take for granted that it will completely offset the wide range of inflationary tailwinds mentioned above. Growth in AI doesn't happen in a vacuum. The massive amount of computing power required for AI's ongoing expansion will consume exorbitant amounts of materials, physical space and energy — real-world inputs that are in limited supply. AI proliferation is also likely to drain highly skilled labor from other productive areas of the economy given the need to engage in the AI ecosystem.

FIGURE 5: **Internet boom productivity gains could portend AI-fueled economic growth**

Internet adoption is a simple modern analog of how productivity gains from technological innovation can fuel economic growth. The annualized rate of U.S. non-farm productivity more than doubled during the Internet boom.



Source: Bloomberg quarterly data of U.S. Non farm Business Sector Output Per Hour of All Persons YOY SA from Dec 31, 1949 through Mar 31, 2024.

5

Rethink government bonds' role in portfolios

Looking to take advantage of higher rates, at least relative to recent history, 50% of *EQuilibrium* respondents said they are planning on increasing portfolio duration and only 19% are decreasing.

As funding ratios have dramatically improved, part of the planned increases — particularly for corporate pension and insurance-based respondents — are a move to de-risk and more effectively match liabilities. For those adding government bond exposure and perhaps looking to speculate on a return to a zero interest rate policy, a deeper look into the long-term prospects of government bonds is warranted.

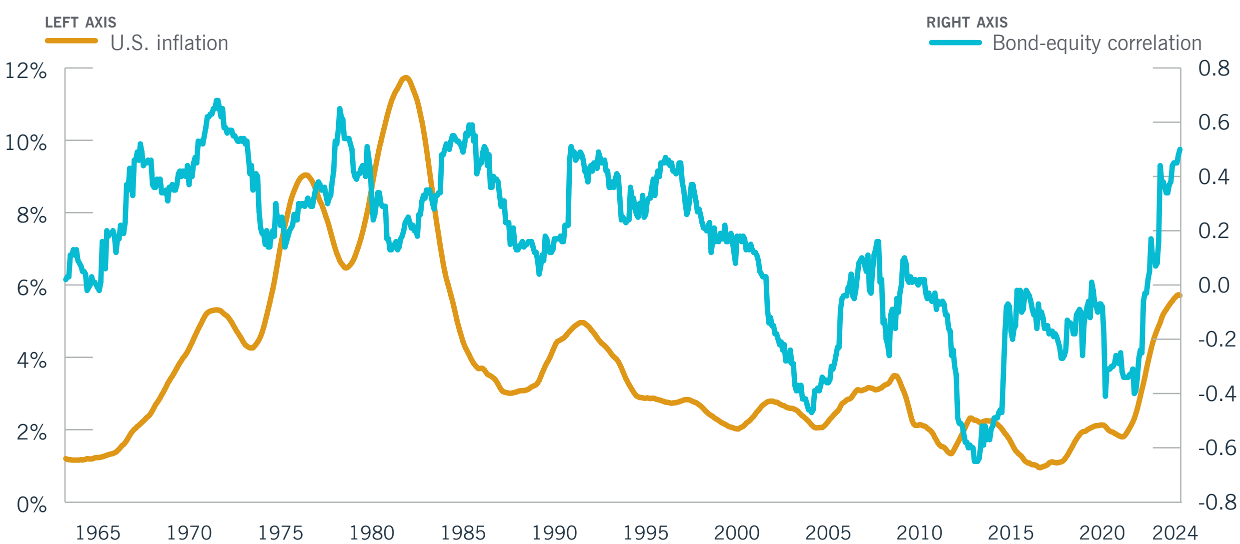
Throughout the latter half of the great moderation, government bonds took on the qualities of a unicorn asset. They provided the dual benefit of a negative short-term correlation to equities while also serving as return enhancers, appreciating in price and generating periodic income. That structural bull market for government bonds was dependent on features of the old regime that are now absent.

