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Global Investment Committee Outlook
2Q | 2020 UPDATE

Five portfolio construction themes
for—and after—the global pandemic

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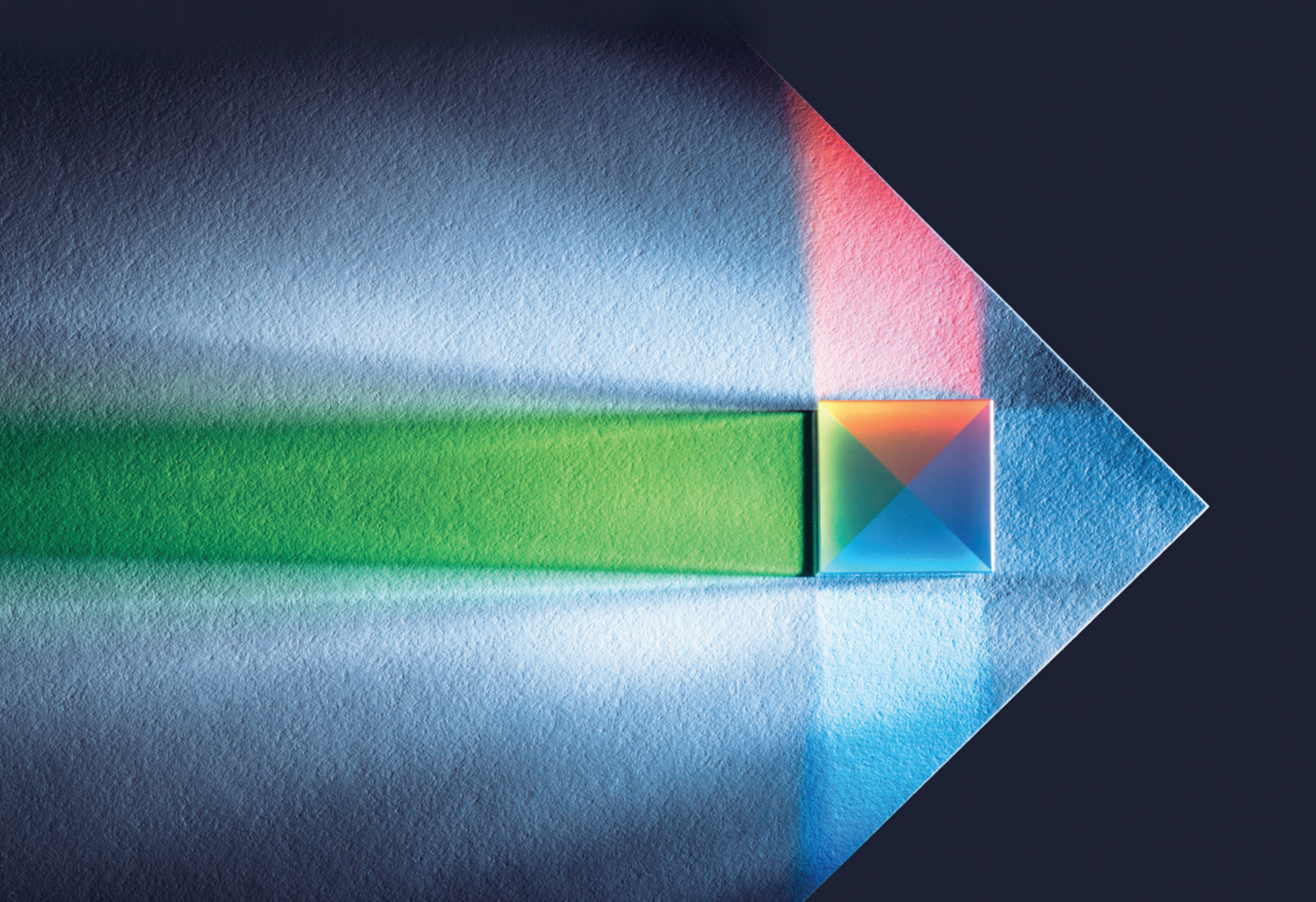

At the end of 2019, we titled our year-ahead outlook, "20/20 vision: a clearer path for growth." That was then. Markets have since been thrown into turmoil, and investors are grappling with positioning their portfolios to minimize the damage from the coronavirus-induced crisis and take advantage of an eventual recovery. To help our clients continue on their long-term investment journeys, Nuveen's Global Investment Committee and our Multi-Asset Investment Team offer perspective about where we are, suggest five portfolio construction themes and provide thoughts about where we might be heading.

