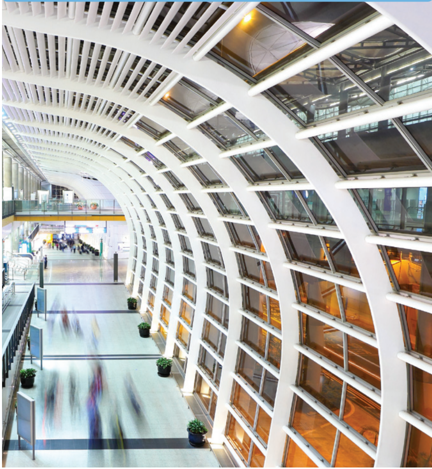
# Taxable Fixed Income Outlook: Riding the Rate Roller Coaster

NUVEEN ASSET MANAGEMENT

MARKET COMMENTARY

SECOND QUARTER



**WHILE ACTIVE MANAGERS CAN ADD VALUE THROUGH INTEREST RATE POSITIONING,** predicting rates in the short term is a tricky task. Despite widespread fears of rising rates this year, yields confounded investors again by declining. We believe investors can position their bond portfolios for this rate roller coaster using actively managed, broadly diversified, multi-sector bond strategies. These portfolios have many return drivers, in addition to interest rate positioning, that can help make the roller coaster more like a Sunday drive.

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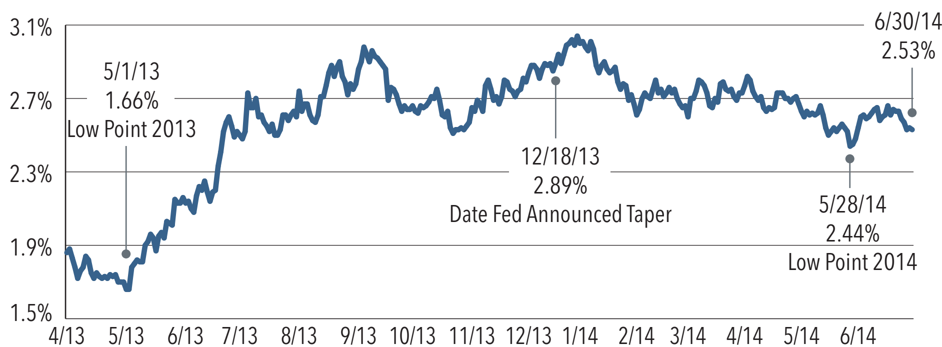
Interest rates can be incredibly unpredictable, and this cycle has been exactly that. Just when everyone felt certain that Federal Reserve (Fed) tapering of asset purchases would cause rates to rise, they fell. Exhibit 1 uses 10-year Treasury rates to illustrate how bumpy the rate ride can be over shorter time periods.

**Exhibit 1: Rates Can Be a Roller Coaster**




Source: www.treasury.gov. Data represents 10-year U.S. Treasury rates from 4/13 to 6/14.

## Why Are Rates Still Low?

Many ask why rates remain so low. The puzzle is complicated because so many factors affect interest rates. These include fundamental factors such as growth rates, inflation expectations, preference for shorter-term securities, investor risk appetite. In addition, technical factors that drive the supply and demand dynamics and have had greater impact lately.

One of the most visible fundamental factors is the Fed's monetary policy position. With the taper, the Fed has begun to unwind its extraordinarily accommodative policy by

reducing its asset purchases. In late 2013, the market initially reacted to this taper announcement with increased rates. But rates reversed course as time passed and more policy clarity emerged. Tactical investors often attempt to take positions based on these policy announcements. Sometimes the buying or selling of larger positions can impact rates. However, it is important to remember these shorter-term technical situations don't change the longer-term fundamental trends that will inevitably unfold. Unless the economy derails, it is likely that rates will rise modestly over the intermediate term.

