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Fourth quarter 2024 outlook

Challenges loom for global equities despite a third-quarter rally

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Following a relatively calm second quarter, global equities endured spikes of volatility in the third, fueled by U.S. recession concerns, an unwinding of the yen carry trade and further signs of deterioration in the Chinese economy. Escalating geopolitical conflicts and U.S. election uncertainty also weighed. Despite these headwinds, major equity indexes posted positive returns, as investors cheered cooling inflation and the U.S. Federal Reserve's first rate cut of its new easing cycle. Central banks in Europe, the U.K. and China also lowered policy rates, while the Bank of Japan tightened. Emerging market (EM) stocks performed best, followed by non-U.S. developed markets. Currencies broadly strengthened relative to the U.S. dollar, boosting non-U.S. returns for dollar-based investors. The S&P 500 Index was a relative laggard even as it delivered its fourth consecutive quarterly gain.

KEY TAKEAWAYS

- Encouraging headline inflation trends gave many key central banks the runway to lower interest rates, although core inflation stayed sticky. The People's Bank of China, however, launched stimulus both to kickstart the domestic economy and ward off deflation.
- We anticipate that the U.S. economy will decelerate, leading to a mild recession in 2025. A slowdown is evident in the data on several fronts: Consumer resilience has been choppy, manufacturing activity is contracting and the housing market remains sluggish.
- Our relatively cautious outlook leads us to favor (1) defensive areas like U.S. dividend growers and global infrastructure; (2) exposure to specific EM opportunities in countries like Brazil and (3) Japanese banks and high-dividend stocks.
- On balance, we still generally prefer U.S. over non-U.S. equities for their better defensive characteristics in case of a global economic slowdown.
- Within the U.S., we're not yet prepared to upgrade our view on small cap stocks, although they have historically outperformed large caps when the Fed initiates its rate-cutting cycle.

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CENTRAL BANKS TAKE IT EASY

During the quarter, central banks diverged in their monetary policy.

U.S. Federal Reserve. With headline inflation moderating toward the Fed's 2% target and the U.S. employment picture weakening, Fed officials became more focused on supporting the labor market than on cooling prices. Accordingly, they cut the target fed funds rate in September for the first time since 2020. The 50 basis points (bps) reduction, to a range of 4.75%–5.00%, was larger than the 25 bps move that some investors were expecting and came even as core inflation, which excludes volatile food and energy costs, remained above 3% at quarter-end. Meanwhile, the Fed's latest "dot plot" of rate projections implies an additional 50 bps of cuts by year-end 2024 and a further 100 bps in 2025.

European Central Bank (ECB). In September, the Fed's eurozone counterpart trimmed its benchmark deposit rate by 25 bps, to 3.50%, its second rate cut in three months. A dip in eurozone inflation to a 3½-year low (+1.8%) after the ECB meeting reinforced the policy decision, prompting ECB President Christine Lagarde to state that "The latest developments strengthen our confidence that inflation will return to target in a timely manner.[1] We will take that into account in our next monetary policy meeting in October."

People's Bank of China (PBoC). Toward the end of the quarter, in a bid to revive the slumping Chinese economy, the PBoC announced a raft of stimulus measures such as reducing reserve requirements for commercial banks (to encourage lending) and lowering interest rates on mortgages (as the country's housing market remains mired in the doldrums). The PBoC also plans to inject liquidity into the domestic stock market by refinancing bank loans to support share buybacks. By stimulating the economy, the PBoC also hopes to combat deflation in consumer prices, as core inflation fell to its lowest level since early 2021.[2]

We're reserving judgment on the potential efficacy of these measures because China's previous attempts at stimulus haven't resulted in long-lasting recoveries. In this case, the PBoC's actions may have a greater impact on Chinese stocks. For that reason, China's economic activity must improve before we can become more structurally bullish on the country as an investment destination.

Bank of England (BoE). Following a 25 bps cut in August, the BoE kept its bank rate unchanged at 5% in September. In a nod to investors and observers who favor a more dovish policy stance, the BoE noted that with inflation cooling, it expected interest rates to fall gradually.

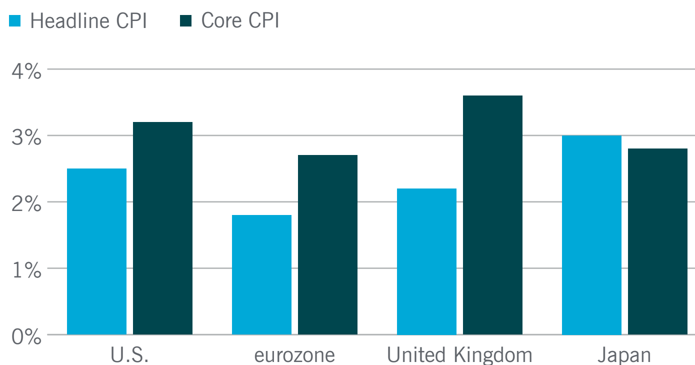
Not all central banks eased policy, however.

The Bank of Japan (BoJ) raised rates to 0.25% at the end of July to stem the yen's steep slide versus the U.S. dollar. It was the second Japanese rate increase of the year and the first since the BoJ ended its negative rates policy with a hike in March. The BoJ paused in September, citing a need for more time to monitor financial markets.