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Setting the stage

As of this writing, the world appears to be emerging from the worst of the financial market crisis, if not the worst of the global health crisis. In mid-March, short-term credit and municipal bond markets were effectively broken, but subsequent fiscal stimulus and aggressive intervention by central banks helped markets return to relative normal. Volatility will likely remain elevated for some time, albeit lower than in March, but financial markets seem to be moving out of emergency crisis mode.

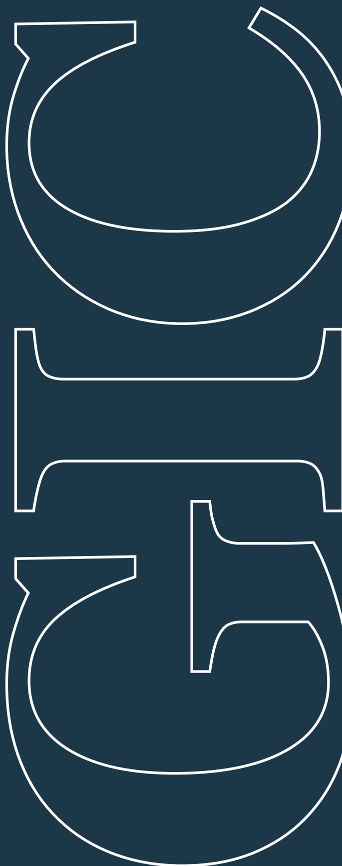
The economic outlook is murky: The depth of the coronavirus crisis itself and the related countermeasures will determine the severity and duration of this downturn, while the extent of the economic damage and policy response will determine the shape and trajectory of the recovery. So far, the bad news has not really been reflected in the economic data. Figure 1 suggests we're in for a rash of bad news, even with expectations already lowered.

At this point, a "V-shaped" recovery — in which consumer demand and other economic activity quickly spike to pre-crisis levels — is too much to hope for, mainly because the downturn has been virtually instantaneous, and the recovery will not be. But there is still reason to hope for a relatively rapid recovery beginning in the second half of this year. Meantime, this is a tough environment to structure portfolios.

Figure 1 — The bad news is only starting to trickle in

Source: Bloomberg. Jan 2017 to Apr 2020. The Citi Global Economic Surprise Index measures the pace at which economic indicators are coming in ahead of or below consensus forecasts.

Portfolio construction themes



THEME 1:

Stay invested and rebalance portfolios

As long as investors and institutions can meet their immediate-term funding, spending and liquidity needs, this is a time to stay fully invested, though holding some cash for opportunistic buying also makes sense.

This leads to the topic of portfolio rebalancing. Many advisors and individual investors rebalance on a quarterly basis, and institutional investors often use a 5% deviation from targets as a trigger. (It's hard to imagine that there are many investors who didn't hit such a trigger since the start of the year.) A rebalancing strategy should be an integral part of every long-term plan or Investment Policy Statement, and we think investors should stick to their plans.

Taking it a step further, investors should think about additional rebalancing considerations. The first is liquidity. At the height of the crisis, market liquidity appeared potentially insufficient to allow for rebalancing trades, but that is no longer the case. We are, however, seeing some investors rebalance in stages rather than all at once, which makes sense. Second, in addition to changes in valuations between asset classes, we have also seen shifts between relative risk expectations. We think both factors need to be considered when constructing and rebalancing portfolios. And third, long-term illiquid investments are priced with a lag, so using public market proxies can only help so much to determine current values for these assets.