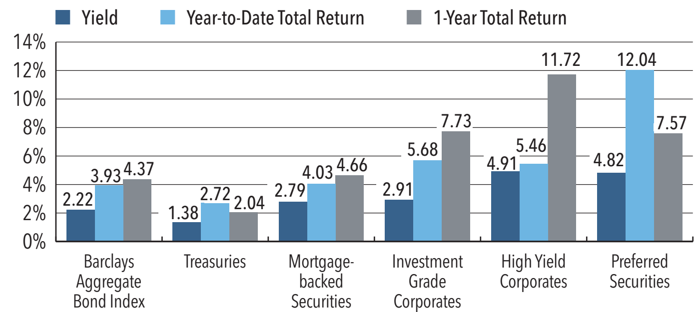
### Exhibit 2: Sorting Out the Causes of Rate Movements

| | Factors that Can Cause Rates to Rise | Factors that Can Cause Rates to Fall |
|---|---|---|
| **Shorter-Term Technical Factors** | ■ Rising Stock Market<br>■ Foreign Central Bank Sales<br>■ Bond Mutual Fund Outflows | ■ Flight to Quality<br>■ Strong Pension Account Demand<br>■ Bond Mutual Fund Inflows |
| **Longer-Term Fundamental Factors** | ■ Growing Economy<br>■ Rising Inflation<br>■ Monetary Policy Tightening | ■ Slowing Economy<br>■ Falling Inflation<br>■ Monetary Policy Easing |

## Let Active Managers Help Smooth the Ride

Even for the most experienced managers, positioning for short-term rate changes can be tricky. We believe investors should let professional money managers help position portfolios for rising rates. Rather than trying to time the market, consider selecting a multi-sector bond strategy that gives the manager the necessary flexibility to position for changing markets. In addition to managing portfolio duration and adjusting yield curve positioning, sector selection can help protect against rising rates. In fact, in 2014 the higher income sectors have continued to outperform the lower income sectors, as shown in Exhibit 3. A portfolio that can move among many market segments may be better positioned to ride out the rate roller coaster.

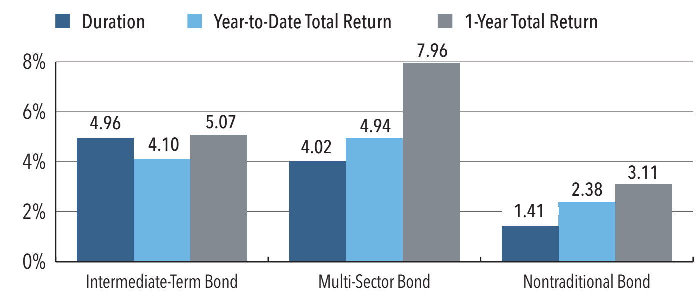
### Exhibit 3: Higher Yielding Sectors Have Outperformed




Source: Morningstar Direct. Data as of 6/30/14. Treasuries represented by Barclays U.S. Treasury Index; mortgage-backed securities represented by Barclays U.S. MBS Index; investment grade corporates by Barclays U.S. Investment Grade Corporates Index; high yield corporates by Barclays U.S. Corporate High Yield 2% Issuer Capped Index; preferred securities by BofA Merrill Lynch Preferred Stock Fixed Rate Index. Past performance is no guarantee of future results. Indices are unmanaged and unavailable for direct investment.

And while low duration nontraditional bond strategies have become the rage, Exhibit 4 shows they actually haven't performed as well in this market as more traditional strategies. This underscores their role as a fixed income alternative strategy, not a big bucket strategy to house the majority of the fixed income allocation.

### Exhibit 4: Nontraditional Strategies Have Underperformed




Source: Morningstar Direct. Data as of 6/30/14. Intermediate-term bond funds represented by the Morningstar Intermediate-Term Bond Fund Category Average; multi-sector bond funds by the Morningstar Multi-Sector Bond Fund Category Average; nontraditional bond funds by the Morningstar Nontraditional Bond Fund Category Average. Duration is the average duration of all funds in the category as of 6/30/14. Past performance is no guarantee of future results. Indices are unmanaged and unavailable for direct investment.

