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Weekly Equities Commentary

18 January 2022

Equity volatility rooted in inflation concerns

Returns were mixed for global equity markets last week. In the U.S., the S&P 500 and Nasdaq each fell 0.3% as technology stocks attempted to recover from the prior week's pullback; the DJIA lost 0.9%. Broad-based non-U.S. equity benchmarks benefited from risk-on trading thanks to a weaker U.S. dollar, especially the MSCI EM Index, which added 2.6%. The MSCI ACWI ex USA gained 1.0%, while developed markets gained a more modest 0.2% as represented by the MSCI EAFE Index.

KEY POINTS

- **Federal Reserve Chair Jerome Powell acknowledged the severity of inflation while helping allay market concerns over more-aggressive tightening.**
- **Inflation hit a 40-year high in December, boosting bond yields and further fueling the rotation away from growth stocks.**
- **Banks kicked off the unofficial start of earnings season with a warning on wage inflation; continued solid earnings growth will be crucial to maintaining the equity markets' upward trajectory.**

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.

Market drivers & risks

- **Dollar extends weakness as Powell pumps the brakes on accelerated hawkishness.**
  — Investors' risk appetites were whetted by the Fed Chair's expressed confidence in the economic recovery and intentions to remain patient with tightening and rate hikes. Currencies were among the most active markets following his remarks, with more yield-sensitive options gaining favor and the U.S. Dollar Index (DXY) falling to a two-month low. Should the Fed avoid the need for more aggressive rate hikes, we expect further dollar depreciation, allowing investors to explore increased allocations to emerging markets (EM) equities.
- **Still, tightening is coming,** and equity markets are (over)reacting accordingly.
  — Though growth stocks had a relative reprieve from the prior week's intense selloff, yields appear to have found support at elevated levels, supporting the rotation away from growth and toward value areas of the equity market. The 10-year U.S. Treasury yield fell below 1.70% only briefly during last Thursday's trading before ending the week back at 1.78%. Value (and cyclicals) should continue to perform well in this environment. At the same time, however, growth-oriented companies, such as select software names (see the "In focus" section), are rapidly approaching oversold territory and could present buying opportunities.
- **Out with holiday season, in with earnings season.**
  — Last week brought the unofficial start of earnings season, kicked off as usual by the largest U.S. financial companies. Headline earnings per share (EPS) exceeded expectations for the first few banks to report, but investors were left feeling doubtful given decidedly downbeat guidance. While higher rates will benefit these institutions, tight labor markets and wage inflation have already weighed on their stock prices. Overall, positive earnings growth, though slowing from 2021's levels, will remain pivotal in driving stock prices this year.

> ***"The next few months could remain challenging for investors, and continued high volatility and possible near-term market selloffs are likely."***

Weekly overview

- From a sector perspective, energy outperformed, adding 5.2% thanks to the appreciation of oil prices that continue to benefit from the current global supply/demand dynamic. Information technology (-0.1%) and communications services (+0.5%) were among the next best relative outperformers as "buy the dip" and Fed Chair Powell's congressional testimony helped growth-oriented stocks. Conversely, elevated rates hit the bond-proxy sectors, with real estate and utilities losing -2.0% and -1.4%, respectively, while consumer discretionary (-1.5%) rounded out the worst performing sectors for the week.
- Retail sales disappointed in December, falling almost 2% month-over-month from November, although they were up nearly 17% year-over-year. Early holiday shopping and Omicron-exacerbated supply chain disruptions were largely to blame. We expect retail sales to remain relatively muted in 2022, as spending could shift from goods to services/experiences.

Risks to our outlook

Inflation and its impact on central bank policy should continue to exert outsized influence on equity market volatility. The Fed's hawkish tone has become more aggressive, causing investors to grow wary of a potential misstep in contractionary measures.

Even as markets have seemingly concluded that Omicron does not pose a substantial threat, we still expect volatility to spike with each related headline. Although another Covid wave had been anticipated, the fear of economic restrictions will likely remain.

U.S. fiscal uncertainty continues to pose a risk. Although Congress reached a one-time resolution on the debt limit last month, the Biden administration's Build Back Better spending program remains in jeopardy, given the Democrats' razor-thin majority and significant objections from within their ranks.

Geopolitical risks have expanded with the recent deterioration of diplomatic efforts between Russia and NATO. Tensions between China and the U.S. remain just below a boil. Further sanctions on Chinese tech firms would likely hamper emerging markets, given China's sizable weighting in broad-based EM indexes.

Best ideas

In the U.S., inflation and expectations for higher yields should bolster returns for small caps and financials, and for companies with pricing power. Stronger producer discipline and global demand should help extend the cycle for energy, while select technology companies, such as front-office software leaders, also look attractive. The prospect of stronger relative earnings growth could be a catalyst for select stocks in developed non-U.S. markets, particularly Europe, and select emerging markets (ex-China, given current risks). We continue to advocate a long-term approach that prefers cyclicals and value stocks exhibiting strong earnings growth and pricing power.

In focus

Digitization in the driver's seat

The Fed's hawkish intentions became more transparent with the release of its December meeting minutes. This has helped propel the recent rise in bond yields and pronounced shift away growth stocks. The software industry has not been immune to this rotation, as illustrated by the iShares Expanded Tech-Software Sector ETF, which has tumbled nearly 20% from its all-time high in November.

As we expected, volatility for the industry has only increased in response to expectations of rising rates, fears of moderating growth and tighter margins. However, given the intensity of this correction, valuations for software names are beginning to look more attractive as they rapidly approach pre-Covid levels.

Pockets of turbulence are likely to persist in 2022 due to less accommodative monetary policy, some demand being pulled forward, the unwinding of Covid-driven expense savings and general labor tightness. That said, we see opportunity in growth and valuation dispersion.

Moreover, the industry's outlook is bright, as demand for software remains robust. According to Gartner, IT/software spending is expected to grow 5.4%/11.5% worldwide in constant currency terms in 2022, versus an estimated 6.8%/10.9% in 2021.

Longer term, we believe that (1) accelerating and pervasive global digitization will serve to improve the pace and duration of the software industry's growth and (2) increasingly strategic positioning with customers will result in more resilient financial models.

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.

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Sources

All market data from Bloomberg, Morningstar and FactSet.

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