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Optimism waivers despite solid economic news

Most global equity markets declined modestly last week as investors grappled with headlines that alternated between improving economic data and rising global COVID-19 case counts. In the U.S., the S&P 500, DJIA and NASDAQ each fell by less than 0.5%. The same was true for the MSCI EAFE and ACWI ex-US indexes while their emerging market counterpart gained 0.4%, despite the rapidly deteriorating health care situation in India.

HIGHLIGHTS

- **Initial jobless claims fell again last week, coming in at a less-than-expected 547,000.**
- **March's Leading Economic Indicators Survey showed a 1.3% increase from February, nearly double expectations.**
- **Preliminary Markit Manufacturing and Services PMIs reached record highs of 60.6 and 63.1, respectively.**
- **The 10-year Treasury yield declined slightly, ending the week at 1.56%.**



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.

Weekly overview

- *The S&P 500 snapped a four-week win streak as COVID-19 cases continue to rise and policy reform proposals caught investors off-guard. Despite the pause, the reopening trade remained largely intact as small caps beat large caps on progressively positive economic data, though results were mixed in terms of style (i.e. growth vs. value) across the market cap spectrum.*
- *From a sector perspective, real estate (2.0%), health care, (1.8%) and industrials (0.5%) led while energy (-1.7%), consumer discretionary (-1.2%) and utilities (-1.0%) fell the most.*
- *Equity market activity was largely driven by growing pessimism surrounding the COVID-19 crisis. Case counts hit record highs outside the U.S., while U.S. vaccination rates have begun to slow. The White House's capital gains tax reform proposal also took a toll on investor sentiment Thursday.*

Market drivers & risks

- **Markets react to tax.** Broad-based indexes hitting record after record has become almost routine, thanks to unprecedented fiscal stimulus being pumped into the economy. However, last week's proposal from the Biden administration for capital gains tax reform to actually increase already-historic government spending sent a minor shockwave through equity markets.
 - The near-doubling of the current capital gains rate, from 20% to 39.6% (plus a Medicare surtax), would affect only the highest earning investors. Many details are pending, and the final rate will likely be notably lower than the initial proposal in order to capture enough



We see solid long-term investments in value styles and select cyclical areas, as well as compelling opportunities in small caps.”

support in Congress. Ongoing focus on higher taxes will likely create more volatility over the balance of 2021, and could hit the biggest winners of 2020 the hardest (such as momentum styles and companies that prospered during shutdowns. Any potential pullback may be short lived, however. The last time capital gains taxes were raised was in 2013, and the S&P 500 Index gained 30% that year.

- **This remains a health care crisis.** The ongoing pandemic prompted higher volatility, with the VIX reaching over 20 last week for the first time in April.
 - While we have been expecting strong earnings growth driven by booming economic activity, the unfortunate reality is that a synchronous global recovery may be impossible at this point. While the U.S. should be able to continue reopening, other regions such as India and Latin America remain under extreme pressure.
- **The proof is in the earnings.** With one quarter of S&P 500 companies reporting actual results, earnings growth is up 33.8% for the quarter. Should this trend continue, it would be the first time earnings experience growth of this magnitude since the third quarter of 2010 (34.0%) following the Global Financial Crisis.
 - Since the end of the first quarter, 10 sectors have reported higher earnings growth rates (or smaller declines), led by the financials sector, with 84% recorded positive earnings-per-share surprises. We expect this strength to persist at least through next quarter, when we believe earnings growth may peak.

Risks to our outlook

In addition to the legislative battle for an infrastructure package, the debate over tax reform is likely to create pockets of volatility. Headline economic data could also spark volatility, as inflationary shocks caused by short-term global supply chain disruptions and year-over-year comparisons will be difficult for investors to ignore.

Though recent Fed comments have seemingly settled investors' nerves, many remain wary about possible rate increases or asset purchase tapering. The central bank's messaging will remain one of the most significant near-term risks.

New COVID-19 cases and varying vaccination rates across the globe could also create volatility for global equity markets. On a related note, incrementally better news out of the U.S., combined with incrementally worse news elsewhere, has led to a recent strengthening of the U.S. dollar. This is likely to create near-term headwinds for emerging markets.

In focus

Room left to grow for small caps

Though the Russell 2000 has outpaced the Russell 1000 by approximately 2% for all of 2021, we believe small caps have a lot left to offer investors. In fact, small caps still look undervalued on a relative basis. At the end of March, the 12-month forward P/E ratio for the Russell 2000 stood at an 18-year low versus the Russell 1000. Additionally, the record equity inflows over the past five months have almost exclusively favored large cap stocks, as small caps have experienced marginal outflows.

Another reason to find small caps attractive has been their underperformance over the past month in the face of rising global COVID-19 case counts, rising vaccination risks and questions over whether reopening optimism has already been priced into the markets. Though hurdles will continue to present themselves on our path back to normalcy, we remain confident in a strong global economic recovery in 2021, which should favor small caps.

Going forward, we anticipate that better-than-expected economic data will push commodity prices higher and put upward pressure on interest rates and inflation. These are the same trends that have helped U.S. small cap stocks outperform large cap stocks in the first quarter of 2021. However, we also believe that these types of economic characteristics will benefit selectivity and active management, as the importance of identifying quality companies capable of appreciating beyond the rising-tide of the pandemic recovery becomes increasingly critical.



Best ideas

Increased economic reopening and recent underperformance have created opportunities in U.S. small caps. We favor consumer service sectors, especially in areas where unemployment remains elevated, and we are keeping an eye on industrials that could benefit from publicly funded infrastructure. Tactical opportunities remain in technology and growth stocks, but with a high degree of selectivity, as the “shelter-in-place” trade may no longer provide a broad benefit to all companies. We also remain bullish on emerging markets over the long term, as efforts to stem the spread of the virus eventually take hold.

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 group 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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