## Our Outlook

As the markets continue to move forward, our key themes remain intact. We believe:

**RATES WILL RISE MODESTLY BUT REMAIN AT RELATIVELY LOW LEVELS.** From March 31 to June 30, the 10-year U.S. Treasury yield fell another 20 basis points, bringing the year-to-date rate decline to 47 basis points.[1] With the global financial markets awash in cash, fixed income market technicals were very supportive, leading to lower rates and tighter spreads. U.S. Treasuries rallied and the yield curve flattened, with yields dropping on the long end but nearly unchanged for short maturities.[1] The catalysts included expectations for the European Central Bank's new easing measures, asset allocation and central bank reserve-related buying, as well as accounts buying to cover short duration positions. Although we don't expect a shock higher in yields, interest rate volatility could occasionally spike in response to economic or geopolitical developments, or renewed uncertainty about the Fed. We estimate that the 10-year U.S. Treasury yield could be 2.75% to 3.00% by the end of 2014.

**DOMESTIC ECONOMIC RECOVERY CONTINUES.** Although disappointing data showed that U.S. gross domestic product (GDP) suffered a much steeper downturn in the first quarter than previously reported, this negative news was rapidly overtaken by more up-to-date economic data that showed the domestic economy rebounding nicely. Employment figures posted steady gains, consumer spending advanced at a moderate pace and manufacturing strengthened. Inflation expectations, however, remained remarkably well anchored in the face of the improving labor market. Consequently, the Fed did not alter its time frame for the removal of monetary easing, and continued to taper asset purchases by $10 billion per meeting. We believe growth will be 3.0% or better for the second half of the year.

**GLOBAL GROWTH STABILIZED.** Global growth has stabilized with the U.S. providing leadership for the world's economies. The Fed and Bank of England, experiencing normalization and recovery, are diverging from Europe and Japan, which face the need for aggressive support. The demonstrated engagement by the European Central Bank in addressing persistently low inflation and depressed lending is an important turn in supporting a key component of global growth. These divergent conditions will help moderate the global cycle and are likely to be particularly supportive of emerging markets.

Emerging market economies have benefited from a recovery in global growth, recent domestic policy adjustments and renewed capital flows. Global rates are very low, but near-term catalysts for a big move may remain scarce. Despite a more benign backdrop than last year, markets continue to reflect divergent conditions and prospects, making country selection very important. We believe that global GDP growth will be in the 3.0% to 3.3% range in 2014, with potential for upside surprise.

## Our Favorite Things

Against this backdrop, we continue to favor the non-government asset classes, such as:

- Selected investment grade corporates
- High yield corporates
- Selected foreign markets
- Preferred securities

**WE LIKE CORPORATE BONDS,** both investment grade and high yield with intermediate durations. Meanwhile, we see no fundamental reasons for credit to weaken, and there is less opportunity for meaningful price appreciation. We expect credit markets to remain less volatile and the yield advantage to drive returns rather than credit spread compression. Within corporates, we believe issue and credit selection will continue to be the primary driver of performance and risk management. Financial issues continue to be attractive, as are selected cyclicals. Within investment grade, we prefer BBB-rated over A-rated industrials, given better relative value and less risk of re-leveraging behavior in lower-rated credits.

**HIGH YIELD CORPORATE BONDS REMAIN ATTRACTIVE** in light of the low default rate environment. The sector generates significant income with moderate interest rate risk. We expect modest spread tightening and stable yields over the course of the summer, as we anticipate a modest rise in Treasury rates.

The default environment is one of the most important fundamental factors to watch in high yield. The U.S. default rate trended at 2.3% in May, in line with projections from the beginning of the year.[2] Looking ahead, Moody's default rate forecasting model predicts that the global default rate will edge lower to 2.1% by the end of this year, before rising to 2.4% a year from now.[2] This outlook is supported by the liquidity backdrop, which remains strong for many companies as they have enjoyed easy access to the debt market in recent years and have refinanced

1 Source: Bloomberg.
2 Source: Moody's Investors Services, Inc.

debt at historically low rates. A modest pace of economic growth, low capital raising needs and a steady U.S. demand recovery all support the profitability of high-yield issuers and are consistent with low defaults expectations.