In the post-moderation environment, it may be more appropriate to view government bonds as risk assets rather than diversifiers. Although they are mostly free from default risk, developed market government bonds are certainly not free from interest rate risk. Therefore, even long-term investors should evaluate whether they are duly compensated for the risk they bear, particularly when term premiums are depressed. Banks learned first-hand in 2023 that government bonds are not risk free. A call on liquidity can quickly turn long-term investors who intend to hold bonds to maturity into short-term traders.

Higher structural inflation also brings about positive stock-bond return correlations. The negative correlation between stocks and government bonds over the past 20 years has been the exception, not the rule. Even moderate levels of inflation are enough to bring us back to a normalized environment of positively correlated stock and bond risk premiums. Given that we are unlikely to repeat the great moderation, investors seeking greater diversification may benefit by looking beyond government bonds.

FIGURE 6: **Inflation need not be high to reduce government bonds' diversification value**

Over the past six decades, the negative correlation between stock and government bond returns occurred during a low and stable disinflationary period. Outside of this period, bonds showed varying degrees of positive correlations to equities.



Source: Bloomberg monthly data of S&P 500 Index, U.S. Treasury Yield Curve Rate T Note Constant Maturity 10yr and U.S. CPI Urban Consumers YoY NSA from 31 Mar 1960 through 30 April 2024. Rolling 36-month correlation between S&P 500 Index return and 10yr Treasury (inverse) change in yields and rolling 36-month average CPI.

6

Do not take more risk than you need

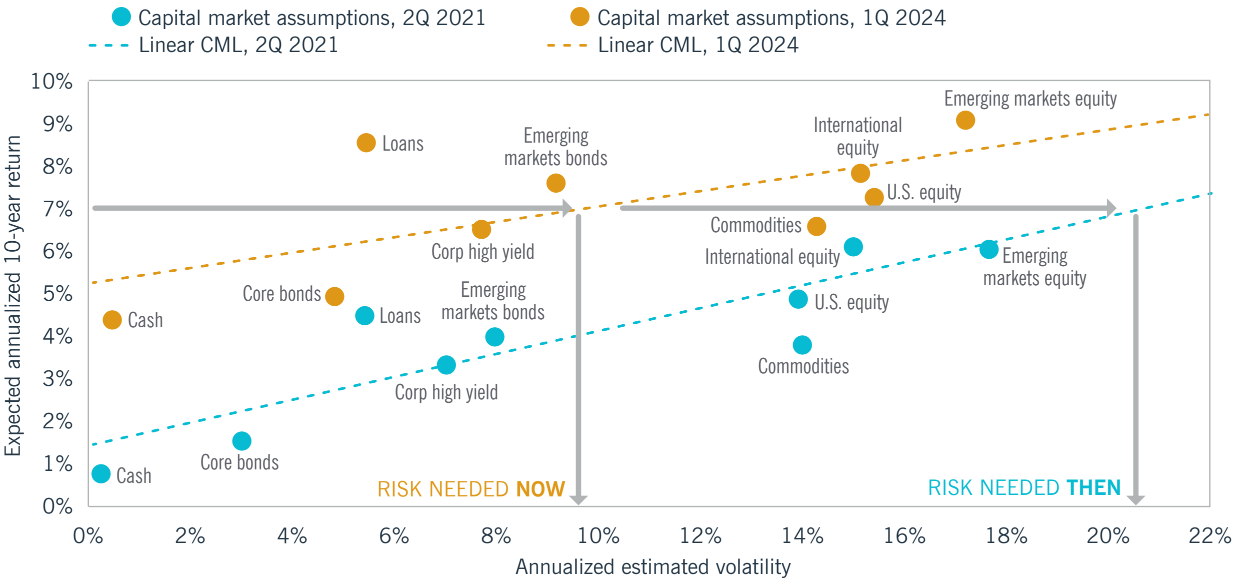
When risk-free rates were negligible — and in some cases even negative — institutions struggled to find assets that would deliver returns high enough to meet their objectives. This low expected return environment forced investors to take on high levels of risk to satisfy seemingly unachievable return objectives that had not changed from decades prior. Now that the risk-free rate — a critical component of total returns for all assets — has reset higher, many more asset and sub-asset classes are capable of achieving targeted returns.

