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CIO Weekly Commentary
17 October 2022

CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

3Q earnings season kicks off, cautiously

Bottom line up top:

The earnings shoe is ready to drop, but whether its impact will be Bigfoot or baby sized remains to be seen. Earnings growth was surprisingly resilient through the first half of 2022, sidestepping growing recession fears and a bear market environment. But higher input costs, especially wages, and the U.S. Federal Reserve's attempts to slow inflation through a series of oversized rate hikes have taken their toll on operating margins — and thus on third quarter earnings estimates.

How low will earnings growth go? With only a fraction of S&P 500 companies reporting so far, blended results (reported numbers plus estimates) for both earnings and revenues have fallen year-over-year compared to the second quarter (earnings are down from 9.5% to 1.4% and revenues 9.8% to 8.5%). In fact, excluding the surging energy sector, which is a significant outlier, the S&P 500's year-over-year earnings growth for Q3 has turned negative (Figure 1). Looking toward full-year estimates for 2023, earnings per share (EPS) growth rates have been cut by over 4 percentage points (12.4% to 8%) since the end of the second quarter, indicating that earnings weakness may persist into next year.

Don't leave your equity allocation in limbo. Inflation expectations remain the top concern in this environment, with EPS growth estimates likely to continue declining amid slowing economic activity caused by hawkish monetary policy. Additionally, with some 40% of S&P 500 revenues derived from outside the U.S., continued U.S. dollar strength will likely remain a headwind to earnings as well. While these forecasts may feel grim, we expect inflation to moderate in the coming months.

Saira Malik, CFA
Chief Investment Officer

On behalf of Nuveen's Global Investment Committee

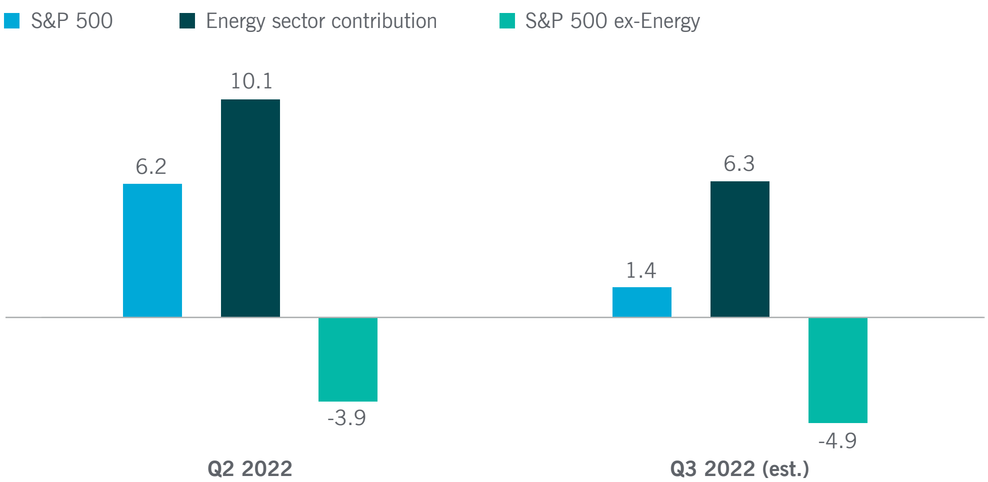
As Nuveen's CIO and leader of our Global Investment Committee, Saira drives market and investment insights, delivers client asset allocation views and brings together the firm's most senior investment leaders to deliver our best thinking and actionable investment ideas. In addition, she chairs Nuveen's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

The bottoming process should be an upward inflection point for EPS expectations.

Equity investors should be prepared for an eventual bottoming process, when markets begin to see cooling in wage growth and employment, as this should be an upward inflection point for EPS expectations.

FIGURE 1: ENERGY'S OUTSIZED CONTRIBUTION TO EARNINGS HIDES TROUBLE IN OTHER SECTORS

S&P 500 EPS growth (%)



Data source: FactSet, 13 Oct 2022. 3Q 22 reflects blended earnings data as of 12 Oct 2022. **Past performance does not predict or guarantee future results.**

Portfolio considerations:

With the 3Q earnings shoe dangling overhead, investors may be tired of the suspense and looking forward to getting the season over with, good or bad. Even if equities squeeze out positive surprises versus now-lowered estimates, the pain of labor costs and restrictive Fed policy will eventually be felt. Figure 2 shows that Purchasing Managers Indexes (PMIs) tend to lead earnings estimates by about six months, and given where PMIs have been trending, further downgrades to estimates seem likely.

With earnings down, where might investors find opportunities?

