The Fed's shadow continues to loom large

BRIAN NICK, CAIA, CHIEF INVESTMENT STRATEGIST

The last week's market highlights:

- Financial markets continue to be rattled by data indicating that monetary policy may need to tighten further to slow economic growth and inflation. U.S. equities and fixed income ended the week with broad-based declines.[1]
- In January, core inflation registered its largest month-over-month increase (+0.6%) since June, driven by surging personal income and spending.[2] Warmer weather and a large adjustment to Social Security payments likely contributed to the upswing.
- Minutes from the Fed's February meeting, released on Wednesday, showed "almost all" officials agreed it was appropriate to raise interest rates by 25 basis points, while "a few" favored or could have supported a 50 basis-point hike. These comments reinforced the market's impression of the Fed's near-term plans. Since the start of February, traders have priced in an additional 36 basis points of tightening by June.[3]
- In the eurozone, core inflation edged up in January, while service-sector and manufacturing activity reached a nine-month high in February.[4] Against that robust backdrop, the euro continued its recent run-up versus the U.S. dollar. Inflation is also increasing in Japan, where core consumer inflation hit 3.2% year-over-year, the fastest rate since 1990.[5] The country's central bank, the Bank of Japan, which has thus far refrained from raising interest rates, may soon be forced to rethink its dovish policies.
- This week, we'll be treated to business confidence surveys from several major economies, including the U.S., the U.K., Japan, and Germany. All are expected to show continued strengthening of economic activity. In the U.S., we'll also receive a variety of data on home prices, which have begun to fall modestly but may be supported by solid demand and a lack of new single-unit home construction.

Each week, we present our featured topics in the context of the major themes from Nuveen's most recent **global investment outlook**:

- **U.S. economy:** Inflation risks may be fading, while the labor market remains strong.
- **Global economy:** Still nursing a hangover from the post-pandemic binge, hampered further by higher borrowing costs and diminished savings.
- **Policy watch:** Central banks worldwide have fixated on inflation fighting at the expense of economic growth.
- **Fixed income:** Modestly extend duration and focus on higher-quality areas of the bond market.
- **Equities:** Favor U.S. stocks (especially large caps) over non-U.S. developed and emerging market shares, as they offer better opportunities for both defensive positioning and growth.
- **Asset allocation:** Diversification benefits remain elusive, but fixed income continues to be valued more attractively than equities.

Quote of the week:

"February is merely as long as is needed to pass the time until March." – J.R. Stockton

Is the 60/40 portfolio back? Maybe.

A longstanding "all weather" asset allocation strategy — the 60/40 portfolio — is catching some heat.

This simple model, which involves allocating 60% of a portfolio to U.S. stocks and 40% to U.S. investment grade bonds, was developed in 1952 by Nobel Laureate Harry Markowitz. Markowitz proposed that a portfolio should incorporate not only return expectations, but also how the underlying assets move in relation to one another— that is, how closely they're correlated. The "60/40" has served investors well for the better part of 40 years. Stock and bond prices have tended to move in opposite directions during that stretch, so when equities have struggled, bonds have generally delivered positive returns, and vice versa. Overall, this negative correlation has generated healthy risk-adjusted performance.

But then we suffered through 2022. Market focus shifted from post-Covid optimism about the economy to fears over surging inflation, which lifted interest rates and battered bonds. (Bond yields and prices move in opposite directions.) Meanwhile, the Federal Reserve's aggressive series of rate hikes designed to quell inflation triggered recession fears, stifling stocks. Against that unsettling backdrop, a 60/40 portfolio fell 16%, with U.S. equities, as represented by the S&P 500 Index, dropping 18.1%, while the Bloomberg Barclays U.S. Aggregate Bond Index, a proxy for the broad U.S. investment grade bond market, lost 13%.[6]

That marked the 60/40's worst annual result since 2008, when it plunged 22.1% amid the global financial crisis.[7] Despite that dreadful downturn, the portfolio actually performed "as advertised" — steep equity losses were tempered by bond market gains.

And for the most part, that's what *didn't* take place last year. To illustrate, both stock and bond prices fell in the same month seven times. During three other months, they moved up together. In November, for example, U.S. equities (+5.6%) and high-quality fixed income (+3.7%) rallied on hopes the Federal Reserve would achieve its goal of a soft economic landing — lowering inflation through policy tightening but averting a recession.[8]

Positive correlations have largely continued this year despite changing investor sentiment. In January, renewed optimism over a soft landing led to bullish results for stocks and bonds. This month, unexpectedly strong job, retail sales and inflation releases have rekindled concerns of an overheating economy, and with it, the greater likelihood of a no-landing scenario in which the Fed raises interest rates longer than traders or central bankers had previously anticipated. As one might expect, a hot economy with Fed fears back on the top of the agenda is no friend to either segment of a 60/40 portfolio.

Small wonder, then, that headlines have heralded the demise of the 60/40's long-time diversification benefits. Can we offer assurance that stocks and bonds will begin moving in opposite directions anytime soon? No, but that doesn't mean we believe investors should abandon building a balanced portfolio.

The conditions that fueled last year's poor performance are by no means the new baseline for what we expect going forward. Markets are unlikely to be rattled by a combination of white-hot inflation and aggressive Fed rate hikes, exacerbated by a geopolitical shock (i.e., the war in

Ukraine), similar to what they encountered last year. In our view, building a diversified portfolio, set appropriately for one’s goals and time frames, is still a winning strategy.

Sources:

1. Bloomberg (via Nuveen), Marketwatch
2. Bloomberg
3. Bloomberg
4. Markit/S&P
5. Bloomberg
6. Bloomberg, FactSet
7. Bloomberg
8. Bloomberg

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