That said, most equity valuations are stretched, and credit spreads are extremely tight. While total expected returns appear quite attractive, particularly relative to requirements, they have become appealing because of the higher embedded risk-free rate, not because of an increase in the expected equity risk premium or credit spreads. As a result, investors today do not need to extend themselves as far out on the risk spectrum to meet their return needs.

Today's environment also creates a greater need to adopt a more nuanced approach to diversification and risk management and, as we discuss later, a more dynamic approach to strategic asset allocation. Analyzing portfolio risk factor exposures will become increasingly important in the new regime. For example, some investors may find that their risk exposures are not as diverse as they think or that they are not being adequately compensated for the risks that they own.

FIGURE 7: **The rates reset has affected return forecasts along the risk curve**

The rise in interest rates has caused expected returns to increase across asset classes. In addition to shifting upward significantly, the capital market line (CML) has flattened marginally. With a flatter CML, every marginal unit of risk produces less incremental expected return.



Source: Nuveen Multi-Asset Team capital market assumptions as of 30 June 2021 and 31 March 2024.

7

Privates are not compelling just because they are private

The multi-year industry-wide shift toward private investments continues, with more than half (55%) of respondents to the *EQuilibrium* survey planning to increase their private allocations over the next five years. This momentum underscores the need for investors to be thoughtful and precise about how they attempt to harness the value of private markets.

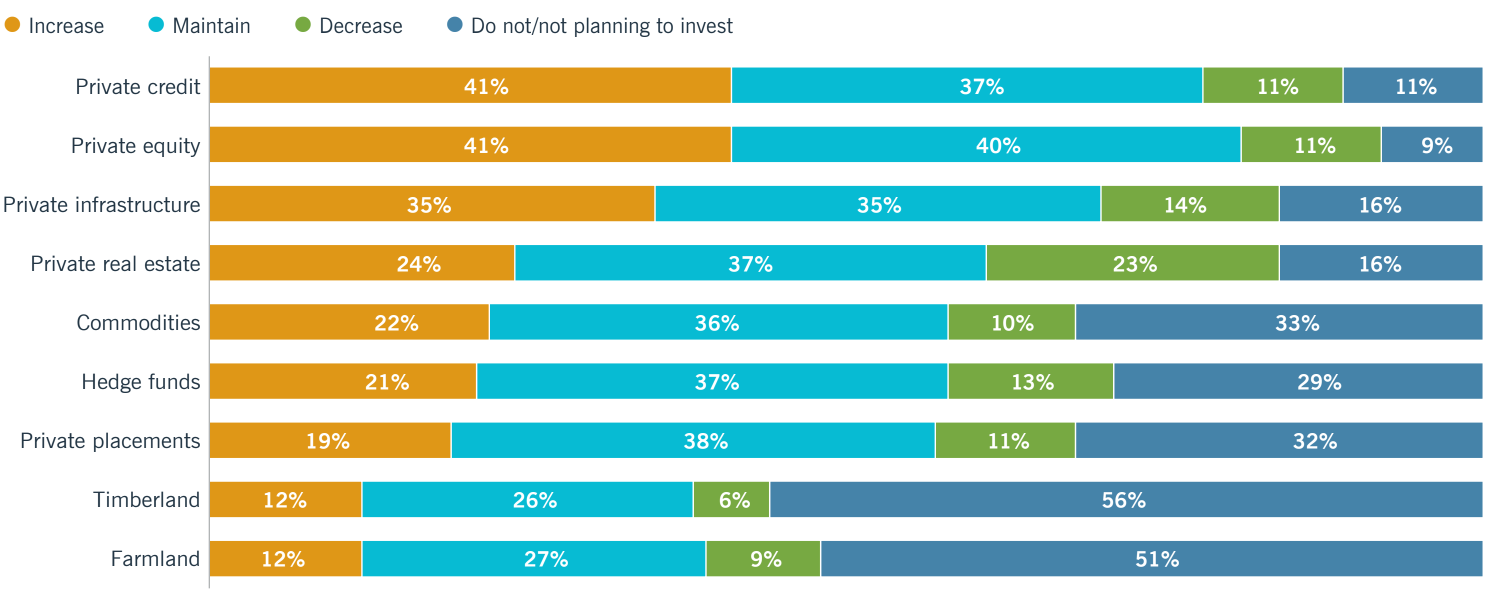
Investors looking to move into private markets should keep the following dynamics in mind: 1) product wrappers are not a feature of economic exposures or risk, 2) private assets do not strengthen or add diversification to a portfolio simply because they are private and 3) some private market investment exposures are easily and cheaply accessed publicly, so be cautious of unwittingly doubling up on similar risk or return factors.