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THEME 2:

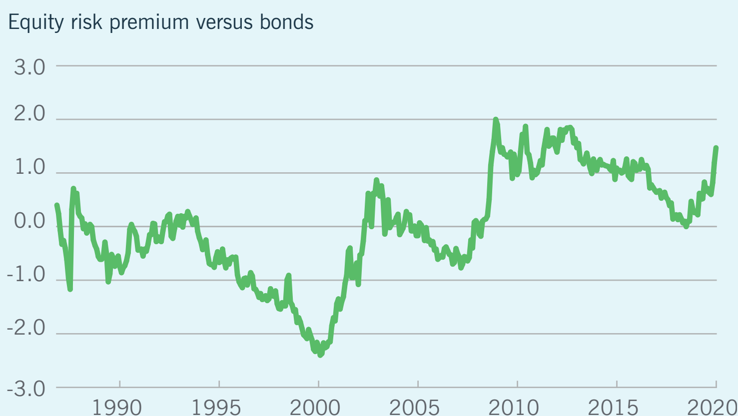
Focus on relative value between and within asset classes

Our first theme leads to some broad asset class considerations. Looking at the relative value between stocks and bonds, the chief risk for stocks would be a further plunge in earnings expectations (and actual earnings) coupled with a rise in defaults and bankruptcies from revenues drying up through the summer. But even if current earnings estimates are much too high, we think stocks still look cheap relative to the bond market, as shown in Figure 2.

From a broad portfolio perspective, at the start of the year, we were focused on relatively defensive positioning — not because of coronavirus risks, but because of rich valuations and low growth expectations. Valuations are most useful for estimating returns over long periods of time (five years or more) and at this point, they suggest that investors should expect unusually strong returns on equities compared to fixed income over the balance of the decade. That said, we don't think it makes sense to dramatically ramp up risk just yet. However, as Theme 4 suggests, we are seeing tactical opportunities.

Within equity markets, we are focusing on companies with strong balance sheets and low debt levels that trade at reasonable prices. We also have a bias toward companies that have high levels of free cash flow. Over the longer term, we favor growth over value, but we think value styles are overly depressed right now and could be due for a bounce. Geographically, we prefer U.S. stocks over other developed markets and think select emerging markets look compelling, especially given our outlook for a falling dollar. Our fixed income positioning is also more defensive: We suggest a focus on higher quality and see opportunities in highly rated areas where yields are incorporating a considerable illiquidity premium, such as TIPS, mortgage-backed securities and investment grade bonds. We also think non-energy-related emerging markets debt investments look compelling. And opportunities continue in municipal bonds, where fundamentals appear stable despite huge price drops and record outflows in recent weeks. Additionally, the muni market is now receiving direct support from the Federal Reserve and the CARES Act.

Figure 2 — Stocks haven't looked this attractive relative to bonds since 2012



Source: Bloomberg, Nuveen. Jan 1987 to Mar 2020. **Past performance is no guarantee of future results.** Equity risk premium calculated using the cyclically adjusted price-to-earnings ratio of the S&P 500 Index minus the Bloomberg Barclays Aggregate Bond Index. Equity risk premium refers to the excess return investing in stocks has provided over bonds. As bond yields fall, that premium tends to grow.

Within real estate, we continue to focus on quality and defensive positioning, favoring properties located in growing cities that are technologically advanced and sustainable, and driven by attractive demographic trends such as younger, educated populations. We think areas of retail could struggle for now and remain cautious on offices. Most forms of housing still present opportunities, including senior living, as well as health care, logistics and infrastructure facilities. Public and private real assets are being helped by lower interest rates, and opportunities in infrastructure investments include data centers that offer high relative income and relatively modest downside risk. We also think a focus on such essential areas such as agriculture (especially sustainable agriculture) makes sense in today's environment: Crisis or calm, the world must eat.

Finally, it's worth mentioning cash holdings. As we said in our first theme, this is not a time to sell indiscriminately, but cash and cash equivalents always have a role in a portfolio. Maintaining liquidity to meet ongoing needs is important, as is holding reserves for new opportunities.

THEME 3:

Take on more illiquidity risk

Most investors are under-allocated to alternatives in general and illiquid investments in particular. We think long-term investments in private equity and private credit, as well as private real assets such as farmland and agriculture, can play a role in most portfolios, particularly during times of market turmoil.