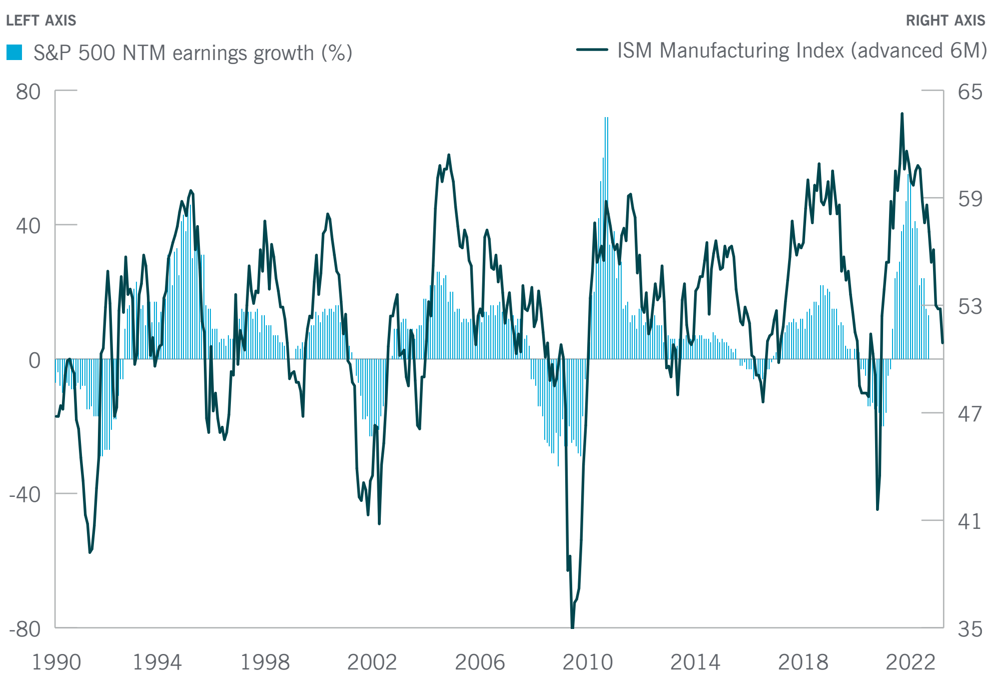
In periods of declining earnings, quality companies with high margins, solid return on assets and low leverage tend to be resilient. Defensive sectors — namely, utilities, consumer staples and health care — exhibit these characteristics, but they're also currently trading at **historically high relative valuations**, except for health care.

- Within **health care**, we like large cap pharma on strong growth prospects, durable margins and healthy balance sheets.
- We continue to find **dividend growth** strategies attractive, based on their defensive nature and historically low relative valuations.
- Although fundamentals for **information technology** are strong, the sector is unwinding from very high relative valuations and generally has demonstrated less reliable defensive behavior than others.
- Within cyclicals, we continue to favor **energy**, given continued global supply discipline and still-cheap valuations.
- In contrast, **consumer discretionary** remains expensive. Consumers are still spending, but with the Fed's inflation fight focused on curbing consumption through the labor and housing markets, this sector looks more vulnerable.

Within health care, we like large cap pharma on strong growth prospects, durable margins and healthy balance sheets.

FIGURE 2: MANUFACTURING PMI TENDS TO LEAD EARNINGS GROWTH BY SIX MONTHS

S&P 500 earnings growth and ISM manufacturing index



Source: Bloomberg, L.P. S&P 500 NTM earnings growth represents analyst estimates for earnings growth 12 months forward from current levels. ISM Manufacturing Index is provided by the Institute for Supply Management. **Past performance does not predict or guarantee future results.**

FIGURE 3: DEFENSIVE SECTORS TRADING AT TIGHT VALUATIONS

S&P 500 sector relative valuations

	Margin	Return-on-equity	Return-on-assets	Forward P/E	Relative valuation Z-score
S&P 500	11.8	19.6	3.9	15.6	–
DEFENSIVE					
Consumer staples	6.5	26.3	7.9	19.3	0.9
Utilities	10.0	8.7	2.2	17.0	0.9
Health care	8.3	22.6	8.0	15.5	-0.3
SENSITIVE					
Communication services	15.5	18.1	7.0	12.8	-1.0
Information technology	22.5	34.1	13.4	18.8	0.2
Industrials	7.8	19.8	5.1	15.9	0.0
Energy	11.3	23.6	10.5	9.0	0.0
CYCLICAL					
Materials	11.8	18.7	7.7	13.3	-0.7
Consumer discretionary	6.5	29.0	6.2	21.1	1.2
Financials	18.4	11.8	1.2	11.3	-0.2
Real estate	22.2	10.3	4.1	28.8	1.8
Dividend growth	7.2	19.7	6.2	15.9	-0.5

Spreads tighter than historic average — Spreads wider than historic average

Source: Bloomberg L.P. Margin is net income margin. Forward P/E uses blended forward 1-year earnings estimates. Relative valuation Z-scores measure the current forward P/E of each sector vs. the S&P 500 compared to history. Sector history begins in 1990 while dividend growth is measured from 2012. Dividend growth is represented by the S&P 500 Dividend Growth Index. **Past performance does not predict or guarantee future results.**

Consumers are still spending, but this sector looks more vulnerable.

About Nuveen's Global Investment Committee

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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