Adding allocations to private assets based on the asset's ability to deliver an idiosyncratic exposure not replicable in public markets is an effective approach to optimizing a portfolio's illiquidity buckets. For example, royalty portfolios or farmland possess economic exposures not commonly found in public markets.

In addition to harnessing idiosyncratic risk, investors can also employ private markets to extract value from deal sourcing, operational improvements and structuring expertise. Investors may be better served by focusing on these private market value adds rather than the often-cited illiquidity premium, which is difficult to estimate and varies over time, or volatility-suppression, which is more a reporting construct than a reflection of risk.

FIGURE 8: **Institutional allocation plans across alternative asset classes**

Please select the alternative investments you are currently allocated to and how you plan to adjust allocations over the next two years. (800 respondents)



Figures may not sum to 100% due to rounding.

Source: Nuveen, 2024 *EQuilibrium* survey

8

Appreciate the scarcity value of real assets

Conversations about real assets, including commodities, farmland, timberland and infrastructure, are often centered on their ability to manage inflation risk. Some real assets are good at hedging short-term inflationary spikes, while others have a high likelihood of delivering positive real returns over the long run.

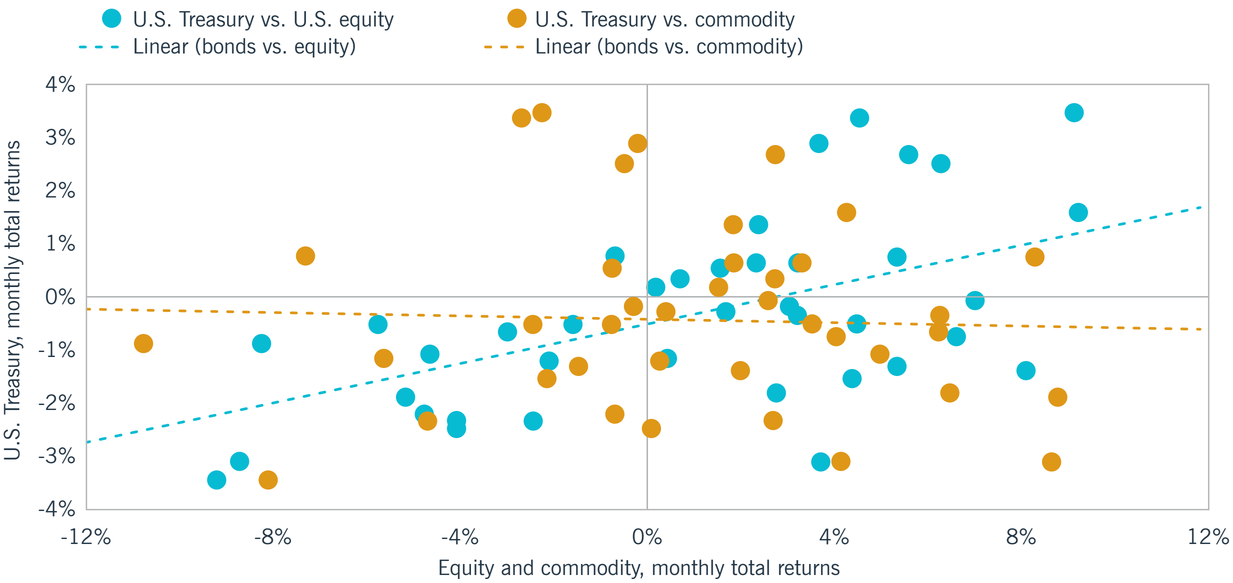
Real assets strengthen traditional portfolios by delivering attractive returns in environments that are often detrimental to financialized assets, such as listed stocks and bonds. This is because of the simple fact that much of the value of real assets is derived from their scarcity — the supply of tangible assets is inherently limited. Timber, for example, cannot be produced faster than it can grow. The amount of tillable farmland in the world is finite, and expanding toward that limit often means eliminating forests. Finding, extracting and refining a barrel of oil is a costly endeavor that requires unique skills and resources. Financialized assets, on the other hand, can be produced quickly, cheaply and without physical limitations.

