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Weekly Equities Commentary

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Volatility rises over "peak earnings growth" concerns

Performance was bifurcated in global equity markets last week. Major U.S. indexes rebounded on Friday, locking in gains, while non-U.S. markets were broadly lower. The DJIA, S&P 500 and tech-heavy Nasdaq all closed at record highs on Friday, while the MSCI EAFE, EM, and ACWI ex-USA fell 0.1%, 2.6% and 0.9%, respectively.

KEY POINTS

- **The COVID-19 pandemic remains the driving force of volatility, especially as we see how vaccines and variants play out.**
- **Although the economic expansion is decelerating, the U.S. remains in recovery mode. Economic data will likely become more mixed.**
- **We expect earnings growth to peak in the second quarter reporting season, making security selection increasingly critical as growth rates decline.**
- **Investors remain focused on Fed tapering, but the central bank does not appear ready to shift policy.**

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

- **Growth is decelerating, not disappearing.** Equity market volatility during the holiday-shortened week was largely driven by the narrative of peaking growth and inflation concerns.
  - Equity markets are having a hard time pricing in positive but decelerating growth. For its part, the bond market rallied, driving the 10-year Treasury yield below 1.30% for the first time since February. This led growth and defensive stocks to outperform. However, U.S. stocks recovered on the final trading day of the week and recaptured record highs on Friday.
- **COVID-19 is not disappearing, either.** The spread of the delta variant of COVID-19, now the most prevalent strain in the U.S., also contributed to volatility.
  - Investor confusion over the state of the pandemic is understandable. Pfizer's announcement of its intention to develop a delta-variant vaccine booster coincided with a CDC report stating there was no need for such a booster at this time.
  - The bottom line for us is that although headlines are always a source of volatility, we do not expect the delta variant to derail the recovery in the U.S. thanks to existing vaccination levels. We may see delayed recoveries in regions where vaccination rates lag.
- **China toughens trade regulations.** The Chinese government grew more aggressive in its regulation of U.S.-listed tech companies last week, leading to further weakness for the Chinese tech sector. Notably, China ordered the ride-sharing service Didi to remove its app for download days after its IPO in the U.S.
  - The fight for digital global superiority between the U.S. and China is here to stay. As a result, Chinese internet stocks will likely remain under pressure. This will likely lead to greater government support for these companies, as well as increased regulation as the sector grows.
  - With the U.S. pushing back on Chinese ADRs, non-U.S. indexes such as Hong Kong's Hang Seng could benefit.

"The shifting economic and earnings environment should make bottom-up security selection critically important in the coming quarters."

Highlights from last week

- Eight of the eleven S&P 500 sectors were positive for the week. Yields fell rapidly, leading to a 2.7% gain for the real estate sector, while financials returned -0.6%. Consumer discretionary (+1.5%) and utilities (+1.0%) rounded out the winners, as communication services fell 0.3% and energy lost 3.4% despite crude oil prices hitting a 3-year high.
- Equity market flows show the reflation trade coming under pressure as growth continues to outperform. Banks and materials saw their biggest three-week outflows since March 2020, as U.S. value and small cap companies experienced their third consecutive week of outflows.

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 delta variant, as any sign of diminishing vaccine effectiveness would likely cause significant volatility in global equity markets.

With rate hikes still likely 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.

The infrastructure agreement is an optimistic sign, but any disruptions in the legislative process could spark additional bouts of volatility.

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.

In focus

Growth may peak, but not fall off a cliff

Consensus estimates call for second quarter earnings growth of 65%, up from the projected 52% at the end of March. With some economic data no longer exceeding or even meeting expectations (such as the ISM Services Purchasing Managers Index for June, released last week), we suspect second quarter earnings reports will hold fewer upside surprises, and that the actual earnings growth rate may come in closer to 60%.

Regardless, earnings growth between 60% and 65% would be the largest year-over-year increase since the quarters immediately following the Global Financial Crisis in 2009. And with the S&P 500's current P/E multiple sitting approximately 18% above its five-year average, this level of earnings expansion should help ease concerns about lofty valuations.

Going forward, however, the benefits of the rising tide of the economic recovery lifting all boats are likely to wane. That means it will be imperative to focus on how individual companies are filling employment gaps, dealing with supply shortages and increasing productivity. The theme of "peak growth" has recently brought with it some volatility in equity markets, but investors should not be preparing for an end to the current growth cycle. We expect economic progress to continue – especially when considering the impact of eventually filling nine million U.S. job openings and the sequential global recovery that is still in its early stages.

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.

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Sources

All market data from Bloomberg, Morningstar and FactSet.

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