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Peak growth and inflation remain center stage

Global equities were mostly lower last week, with the notable exception being emerging markets, which added 1.7% thanks in large part to a positive surprise from Chinese exports. The DJIA, S&P 500 and tech-heavy Nasdaq lost 0.5%, 1.0% and 1.9% (respectively) on concerns over slowing growth, while the MSCI EAFE fell 0.5%.

KEY POINTS

- **Though we expect inflation to decline, future targets may “normalize” above pre-pandemic levels.**
- **Volatility will remain elevated as investors digest peak earnings growth, the COVID-19 delta variant, high valuations and yield curve fluctuations.**
- **Economic growth may be peaking, but it should remain solid through year-end, thanks in part to historically low rates.**
- **Do not let recent factor outperformance influence long-term investment decisions, as quick shifts between growth and value are likely to continue.**



Saira Malik, CFA
CIO of Nuveen Equities

Saira Malik oversees the equities strategic direction for Nuveen as chair of the Equities Investment Council (EIC) and a member of Nuveen’s Global Investment Committee (GIC). She has responsibility for equity portfolio management, equity research, equity trading, target date, quantitative and index strategies, as well as portfolio management responsibilities for global equity strategies.

Market drivers & risks

- **Inflation continues to run hot.** Last Tuesday's CPI data revealed persistently elevated levels of inflation, calling into question whether the Federal Reserve can continue to take its dovish, "transitory" stance.
 - Fed Chair Jerome Powell insists recent inflation data will not provoke policy changes, but markets remain skeptical. We are not expecting inflation to derail this equity bull market, as raw material costs are falling and only a few CPI components (airfare, energy, used cars) are having an outsized impact. While some of these elements are expected to subside, other inflationary pressures such as wage growth may become more permanent. As a result, we favor companies with enough pricing power to offset these inflationary pressures and preserve margins.
- **Markets are still worried about growth rates** and whether they are peaking or could become stymied by the COVID-19 delta variant. Bond markets also continue to flash warning signs, with the 10-year U.S. Treasury yield breaking below a key support level and hitting 1.29% last week.
 - We believe this to be an overreaction, as the last time the 10-year Treasury saw these levels was in February, when economies were still closed and only 5% of Americans were vaccinated. Equity markets should be buoyed by above-average economic growth into 2022, rising vaccination levels, consumer strength, easing supply disruptions, decreasing unemployment and increased capital expenditure.
- **Global exposure leading to greater earnings growth?** According to FactSet, S&P 500 constituents that derive more than 50% of sales from outside the U.S. have a blended earnings growth rate of 87% in the second quarter, substantially higher than the 62% rate for those with international sales exposure of less than 50%.



The next few months could remain challenging for investors, as continued high volatility and possible near-term market selloffs are likely.”

- This data supports our overall thesis for non-U.S. equity markets to outperform in the second half of 2021 as the baton of asynchronous global growth is passed from the U.S. to other countries and regions. Europe and select emerging markets countries continue to look attractive, as vaccination rates improve and valuations remain attractive, relative to the U.S. and to their own history.

Highlights from last week

- Eight of the eleven GICS sectors were lower for the week as investors continued to grapple with COVID-19 delta variant headlines, as well as concerns over peaking growth. Defensive and bond-proxy sectors fared the best, as utilities (+2.6%), consumer staples (+1.3%) and real estate (+0.7%) were the only sectors with positive returns. Large caps outpaced small caps by a large margin, while growth fared only slightly better than value after alternating sessions of outperformance.
- A path to federal infrastructure spending became clearer last week as Senate Democrats approved a \$3.5 trillion budget resolution. This resolution could ultimately be used to fund the “soft infrastructure” plan, separate from the \$1.2 trillion bipartisan “hard infrastructure” bill currently being negotiated. We still expect some level of infrastructure stimulus to be passed this year, which should continue to support economic growth.

Risks to our outlook

Economic forecasting remains a challenge, and with decelerating growth taking center stage, we suspect equity markets may react poorly to economic data that miss consensus expectations.

We will be keeping an eye on the spread of the COVID-19 delta variant, as any sign of diminishing vaccine effectiveness would likely cause significant volatility in global equity markets.

With rate hikes likely still far in the future, a flattening yield curve could hinder those industries that are more sensitive to interest rate momentum, such as financials, which benefited from sharp yield increases in the first half of 2021.

Any disruptions in the legislative process toward infrastructure stimulus could spark additional bouts of volatility.

In focus

'Banking' on European recovery and growth

The financials sector has been one of the best performing this year, returning 25%, thanks to rising rates and impeccable balance sheets. Earnings growth expectations for financials topped 115% year-over-year, driven by U.S. banks whose rate topped 300%. Although this extraordinary figure includes one-time reserve releases, these actions build capital that allow banks to grow or return capital to shareholders.

We currently view U.S. banks as fairly valued, with share prices seeming to account for a stronger economy, a solid operating environment and a steepening yield curve. However, optimism is waning of late and the 10-year Treasury yield has fallen from 1.7% in March to 1.3% lately. That leaves bank valuations around 5% above their prior peak in February 2018, when the 10-year yield was 2.7%. Though we expect fundamentals to improve and meet these price levels over time, near-term trends look challenging.

With this in mind, we reiterate our expectation for outperformance by non-U.S. stocks, including European banks, through the rest of 2021. Banks in Europe are accustomed to operating in a negative rate environment, so they are less likely to face significant headwinds from low yields. Additionally, given more attractive valuations and expectations for higher capital returns, sentiment for European banks could improve dramatically as Europe reopens.



Best ideas

We see opportunities in developed non-U.S. markets, particularly in Europe, which appears relatively inexpensive and should benefit from improved vaccination rates, solid earnings growth and a more cyclically oriented economy. In the U.S., reflation and expectations for higher yields could bolster returns for small caps, while select industrial companies should benefit from still-improving economic growth. We are also bullish on emerging markets, specifically Brazil and areas such as China's lodging and gaming sectors, which stand to benefit from easing travel restrictions.

About the Equities Investment Council:

The Nuveen Equities Investment Council (EIC) includes the firm's senior equity portfolio managers, averaging three decades of investing experience. The EIC brings global expertise across different styles of equity investing and provides value-added insights to Nuveen's investment process by refining and delivering the firm's collective equity market outlook, including key risks and drivers, to clients. Led by Saira Malik, CIO & Head of Equities, the team shares best global equities ideas, while focusing on individual areas of expertise to help generate alpha.

For more information or to subscribe, please visit nuveen.com.

Sources

All market data from Bloomberg, Morningstar and FactSet.

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