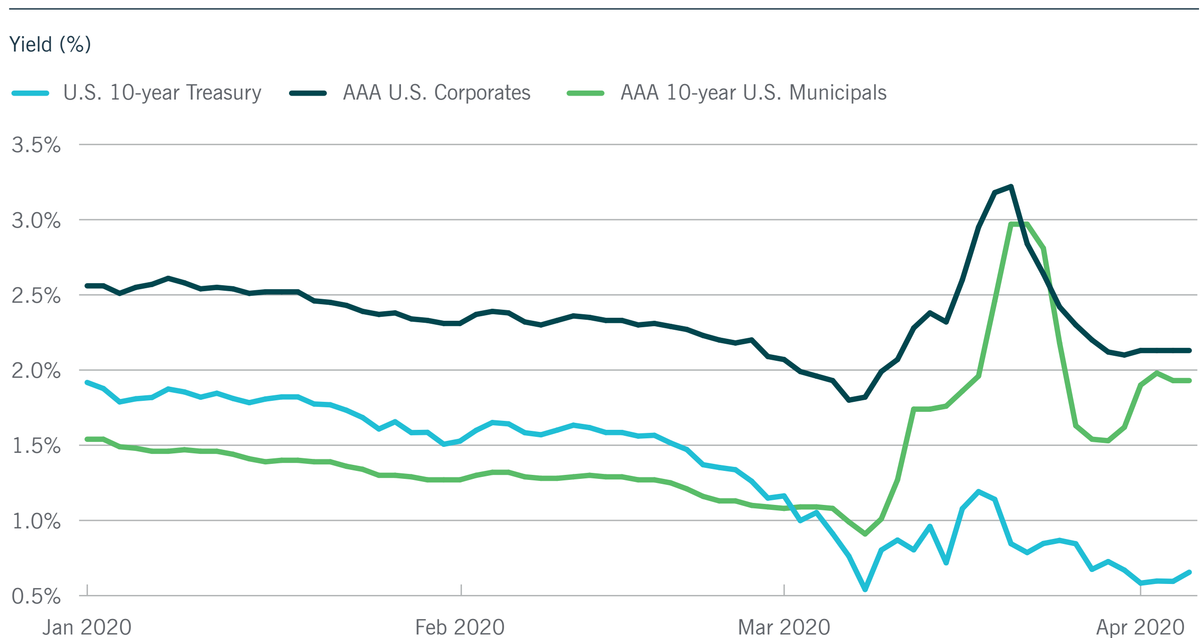
As with most of our investment positioning, we think an overall defensive stance in private investments makes sense. For example, we're seeing better value in private credit spaces such as health care and technology, and would avoid industries that rely on commodities and heavy cyclicals.

Even in public markets, liquidity considerations are important. Lack of liquidity is still suppressing prices in some credit markets, as our comments around fixed income in Theme 2 suggest. That illiquidity premium has allowed some areas of the fixed income markets (including investment grade corporates, securitized assets, TIPS and municipal bonds — see Figure 3) to offer compelling yield opportunities without adding significant credit risk to a portfolio.

Choosing illiquid investments can be especially tricky, as investors must consider such factors as frequency of pricing and how different investments work within an overall portfolio. It is important that investors understand their illiquidity tolerance, ensuring that investment time horizons match their need for capital.

Choosing entry points is also critical. We're concerned about compressed liquidity premiums in some areas of private credit and private equity, but also think long-term investors can find opportunities to enter these investments at distressed prices. Additionally, there are massive differences between sectors and among investments, making selectivity paramount.

Figure 3 — Some high-quality bonds are trading with deep liquidity discounts



Source: Bloomberg. 01 Jan 2020 to 06 Apr 2020. **Past performance is no guarantee of future results.** Representative yields: **U.S. 10-year Treasury yield; AAA U.S. Corporates:** Bloomberg Barclays AAA Corporate Index; **AAA 10-year U.S. Municipals:** Municipal Market Advisors AAA General Obligation 10-year yields. Indexes are unavailable for direct investment.

