Where Are We in the Credit Cycle?

NUVEEN ASSET MANAGEMENT

MARKET COMMENTARY

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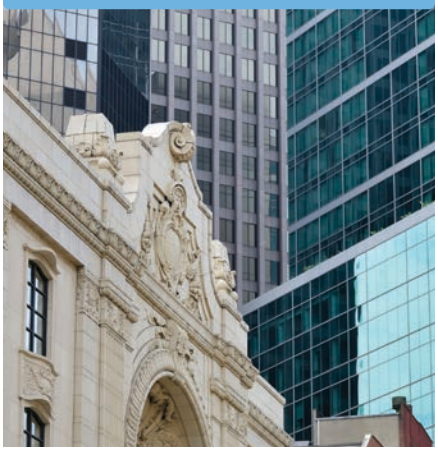

MANY INVESTORS ARE QUESTIONING IF THE CREDIT CYCLE IS ENDING, given the extended period of economic expansion and prolonged attractive performance across fixed income credit sectors. We say no. We believe the current cycle has legs, as the corporate bond sectors still exhibit solid fundamentals. Credit cycles do not die of old age or end due to rising rates. They have historically ended due to recession, which we do not foresee in the near future. We continue to favor the credit-oriented sectors across our portfolios.

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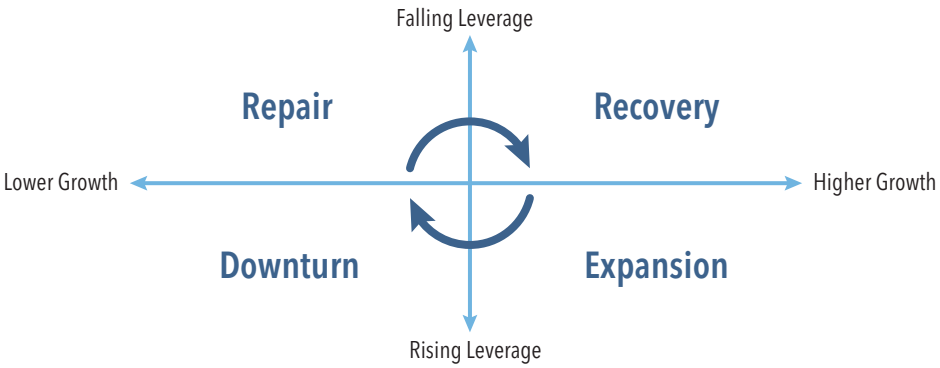
What Is the Credit Cycle?

The credit cycle tracks the expansion and contraction of access to credit over time. It influences the overall business cycle because access to credit affects a company's ability to invest and drive economic growth. Over time, performance of credit-oriented fixed income sectors such as investment grade corporates, high yield corporates and preferred securities is linked directly to the credit cycle.

It is important for bond investors to understand the phases of the credit cycle, as described in Exhibit 1. Corporate bond prices tend to decline during a downturn, and investors often reposition portfolios away from the corporate sectors in anticipation of the downturn. The recent widening and volatility of corporate spreads in late 2015 and early 2016 led many to question whether the downturn phase had already begun. However, we believe that we remain in the late expansion phase, and allocations to corporate bonds may still provide benefits.

Exhibit 1: The Four Phases of the Credit Cycle



Each phase of the credit cycle exhibits unique features:

REPAIR. Following a downturn, economic growth improves as the economy emerges from recession. Companies begin to repay debt and strengthen balance sheets. Leverage declines with a focus on cost cutting and cash generation. Corporate bond spreads typically decline.

RECOVERY. Corporate profit margins get a boost from restructured balance sheets and reduced debt loads. The economy continues to improve. Leverage decreases and free cash flow grows. Corporate bond spreads continue to decline.

EXPANSION. In a strengthening economy, banks increase lending and confidence improves. Leverage continues to rise as higher growth rates lead companies to increase borrowing. As confidence builds, speculative and merger and acquisition activity increases. Typically, corporate bonds experience heightened price volatility and the credit cycle peaks.

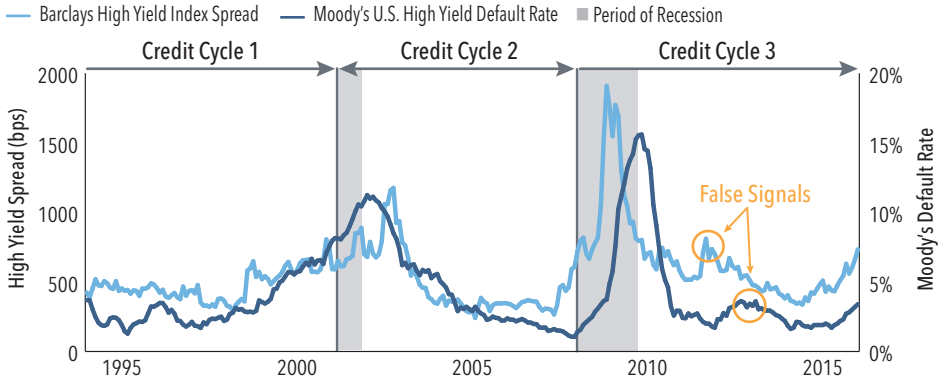
DOWNTURN. High leverage and lower earnings due to slowing growth lead to peak default rates. Banks reduce lending and tighten credit standards. The economy typically experiences a slowdown or recession. Corporate bonds generally experience poor returns as spreads widen and prices fall.

