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Markets take the Fed's tapering plans in stride

Equities continue to march higher. Despite the coming taper, Fed policy remains accommodative, and a strong earnings outlook supports select stocks. Although COVID-19 hospitalizations have surged, last week investors focused on the FDA's full approval of the Pfizer vaccine. Both the S&P 500 (+1.5%) and Nasdaq (+2.8%) closed at all-time highs, and small caps (+5.1%) had their best week since March. Events in financial markets, however, were overshadowed by tragedy in Afghanistan.

KEY POINTS

- **Chair Powell noted in his Jackson Hole speech that the Fed is likely to begin tapering before year end, but that interest rate hikes are not imminent.**
- **The Delta variant is causing some weakness in economic data, but the growth outlook is intact.**
- **Chinese regulatory contagion poses limited risks to global technology companies and may benefit other emerging markets.**
- **Volatility will likely increase in the near term as investors adjust to peak growth, the Delta variant and high equity valuations.**



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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

- **QE tapering may begin this year.** A move to start scaling back asset purchases, however, should not be construed as a signal about rate hikes.
 - Speaking from the Jackson Hole symposium, Chair Powell noted that there is still “much ground to cover” before the economy reaches full employment. He also reaffirmed his conviction that high inflation is transitory and noted that the hurdle for interest rate hikes in 2022 remains very high. If confidence increases and the yield curve steepens further, we could see another run of sustained small cap and cyclical sector outperformance. A strong August jobs report on Friday would reinforce our base case that tapering will commence in either November or December of this year.
- **The virtuous circle of strong corporate profits continues.** U.S. corporate profits surged at an annual rate of +45% in the second quarter, indicating that employment gains and business spending should strengthen.
 - The BEA released its second estimate of Q2 real GDP growth at +6.6% annualized. This healthy expansion helps explain the jump in corporate profits and supports consumer spending projections at an annualized 5.0% increase in the current quarter, after a robust 11.9% rise in the three months through June, according to Bloomberg survey data. To the extent that the COVID-19 Delta variant may have peaked, reopenings can accelerate and consumer confidence is likely to increase further. It appears that the recent disappointment in consumer sentiment two weeks ago was an outlier.
- **More questions than answers remain on the U.S. federal budget.** House Democrats passed the \$3.5 trillion budget resolution last week, which will lead to the reconciliation bill.



With the Delta variant peaking and QE taper expectations reaffirming a strong outlook, we expect earnings growth to jump-start a move higher in cyclical sectors and small caps.”

- House Speaker Nancy Pelosi has committed to a path of approval by the end of September. However the bill’s future is uncertain in the Senate, where moderate Senators Sinema and Manchin have pushed for a much smaller, narrower bill. Financial markets continue to assess the tax considerations connected to this bill, as President Biden’s original plan outlined an increase in the corporate tax rate, as well as higher rates on incomes and investments for wealthy individuals. We believe moderates are especially likely to face pressure on higher taxes, certain to be a particularly contentious issue ahead of the 2022 midterm elections.

Highlights from last week

- Seven of the 11 GICS sectors posted gains, with energy (+7.3%), financials (+3.5%) and consumer discretionary (+2.6%) confirming a modestly risk-on sentiment. Overall, cyclical sectors (+2.5%) outperformed defensives (-1.2%), partially helped by U.S. Treasuries holding firm and a modest steepening of the yield curve. Small caps (+5.1%) beat large caps (+1.8%), while growth (+2.1%) outperformed value (+1.5%).
- Some economic data did disappoint: manufacturing PMI slowed to a four-month low in August, while services PMI also missed, hitting an eight-month low.

Risks to our outlook

The future of additional fiscal stimulus is uncertain in the Senate, where moderates have pushed for a narrower bill. Additional risks include uncertainty about potential tax increases and the unresolved debt ceiling.

Outside of the U.S., concerns about China were highlighted last week by plans to propose new rules that would ban companies with large amounts of sensitive consumer data from going public in the U.S.

We continue to expect supply chain disruptions, slowed production and persistently high inflation prints (e.g., ocean freight prices) due to struggles containing the Delta variant.

Equity markets remain susceptible to volatility and pullbacks, and may react negatively to economic data that misses consensus expectations.

Despite these challenges, we think that global equity markets will again prove resilient, as underlying fundamentals remain strong.

In focus

What follows Fed tapering is the real question

The Federal Reserve initiated quantitative easing (QE) program last year in response to an acute liquidity shortage amid the COVID-19 outbreak. The program will begin to wind down in the next several months and conclude by the second half of 2022.

Unlike the previous QE tapering in 2014, this wind down hasn't fueled a "taper tantrum" of sharply higher interest rates. Instead, investors have greeted the inevitable with a shrug: long-term rates are down notably from their March peaks, and equity indexes continue to hit new highs.

While the scale of QE has been large (\$120 billion/month in asset purchases), fiscal stimulus and vaccines have been the main drivers of the economy this year. Still, QE has been a reassuring safety net, helping ease market volatility. Such comfort may cease if investors develop vertigo as they ponder the Fed's next agenda item: increasing short-term policy rates. The good news? Rate hikes likely won't start until late 2022/early 2023 and should be gentle.

Even so, the macro backdrop is turning a bit less friendly for stocks. Growth is slowing (albeit from a high peak), and monetary and fiscal policy tailwinds are fading. The relevant takeaway from the last Fed taper wasn't the tantrum itself, but the investment environment that followed — one of lower market returns, higher real interest rates and mixed sector performance. All of these conditions favor active management.



Best ideas

Discounted valuations and stronger relative earnings growth in developed non-U.S. markets, particularly in Europe, will be the catalyst for select stocks in cyclically oriented sectors to outperform. We remain broadly bullish on emerging markets, although guarded with respect to Chinese equities. Further upside in the U.S. as we move toward 2022 will be driven by high single-digit earnings growth with the potential for positive revisions. Continued overall strength in underlying economic data should lead cyclical sectors, such as industrials and small caps to outperformance.

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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