THEME 4:

Selectively take on risk in anticipation of recovery

Across global financial markets, we expect continued near-term stress and selloffs. But value is also being created across and within financial markets, especially in hard-hit areas.

For investors with very long time horizons and, more importantly, very high short-term risk tolerances, it could make sense to make heavier moves into cyclical stocks, consumer-related sectors in equities, lower-quality credit, real estate and real assets and higher-yielding municipal bonds.

Tread carefully, however. Making these moves requires extreme care, diligent research and a high degree of selectivity.

Investment moves today require extreme care, diligent research and selectivity."

THEME 5:

Stick with long-term plans and investment objectives

In addition to staying invested, we are discouraging clients from changing their long-term investment approaches unless their goals have changed. No one can yet anticipate the full impact of the COVID-19 pandemic, and it's equally difficult to predict near-term market movements.

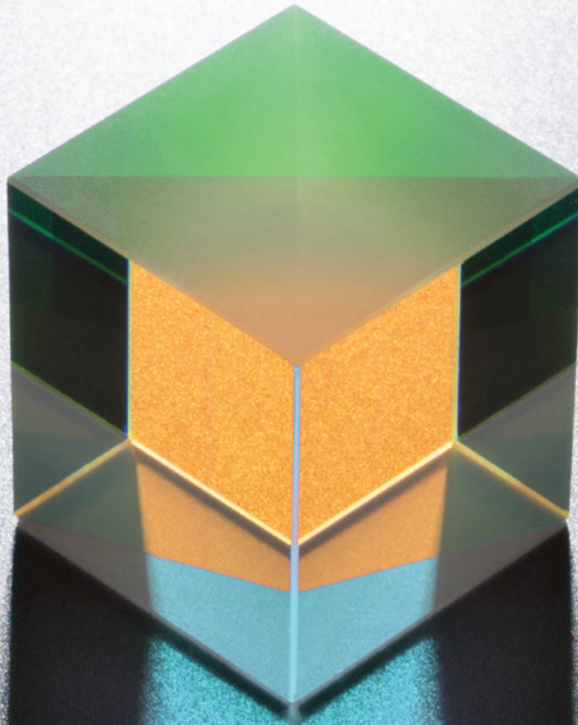
This same uncertainty makes it impossible to time the eventual recovery, so we don't advise trying to exit and reenter stocks or other risk assets to avoid the turmoil. Instead, investors should stay focused on their long-term goals: Stick with rebalancing plans, review asset-allocation strategies and confirm that investments match liability or spending needs.

This is also an opportune time for investors to re-evaluate long-term plans to ensure they understand the risks. We advise investors to assess and adjust their risk exposures on an ongoing basis — including traditional sources of risk such as credit, rates and equity exposure, as well as momentum analysis and style drift.

Objectives also matter. Investors focused primarily on income, for example, may want to consider nontraditional sources of yield, meaning different fixed income sectors as well as real estate, private assets and private credit. Those focused on long-term growth should review their near-term risk tolerance and determine areas of relative value. And for those investors with ultra-long-term (or even infinite) time horizons such as an insurance company general account, we think it is important to continue modeling possible losses while maintaining risk appetites: Today, this could mean looking at select opportunities to take advantage of wider credit spreads in such areas as leveraged loans, municipal bonds, structured assets and possibly even private equity.

We also think it's important for investors to consider issues such as currency exposure and home-country bias. Australian investors with a neutral weight toward Australian equities, for example, could be overexposed to commodities and trade risks. And non-U.S. investors in general may be facing elevated currency risks, which could require reallocating or currency hedging strategies.

Finally, consider the advantages of active management — both in asset allocation and security selection. In all cases, current opportunities are idiosyncratic and fast moving, which speaks to the importance of selectivity, research, nimbleness and confidence.



Investing for the future:
key considerations

Volatility will remain elevated.

Market returns will be less correlated across and within asset classes.

Now is the time for experienced research, careful selectivity and active management.