Historical Credit Cycles and Recessions

We are in the midst of the third credit cycle since the 1990s, as shown in Exhibit 2. It is easiest to see the cycles by observing the credit spreads and default rates of high yield corporate bonds, which are more pronounced than those of investment grade corporates. Recessionary periods have marked the turning points between cycles. Default rates peaked near the end of the recessionary period in both Cycle 1 and Cycle 2. Credit spreads peaked concurrent with the recession or afterward.

While there have been upticks in defaults and spreads, we believe these events are false signals, which we will discuss further later in the paper.

Exhibit 2: Credit Cycles Have Been Marked by Credit Spreads and Default Rates



Data source: Barclays, Moody's from 12/31/93 to 3/31/16. Past performance is no guarantee of future results. Indices are unmanaged and unavailable for direct investment.

We do not believe we are entering a recession. Global growth remains frustratingly slow, but bright spots suggest that slow growth will continue. Credit spreads have increased over the past few months and defaults are ticking up, but increased defaults are focused in the more volatile metals & mining and energy sectors. Both defaults and spreads are low relative to the ends of previous cycles, and remain contained outside of stressed commodity sectors. These factors suggest we have not yet reached the downturn phase.

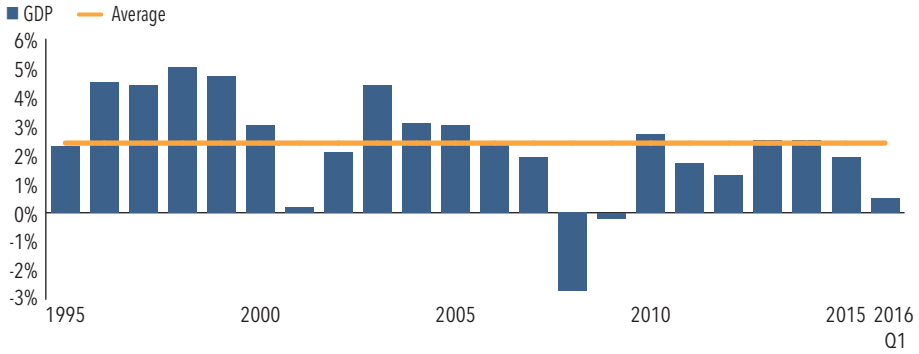
Meaningful Differences from Past Cycle Peaks

But let's dig a little deeper. We see meaningful differences between this cycle and prior cycles in economic growth, Federal Reserve (Fed) monetary policy and the overall financial environment.

The Real Economy Is Moderate

In past cycle peaks, the economy could be characterized as overheating, with strong economic growth and increasing inflationary pressures. As the credit cycle shifted from expansion to downturn, economic growth declined and the economy moved into a recession. Recent economic data does not indicate that the economy is overheating and shifting into a recession, as shown in Exhibit 3. Instead, economic growth is low but positive, inflation remains contained and global economic slack remains.

Exhibit 3: The Economy Is Not Overheating



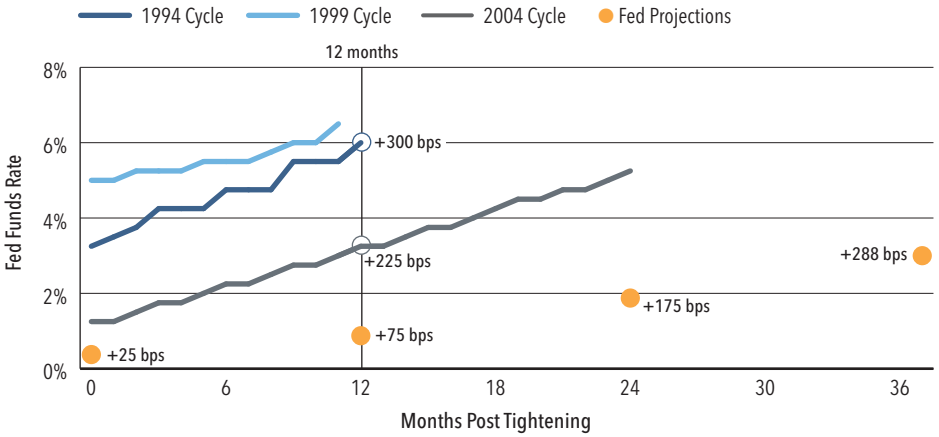
Sources: Bloomberg, Federal Reserve Bank of Atlanta from 1995 to 2015. Annual GDP is represented by the average of quarterly GDP for each year. First quarter 2016 estimate as of 3/28/16.

