

CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

Small stands tall in the face of inflation

Bottom line up top

Global investment performance continues to be driven by a familiar set of thematic drivers: tight labor markets, stronger-than-expected wage growth, sticky inflation, restrictive monetary policy, economic resilience (or not) and fraught geopolitics, to name a few. With each new data point or headline, many investors find themselves attempting to adjust their portfolios based on their best guess at which pithily named outcome is most likely: a “soft landing,” a “hard landing” or — most confusingly — “no landing.”

Making sense of the trends and terminology is like trying to figure out why a coffee shop labels its small serving size “tall” and its medium size “grande” (though of course the financial stakes are far greater when it comes to investment portfolios). But even if accurately predicting the trajectory and magnitude of key economic indicators is, well, a tall order, we know with certainty that higher-for-longer policy rates aimed at squelching inflation have taken a toll on the global economy (Figure 1). What’s more, as the “last mile” of disinflation continues to be run at a tortoise-like pace, we anticipate central bank rate cuts will remain on hold, likely leading to further economic deceleration.

In this environment, equity investors in particular need to stay vigilant and nimble given extremely narrow market leadership and extended valuations, most notably among large cap stocks.



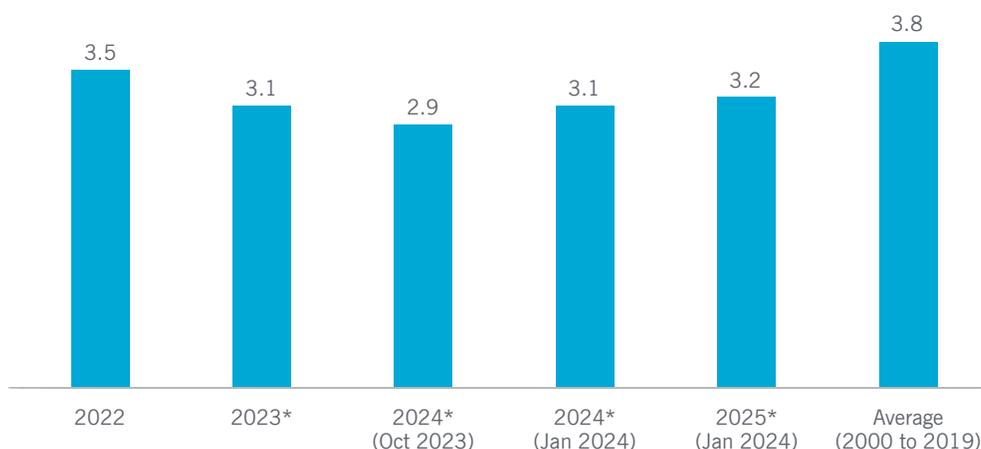
Saira Malik, CFA
Chief Investment Officer

On behalf of Nuveen’s Global Investment Committee

As Nuveen’s CIO and leader of our Global Investment Committee, Saira drives market and investment insights, delivers client asset allocation views and brings together the firm’s most senior investment leaders to deliver our best thinking and actionable investment ideas. In addition, she chairs Nuveen’s Equities Investment Council and is a portfolio manager for several key investment strategies.

FIGURE 1: ELEVATED INTEREST RATES AND INFLATION ARE A DRAG ON THE ECONOMY

IMF global GDP growth forecasts (%)



Data sources: International Monetary Fund as of Jan 2024. *2023 and beyond are IMF forecasts.

The economic outlook remains murky, but inflation and higher interest rates have been causing global growth to slow.

Portfolio considerations

Bigger isn't always better. U.S. small cap equities underperformed their large cap counterparts by nearly 10 percentage points in 2023, causing the forward price-to-earnings (P/E) ratio of the small cap Russell 2000 Index versus the large cap Russell 100 Index to hover near its lowest level since December 2001 (Figure 2). With large caps looking quite expensive on this basis, valuations currently favor small caps.

But valuations aren't the only factor to consider when gauging the relative attractiveness of equities. Resilience in the face of sticky inflation is also important. We believe the fundamental characteristics of smaller companies — especially those with pricing power to mitigate the impact of inflation and protect or expand margins — make them a compelling choice for inflation-wary investors.

Selectivity matters as much as size. Of course, not all small cap sectors offer these potential advantages to the same degree, and some are experiencing earnings pressures. We're less constructive on consumer-oriented stocks and prefer high-quality companies exposed to enterprise revenue, a more reliable source of cash flows. The industrials sector, for example, is supported by fiscal policy initiatives such as infrastructure spending and nonresidential construction. Within information technology, areas like software and semiconductors warrant consideration. Software companies in particular are notable for their durable business models and inelastic demand for their products and services.

A small world, after all. With opportunities available around the globe, small cap allocations needn't be limited to U.S. names. Exposure to non-U.S. small caps can enhance portfolio diversification and improve risk-adjusted returns compared to non-U.S. large caps. In fact, in the non-U.S. arena, small caps have outperformed large caps by more than 250 basis points (bps) on an annualized basis since 2001, with only slightly higher volatility. Even with this outperformance, non-U.S. small

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caps remain attractively priced, trading at a 10% valuation discount to their large cap peers. Lastly, research coverage of the non-U.S. small cap universe is relatively low, providing a potential advantage for active management.

Small cap equities in the U.S. and around the world look appealing, but careful selectivity is key.

FIGURE 2: U.S. SMALL CAP VALUATIONS APPEAR COMPELLING



Data source: Factset., Dec 1999 to Dec 2023. Performance data shown represents past performance and does not predict or guarantee future results. Representative indices: **small caps:** Russell 2000 Index; **large caps:** Russell 1000 Index.

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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.

Regular meetings of the GIC lead to published outlooks that offer:

- macro and asset class views that gain consensus among our investors
- insights from thematic “deep dive” discussions by the GIC and guest experts (markets, risk, geopolitics, demographics, etc.)
- guidance on how to turn our insights into action via regular commentary and communications

For more information, please visit nuveen.com.

Endnotes

Sources

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

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