Looking ahead: *factors to watch*

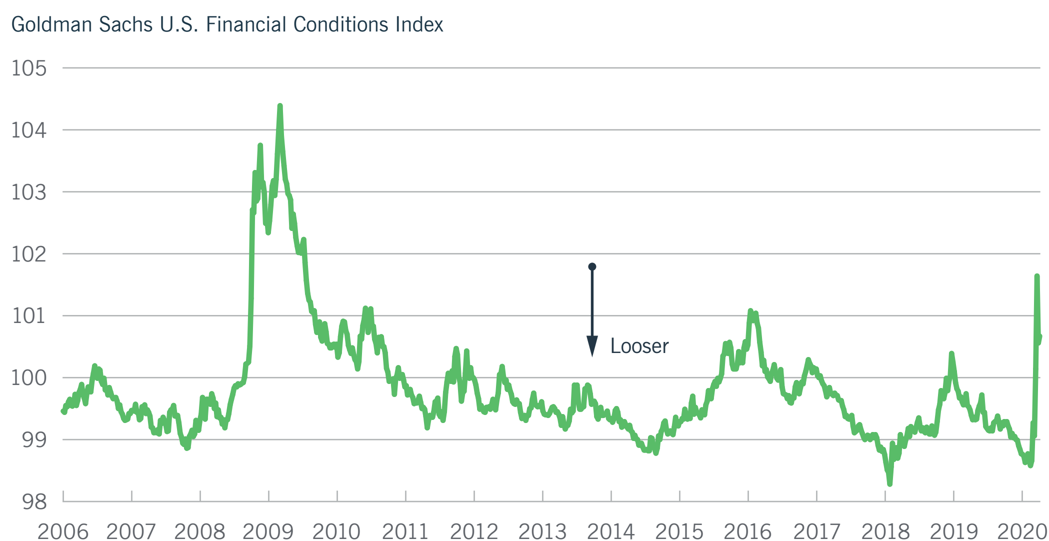
We expect volatility to persist in the near term, and it would be inappropriate to guess at a market bottom. But we are watching for important signs of a market shift. A plateau in new COVID-19 cases in the world's largest developed economies will allow us to better assess supply and demand shocks and provide more clarity on the corporate earnings outlook. There is a risk, however, that we could see a resurgence in the virus during the next flu season.

We're also watching the economic data from countries that have more successfully contained the virus, with particular focus on signs of stability emerging from China. In the U.S., we're keeping a close eye on weekly initial jobless claims and how quickly small business loans are being put into effect to help stabilize the labor market.

In our view, the chief risk of this recession is not its depth, but its length; economic policy is currently not sufficient to help the global economy through more than a few months of shutdown. At some point, U.S. and other governments will likely provide even more aid directly to both households and businesses, which would be a positive for the global economy and financial markets.

From a technical markets perspective, we're also looking for receding market volatility, narrowing credit spreads and declining market correlations. All of these factors would signal improving financial conditions. As Figure 4 shows, market conditions are a bit looser than they were in mid-March, but they remain historically tight.

Figure 4 — Central banks should prevent financial conditions from tightening too much



Source: Bloomberg. Jan 2006 to Apr 2020. The Goldman Sachs U.S. Financial Conditions Index measures market conditions across money markets, bond markets and equity markets. The scores compare current market conditions to the historical average, with higher numbers indicating tighter financial conditions.

Beyond the near term: *how the world might change*

We are living in unprecedented times. Never before outside of wartime have so many governments, businesses and individuals radically changed their daily behaviors. We have also seen unprecedented liquidity shocks, rapid market movements and unparalleled central bank and government responses. All of these events will have unpredictable and far-reaching effects.

Determining what the world will look like a year from now is tricky. After all, one year ago no one was forecasting anything close to what we're living through today. But we can make some estimations and guesses, especially when it comes to how these changes might affect financial markets.

First, certain areas of the global economy will be slower to recover than others. Even after some businesses start to reopen, we will likely see a reduction in global trade, travel, large gatherings and live sports and other events for some time. Leisure spending as a whole will probably take time to recover.

Conversely, other areas of the economy may see benefits. Some people who turned to online delivery services out of necessity will stick with those decisions. And emergency procedures such as drive-through medical screening clinics may have staying power.