The Fed Is Normalizing Rates, Not Tightening

Historically, the Fed finished raising interest rates well before the end of the credit cycle. The last two recessions occurred 9 to 18 months after the Fed completed its rate hikes.

This credit cycle is very different, as the Fed is normalizing rates from a very low level rather than tightening to slow the economy, as shown in Exhibit 4. The Fed signaled that it intends to increase rates very slowly, which will likely keep credit conditions favorable for corporations and further lengthen the credit cycle.

Exhibit 4: This Fed Tightening Cycle Is Projected to Be Lower and Longer



Sources: Bloomberg; Federal Reserve Projection Materials, 3/16/2016. Fed forecast represents the median forecast of each Federal Open Market Committee participant for the midpoint of the fed funds rate at year ends 2016, 2017 and 2018. Month 0 shows first rate increase.

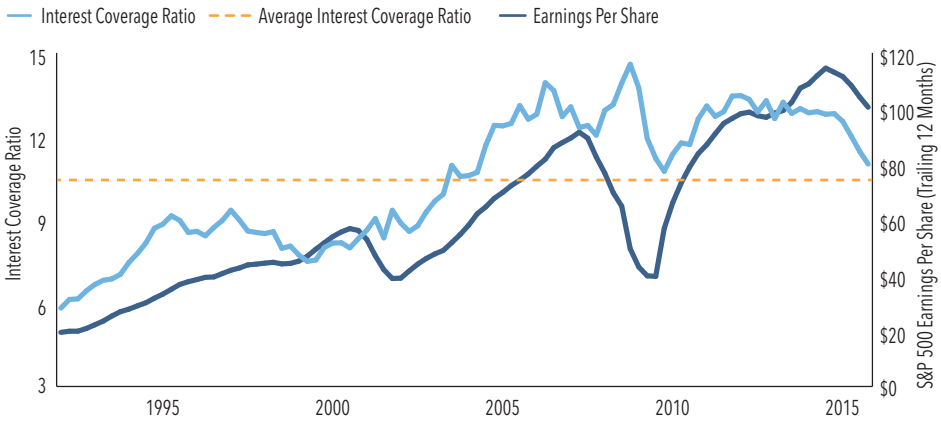
Financial Conditions Are Supportive

Bank balance sheets are much stronger than the past, due to enhanced regulations following the financial crisis. The strength of the banking sector will likely allow for continued access to credit. Additionally, global central bank policy is aimed to support loan growth.

Corporate Fundamentals Are Still Healthy

While earnings growth has slowed recently, earnings remain historically high. Elevated earnings and the low cost of debt have resulted in an above-average interest coverage ratio, as shown in Exhibit 5. This indicates that companies are generating sufficient earnings to cover the cost of debt, translating to a low level of defaults. Additionally, corporate cash balances are at record highs, exemplifying corporate financial flexibility.[1]

Exhibit 5: Record High Earnings Are Boosting Interest Coverage



Data source: JPMorgan, Bloomberg from 9/30/92 to 12/31/15. The interest coverage ratio is based on the JPMorgan U.S. Liquid Index.

1 Source: JPMorgan as of 12/31/15.

False Signals Confused as the Cycle Peaks

Numerous factors suggest that we are not entering the downturn phase of the credit cycle, but recent false signals have been confused with cycle peaks.

