

CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

The importance of being earnings focused

Bottom line up top:

Earnings estimates need to get real. While U.S. corporate earnings growth estimates have dipped recently to more realistic levels than we saw in much of 2022, they still don't adequately reflect the likelihood of an economic downturn. Fourth quarter earnings growth for S&P 500 Index companies is currently estimated at -3.9% year-over-year. We think this aggregate number understates the difficulties many companies face, especially since the economy has yet to feel the full impact of last year's ultra-aggressive U.S. Federal Reserve tightening. Looking under the hood, 7 of the 11 index sectors are expected to show negative earnings growth this reporting season. Energy's outsized positive estimate (+60.9%) continues to mask weakness elsewhere.

- **Revenues.** Analysts anticipate mixed revenue growth (+3.9% overall) in the fourth quarter. Energy's dominance as the only sector estimated to see double-digit revenue gains (+12.4%) distorts the picture.
- **Margins.** The consensus still calls for margins to expand and contribute to earnings growth. We are hard-pressed to see how this occurs in a meaningful way given persistent cost pressures, as confirmed by recent ISM surveys. Most companies can no longer simply increase prices to protect margins. For example, Darden Restaurants recently noted sales were up 9.4% in the last fiscal quarter (consumers are still spending on dining out), but input costs increased roughly 11%.

Inflation's role remains a wild card. Last week's release of December CPI data showed annual headline inflation fell to 6.5%, and core inflation to 5.7%. The numbers, while welcome, were in line with market expectations. And, while one prominent Federal Reserve official



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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.

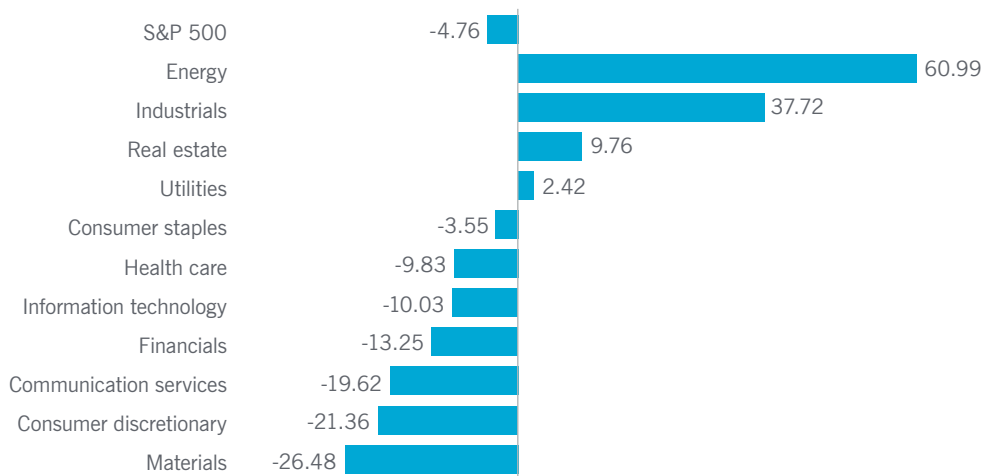
called the report “encouraging,” the overriding takeaway is that the Fed is sticking to its guns – meaning no near-term pause in rate hikes.

What to look for as earnings season unfolds. Revenues and margins may be the most important metrics to focus on as 2023 progresses. Below we examine areas of the market that we believe offer compelling opportunities.

The economy has yet to feel the full impact of last year’s ultra-aggressive U.S. Federal Reserve tightening.

FIGURE 1: ENERGY AND INDUSTRIALS SHOW POSITIVE EPS

S&P 500 fourth quarter 2022 EPS – blended growth (%)



Data source: FactSet, 13 Jan 2023. Blended growth includes actual reported earnings combined with remaining estimates.

Portfolio considerations:

In the near term, we maintain our mantra that the best offense is a good defense when it comes to equity allocations. Further out, we think a likely pause in the Fed’s interest rate hikes at some point in the first half of 2023 could serve as a catalyst for equity sectors that have struggled the most during the rising rate cycle. Certain areas of U.S. technology, such as semiconductors and software, are particularly intriguing. This month could bring the final round of lowered earnings growth estimates for semis. As for software companies, cash flows are driven more by enterprise revenue than by consumers, and enterprise contracts tend to have more consistent recurring revenues. Select software names could serve as a source of quality growth within an equity allocation.

Public real estate is also attractive. We favor apartment REITs, which can benefit from revenue growth (Figure 2) as elevated interest rates lead more people to rent rather than purchase homes. Additionally, apartment REITs are more insulated from weakness in the broader global economy, as 80%

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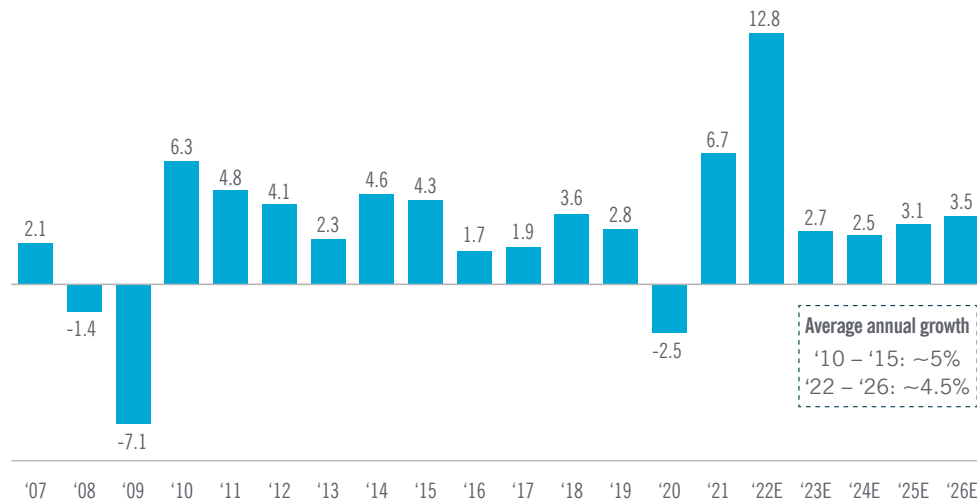
of their trailing 12-month revenue is derived from the U.S. We continue to prefer U.S. equities versus their non-U.S. counterparts.

We're much less constructive on the consumer discretionary sector. Headwinds include slowing economic growth and a sharp drop in the personal savings rate to levels not seen since the global financial crisis, as inflation erodes disposable income. This has fueled an increase in consumer credit card debt that may not be sustainable, and higher credit card interest rates. Although we don't forecast a severe recession, we do expect consumer spending on non-essentials to come down meaningfully in the first half of this year.

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FIGURE 2: REVENUE GROWTH FOR APARTMENT REITs

U.S. apartment market revenue per available foot growth – Top 50 markets (%)



Data sources: CBRE and Green Street, LLC. Performance data shown represents past performance and does not predict or guarantee future results. Revenue Growth based on Green Street's Market RevPAF (M-RevPAF) growth, which combines changes in effective rents and occupancies into a single measure.

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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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