More broadly, the global policy landscape will be forever changed. The massive degree of stimulus must be paid for. The world has effectively borrowed from future growth — admittedly at very low interest rates — to salvage today's economy. This has been largely unavoidable and was probably the right short-term call, but not every country can shoulder a much larger debt load without increased risk of default or a long-term drag on growth. At some point, we'll also need to focus on whether the increase in monetary supply could cause higher inflation — although that's not a near-term concern.

All of these trends speak to the importance of active management to help investors lean into those industries, sectors, geographies and asset classes that could see relative benefits and avoid areas that could experience a semi-permanent impairment.

One thing we're convinced that won't change? The need for advice, partnership and planning when it comes to investing.

Stay safe out there.

One thing that won't change? *The need for advice, partnership and planning.*

About Nuveen’s Global Investment Committee

Nuveen’s Global Investment Committee (GIC) brings together the most senior investors from across our platform of core and specialist capabilities, including all public and private markets. Quarterly meetings of the GIC lead to the creation of published outlooks that offer 1) macro and asset class views where there is consensus among our investors 2) insights from thematic “deep dive” discussions by the GIC and guest experts (markets, risk, geopolitics, demographics, etc.) 3) guidance on how to turn our insights into action via commentary from the Global Investment Committee and Nuveen’s Multi-Asset Investment Team.

For more information, please visit nuveen.com

Endnotes

Sources

All market and economic data from Bloomberg, FactSet and Morningstar.

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Glossary

The **Bloomberg Barclays Global Aggregate Index** is a flagship measure of global investment grade debt from 24 local currency markets. The **S&P 500** is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization. The **Bloomberg Barclays AAA Corporate Index** measured the AAA-rated, fixed-rate, taxable corporate bond market. The **Municipal Market Advisors AAA General Obligation Consensus 10-year yields** are derived from evaluations from seven of the largest municipal underwriting firms of the current level of "AAA" yields based on secondary and primary market transactions.

A word on risk

All investments carry a certain degree of risk and there is no assurance that an investment will provide positive performance over any period of time. Equity investing involves risk. Investments are also subject to political, currency and regulatory risks. These risks may be magnified in emerging markets. Diversification is a technique to help reduce risk. There is no guarantee that diversification will protect against a loss of income. Investing in municipal bonds involves risks such as interest rate risk, credit risk and market risk, including the possible loss of principal. The value of the portfolio will fluctuate based on the value of the underlying securities. There are special risks associated with investments in high yield bonds, hedging activities and the potential use of leverage. Portfolios that include lower rated municipal bonds, commonly referred to as "high yield" or "junk" bonds, which are considered to be speculative, the credit and investment risk is heightened for the portfolio. Credit ratings are subject to change. AAA, AA, A, and BBB are investment grade ratings; BB, B, CCC/CC/C and D are below-investment grade ratings. As an asset class, real assets are less developed, more illiquid, and less transparent compared to traditional asset classes. Investments will be subject to risks generally associated with the ownership of real estate-related assets and foreign investing, including changes in economic conditions, currency values, environmental risks, the cost of and ability to obtain insurance, and risks related to leasing of properties. Socially Responsible Investments are subject to Social Criteria Risk, namely the risk that because social criteria exclude securities of certain issuers for non-financial reasons, investors may forgo some market opportunities available to those that don't use these criteria. Investors should be aware that alternative investments including private equity and private debt are speculative, subject to substantial risks including the risks associated with limited liquidity, the use of leverage, short sales and concentrated investments and may involve complex tax structures and investment strategies. Alternative investments may be illiquid, there may be no liquid secondary market or ready purchasers for such securities, they may not be required to provide periodic pricing or valuation information to investors, there may be delays in distributing tax information to investors, they are not subject to the same regulatory requirements as other types of pooled investment vehicles, and they may be subject to high fees and expenses, which will reduce profits. Alternative investments are not suitable for all investors and should not constitute an entire investment program. Investors may lose all or substantially all of the capital invested. The historical returns achieved by alternative asset vehicles is not a prediction of future performance or a guarantee of future results, and there can be no assurance that comparable returns will be achieved by any strategy.

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