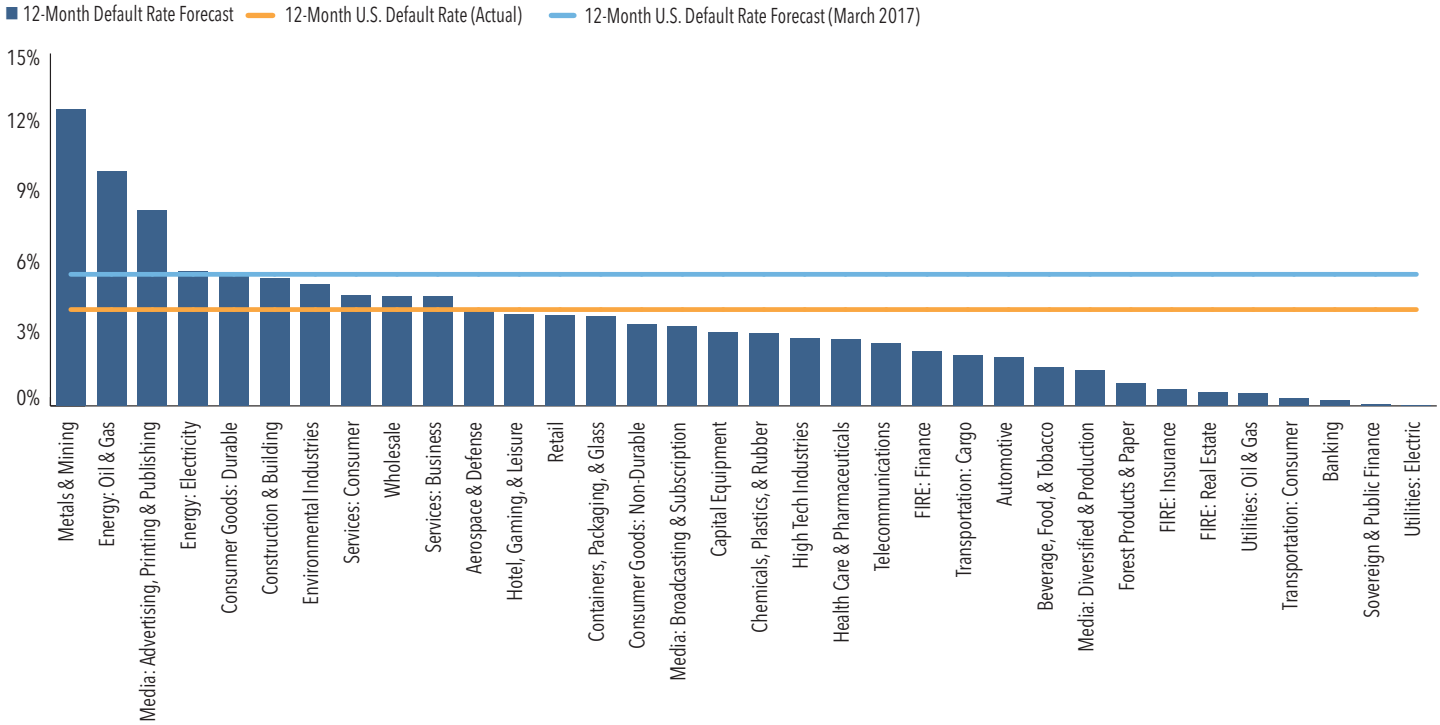
Volatility Has Been Elevated

Volatility has magnified recently, especially within the corporate bond market. Corporate bond market liquidity has declined, as new regulatory requirements decreased dealers' incentive and capacity to hold corporate bonds on their balance sheets. Additionally, exchange-traded fund (ETF) trading has been very volatile, with fixed income ETFs growing in popularity and becoming havens for "hot money." Although volatile ETF flows have impacted the broader market, the recent volatility increase is a false signal because it has not been driven by broadly deteriorating credit fundamentals and market conditions.

Default Rates Have Increased

High yield default rates increased recently, but they remain below the 20-year average of 4.5%, as shown in Exhibit 6. The uptick has been concentrated in the energy and metals & mining industries. The commodity-sensitive sectors may continue to struggle due to low commodity prices, but the credit metrics of the greater high yield universe remain solid. Additionally, high yield companies may extend debt maturity schedules by issuing new low-rate bonds that should support a low level of default rates.

Exhibit 6: High Yield Defaults Are Forecasted to Rise Slightly



Data source: "March Default Report," Moody's Investors Service, April 8, 2016. Past performance is no guarantee of future results.

What Does This Mean for Investors?

We do not believe the credit cycle is over, but we recognize that we are in the late stage of the expansion phase. There is still time to take advantage of additional yield in the credit sectors. However, it is important to avoid market areas in a later stage of the cycle that are more susceptible to widening spreads and higher default rates. Active management with professional credit research may help investors avoid pitfalls and generate a diversified source of income. ■

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

DEFINITIONS

Barclays U.S. Corporate High Yield Index measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if they fall within the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes emerging market debt.

The **JPMorgan U.S. Liquid Index** provides performance comparisons and valuation metrics across a carefully defined universe of investment grade corporate bonds, tracking individual issuers, sectors and sub-sectors by their various ratings and maturities.

One **basis point** equals .01%, or 100 basis points equal 1%.

The **interest coverage ratio** is a debt ratio and profitability ratio used to determine how easily a company can pay interest on outstanding debt.

RISKS AND OTHER IMPORTANT CONSIDERATIONS

This information represents the opinion of Nuveen Asset Management, LLC and is not intended to be a forecast of future events and this is no guarantee of any future result. It is not intended to provide specific advice and should not be considered investment advice of any kind. Information was obtained from third party sources which we believe to be reliable but are not guaranteed as to their accuracy or completeness. This report contains no recommendations to buy or sell specific securities or investment products. All investments carry a certain degree of risk, including possible loss principal and there is no assurance that an investment will provide positive performance over any period of time. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

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