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Equity markets look ahead as earnings season ends

Global equities performed well last week on healthy earnings, upbeat corporate commentary and strong data releases, capped by a big upside surprise in July's U.S. nonfarm payrolls. Concern about the Delta variant tempered some enthusiasm for the reflation trade. Against this backdrop, gains for the DJIA (+0.8%), S&P 500 (+1.0%) and Nasdaq (+1.1%) were similar. Outside the U.S., emerging markets (+1.2%) benefited from stability in Chinese stocks (+1.8%), which had sold off the week before.

KEY POINTS

- **High valuations, peak U.S. growth and Delta variant worries will keep equity markets on edge.**
- **July's stellar nonfarm payrolls report may be a key input to the Fed's tapering timeline.**
- **Global manufacturing PMI remains elevated. In the U.S., manufacturing PMI slowed only modestly in July, and services PMI set a new record high, both supporting our view of still-solid economic growth.**
- **The 10-year U.S. Treasury yield reversed its recent slide last week, a sign that it may have bottomed, which would bode well for a rebound in cyclical.**



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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

- **Big beat for July nonfarm payrolls may influence the Fed's tapering decision.** Payrolls had their largest monthly increase since August 2020 with a better-than-expected 943,000 jobs added and upward revisions to prior months.

- The unemployment rate decreased to 5.4% from June's 5.9% reading. Labor force participation rose to 61.7% and average hourly earnings grew 0.4% (+4.0% year-over-year). Labor market conditions are a key input to the Fed's tapering decision, though the July report alone is unlikely to significantly shift expectations. While Chair Jerome Powell may drop some hints later this month during his speech in Jackson Hole, an announcement may be more likely in September given uncertainties.

- **Decrease in ISM manufacturing PMI may indicate the U.S. has passed peak growth.**

- ISM's July manufacturing PMI marked its 14th consecutive month of expansion, providing a positive signal for both S&P 500 earnings growth estimates and capital expenditures. A record-low reading in the customers' inventories subindex also fed expectations for an increase in capital spending and an inventory surge. Because July's PMI was slightly below expectations and less than June's 60.6 reading, it was interpreted as a minor deceleration in the expansion cycle, or perhaps evidence that U.S. growth is past its peak. The ISM services PMI (64.1) reached an all-time high, although the service sector is not replacing lost jobs at a rate commensurate with its overall expansion.

- **Earnings season is just about complete.**

With nearly 90% of S&P 500 companies reporting, earnings grew by nearly 89%, up from estimates of 52% at start of the quarter and 64% at the start of earnings season.



Despite some concerns, underlying equity fundamentals remain strong. Investors will likely increasingly focus on valuations, earnings and selectivity through late summer.”

- In aggregate, earnings have come in at 17.1% above expectations, well above the five-year average of 7.8%. Revenue growth increased to 25%, up from 16.5% at the beginning of the quarter and nearly 20% when earnings season began. Prominent themes include strong demand, reopening momentum, supply chain constraints, input price pressures, still-elevated operating leverage and margins, capital return increases and optimism regarding the spread of the Delta variant.

Highlights from last week

- Ten of the 11 GICS sectors posted gains for the week against a backdrop of broadly strengthening demand and operating leverage. Supply chain constraints and input price pressures remained in focus across industries and sectors. Financials performed best (+3.6%), followed by utilities (+2.3%) and information technology (+1.0%). Only consumer staples (-0.5%) showed a negative return. Small caps (+1.0%) edged large caps (+0.9%), while growth (+0.9%) had a slight advantage over value (+0.8%).
- Earnings and revenue beats remained at or near record levels. Despite progress on the bipartisan infrastructure deal, the path to additional fiscal stimulus remains complicated. The Democrats hope to pass a separate, much larger and more polarizing budget bill using the reconciliation process.

Risks to our outlook

Global demand remains strong, but we acknowledge that global growth is past its peak as we move beyond the reopening catalysts in the U.S. and Europe.

We continue to monitor the regulatory crackdowns in China to learn more about their overall aim and scope, and how they may affect global financial markets.

The continuing spread of the COVID-19 Delta variant remains in sharp focus, with new U.S. cases hitting a six-month high last week and hospitalizations increasing by roughly 40% from the prior week.

We maintain our view that equity markets are likely to remain highly susceptible to pullbacks and may react negatively to economic data that misses consensus expectations.

Despite these challenges, global equity markets proved again last week that they can be resilient when underlying fundamentals are strong.

In focus

Utilities: small sector can punch above its weight

While utilities may be among the smallest sectors in the U.S. stock market, it tells a compelling secular story. The sector has fully regulated business models and large capital expenditure programs expected to lead to 5%-7% earnings per share CAGRs (compound annual growth rates) for many years to come. In addition, the sector currently offers a dividend yield of 3.2%, a meaningful contribution to total returns. And because of their defensive characteristics, utilities tend to be less affected by changes in the health of the economy.

Recent developments have piqued investor interest in the sector. Especially notable is the deployment of company capital in renewable energy transmission and distribution-system modernization. Regulators support these investments because they help lower carbon emissions, increase reliability and customer satisfaction and, in some cases, reduce operating expenses.

In terms of stock selection, certain characteristics can differentiate individual utility companies: low- or no-coal power generation, a focus on renewables and relatively stronger balance sheets. The median utility currently trades at 19.1x 2022 estimated EPS, offering a discount to the broad U.S. equity market. Eventually there should be a broad risk-off trade and a rotation into defensives. Given their current valuations and dividend yields, utilities should be in a good position to outperform when that happens.



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, which offers opportunities tied to growth in the global digital economy, including innovative fintech and e-commerce names.

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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A word on risk

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