Asset prices are derived from the intersection of supply and demand. While the supply function of real and financialized assets differ markedly, demand for all assets is largely driven by real economic growth. Investors can use real assets to focus on long-term structural growth drivers of the economy. For example, investing in the infrastructure, land and commodities required to enhance the world's computing bandwidth can be effective avenues to gain exposure to the growth of AI.

Many of the underlying risk factors that drive the value of real assets are highly idiosyncratic, as they are tied to different crop types, operating structures, contractual agreements, geographies and other factors that vary from asset to asset. These idiosyncrasies, when combined with supply limitations, enable real assets to retain their portfolio diversification benefits in a post-moderation world where heavily financialized assets may have lost some luster.

FIGURE 9: **Real assets provide diversification in a post-moderation world**

In the post-moderation period, the correlation between equities and bonds has reverted back to its normal, positive relationship. The correlation between bonds and commodities, however, continues to show no relationship.



Source: Bloomberg monthly data S&P 500 Total Return Index, Bloomberg Commodity Index Total Return, and Bloomberg US Treasury Total Return Unhedged USD from 31 Dec 2020 through 30 April 2024.

9

Be active where you can have the greatest impact

Much ink has been spilled debating the merits of active versus passive management within equities and other asset classes. While skilled single-asset active investors can be additive to portfolios, the biggest driver of a diversified portfolio's outcome is the asset allocation. Currently, most long-term investors use largely static asset allocations. Investors seeking to enhance portfolio resilience are best served by taking a more dynamic approach to strategic asset allocation, in addition to tactical allocations and security selection within asset classes.

In the post-moderation world of heightened macro variability, the unintentional risk and return drift incurred by holding asset allocations constant will be much larger. Simply put, a 'set-and-forget' approach is unlikely to thrive. Expected risks and returns, which are driven by a common set of macro factors, are changing. This warrants more dynamism in the strategic asset allocation. Without it, the portfolio's risk posture becomes a byproduct of evolving market dynamics and investors forego their ability to intentionally link the portfolio to their desired outcome.

Many investors, however, appear to be staying the course. While almost half of the *EQuilibrium* respondents agree that market fundamentals have significantly changed and are subsequently re-formulating how they calculate their capital market assumptions, less than a quarter are making foundational changes to their asset allocations.

FIGURE 10: **Changes in market fundamentals are not necessarily carrying over to changes in strategic asset allocation**

CAPITAL MARKET ASSUMPTIONS		STRATEGIC ASSET ALLOCATION	
Market fundamentals **remain the same,** so we are **maintaining** our standard approach to reviewing and updating capital market assumptions.	52%	We are making **little change** to our strategic asset allocation.	76%
Market fundamentals have **significantly changed,** so we are **reformulating** how we calculate our capital market assumptions.	48%	We are making **foundational changes** to our strategic asset allocation.	24%

Source: Nuveen, 2024 *Equilibrium* survey

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Endnotes

Sources

1 World Development Indicators as of 30 March 2023.

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