**SELECTED FOREIGN MARKETS CAN OFFER EXPOSURE** to countries with better growth prospects, sound financial position or higher interest rates. In addition, they diversify away from the U.S. dollar. The path of global growth and differing domestic monetary and economic conditions will continue to drive returns. As the market increasingly comes to grips with moderate Fed moves and improving U.S. growth, we see continued attractive valuations in foreign markets. We favor countries with stable economic and fiscal profiles, and those benefitting from improving global growth. We also like selected emerging market corporate bonds and specific sovereign debt of countries whose policymakers have demonstrated sound policies to improve competitiveness, promote structural reforms and enhance fiscal and monetary credibility. The U.S. dollar is likely to benefit marginally from continued economic improvement and Fed action, although such support will largely manifest itself vs. particular currencies, rather than driving a broad U.S. dollar rally.

**PREFERRED SECURITIES CAN ALSO BE ATTRACTIVE** for both yield and diversification. These hybrid securities are heavily owned by the less efficient retail investing segment, so they may benefit from active, professional management. In addition, the changing bank regulatory environment creates many opportunities. We favor the fixed-to-floating rate coupon structures, which offer reduced interest rate risk. ■

## For more information, please consult with your financial advisor and visit nuveen.com.

### INDEX DEFINITIONS

**Mortgage-Backed Securities:** The Barclays U.S Mortgage-Backed Securities Index is the mortgage backed securities component of the Barclays U.S. Aggregate Index.

**Broad Bond Market:** Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

**Investment Grade Corporate Bonds:** Barclays U.S. Investment Grade Corporate Index is a broad-based benchmark that measures the investment grade, fixed-rate, taxable corporate bond market.

**High Yield Corporate Bonds:** Barclays U.S. High Yield 2% Issuer Capped Index tracks the performance of U.S. noninvestment-grade bonds and limits each issue to 2% of the index.

**Treasuries:** Barclays U.S. Treasury Index includes public obligations of the U.S. Treasury. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index. In addition, certain special issues, such as state and local government series bonds (SLGs), as well as U.S. Treasury TIPS, are excluded. STRIPS are excluded from the index because their inclusion would result in double-counting.

**Preferred Securities:** BofA Merrill Lynch Preferred Stock Fixed Rate Index is designed to replicate the total return of a diversified group of investment-grade preferred securities.

The **Morningstar Intermediate-Term Bond Fund Category** contains funds that focus on corporate, government, foreign or other issues with an average duration of greater than or equal to 3.5 years but less than or equal to six years, or an average effective maturity of more than four years but less than 10 years.

The **Morningstar Multi-Sector Bond Fund Category Average** is used for funds that seek income by diversifying their assets among several fixed-income sectors, usually U.S. government obligations, foreign bonds, and high-yield domestic debt securities.

The **Morningstar Nontraditional Bond Fund Category** contains funds that pursue strategies divergent in one or more ways from conventional practice in the broader bond-fund universe. Many funds in this group describe themselves as "absolute return" portfolios, which seek to avoid losses and produce returns uncorrelated with the overall bond market; they employ a variety of methods to achieve those aims. Another large subset are self-described "unconstrained" portfolios that have more flexibility to invest tactically across a wide swath of individual sectors, including high-yield and foreign debt, and typically with very large allocations. The category is also home to a subset of portfolios that attempt to minimize volatility by maintaining short or ultra-short duration portfolios, but explicitly court significant credit and foreign bond market risk in order to generate high returns.

### RISKS AND OTHER IMPORTANT CONSIDERATIONS

Investing involves risk; principal loss is possible. Debt or fixed income securities are subject to market risk, credit risk, interest rate risk, call risk, derivatives risk, dollar roll transaction risk and income risk. As interest rates rise, bond prices fall. Below investment grade or high yield debt securities are subject to liquidity risk and heightened credit risk. Preferred securities are subordinated to bonds and other debt instruments in a company's capital structure and therefore are subject to greater credit risk. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. Asset-backed and mortgage-backed securities are subject to additional risks such as prepayment risk, liquidity risk, default risk and adverse economic developments.

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GPE-TFICOM-0614P 1982-INV-Q10/14