Emerging markets. Several EM central banks increased borrowing costs during the third quarter. Notably, the **Bank of Brazil**, after cutting interest rates aggressively in 2023, began a tightening cycle and signaled more hikes were likely to tackle a challenging inflation outlook driven by stronger-than-expected economic activity.

Looking ahead, the escalation of hostilities in the Middle East could complicate matters for central banks as they seek to keep inflation contained. For now, though, we still expect the Fed and other monetary policymakers to remain data-dependent and proceed cautiously, with a continued bias toward easing.

Figure 1: Core inflation remains sticky



Data source: FactSet, 31 Aug 2024.

THIRD-QUARTER MARKET PERFORMANCE AND DRIVERS

The Fed and volatility vie for attention

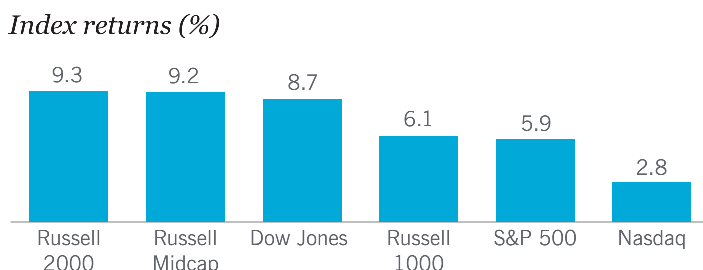
Equity indexes got off to a positive start in early July, aided by falling U.S. Treasury yields and Fed rate cut optimism. But a bullish beginning for the S&P 500 and large cap stocks more broadly gave way to concerns about slowing earnings growth for technology companies, whose outsized gains had powered the U.S. equity market for much of the year, and a pivot to small caps amid expectations that smaller companies would benefit from Fed easing. Only a rally on 31 July, driven by a dovish Fed meeting, saved the S&P 500 from ending the month in negative territory.[3]

July's volatility spilled into August. A disappointing U.S. jobs report fanned recession fears, sending the S&P 500 down about 6% in the month's first three trading days. But the index erased those losses and gathered steam thanks to a string of healthy U.S. economic data releases, encouraging corporate earnings reports and assurances from Fed Chair Jerome Powell at the central bank's annual Jackson Hole symposium that "the time has come" for rate cuts.

In September, the index notched a series of record highs, with investors betting that the Fed's jumbo 50 bps rate cut would help enable a soft economic landing. Also sparking the risk-on mood was surprisingly robust stimulus from China, the world's second-largest economy.

Figure 2: Smaller companies soar past the Nasdaq

Index returns (%)



Data source: Morningstar Direct, 30 Sep 2024. **Performance data shown represents past performance and does not predict or guarantee future results.** It is not possible to invest in an index.

Major U.S. equity benchmarks performed well for the quarter as a whole, led by small caps (+9.3%) and mid caps (+9.2%) (Figure 2). Because they carry more floating-rate debt on their balance sheets, smaller companies rallied more than large caps when the Fed began to lower borrowing costs. Although large cap indexes such as the S&P 500 (+5.9%) and Russell 1000 (+6.1%) were relative laggards during the quarter, both ended the period with year-to-date gains exceeding 20%.

The 30-stock Dow Jones Industrial Average (+8.7%) also notched record highs during the period, handily outperforming the tech-heavy Nasdaq (+2.8%).

Nuveen's Macro Market Monitor (Figure 3) provides a quantitative snapshot of the state of the U.S. economy and markets. Our investment committees use this tool to evaluate periodic changes in conditions, prioritize research and stimulate discussions when developing portfolio strategies.

Figure 3: Our Macro Market Monitor looks at the big picture

Category	Gauge	Current	Unit
INFLATION	Long-term inflation expectations	2.27%	Trailing inflation and forward-looking inflation expectations remain above the Fed's 2% target.
U.S. MONETARY POLICY	Fed funds rate	5.0%	Generally restrictive given the current fed funds rate. Financial conditions, however, have loosened with the decrease in yields.
	Financial conditions	98.7	
U.S. EQUITY FUNDAMENTALS	S&P 500 forward price-to-earnings ratio	21.4x	Index-level valuations remain expensive compared to their long-term average.
	S&P 500 forward expected earnings growth	14.6%	
	Revisions to expected earnings	2.3%	

Neutral　Negative

Data source: Bloomberg L.P., 30 Sep 2024. **Performance data shown represent past performance and do not predict or guarantee future results.** The views above are for informational purposes only and do not reflect the experience or performance of any Nuveen product, strategy or service. Financial conditions are based on the Goldman Sachs Financial Conditions Index (GSFCI), a weighted average of riskless interest rates, exchange rates, equity valuations and credit spreads, with weights that correspond to the direct impact of each variable on GDP. A higher number implies tighter conditions, which are worse for the economic outlook. At 98.7, the GSFCI is at the 10th percentile compared to levels over the past 20 years, according to Bloomberg.

U.S. INVESTORS CHEER A WEAK DOLLAR

Equity markets outside the U.S. also posted positive returns, outperforming the S&P 500. Currencies in both developed and EM economies generally strengthened against the U.S. dollar during the quarter, significantly boosting many non-U.S. index returns when translated into dollars. Based on non-U.S. MSCI indexes in U.S. dollar terms, EM equities (+8.7%) bested their developed market peers (+7.3%).

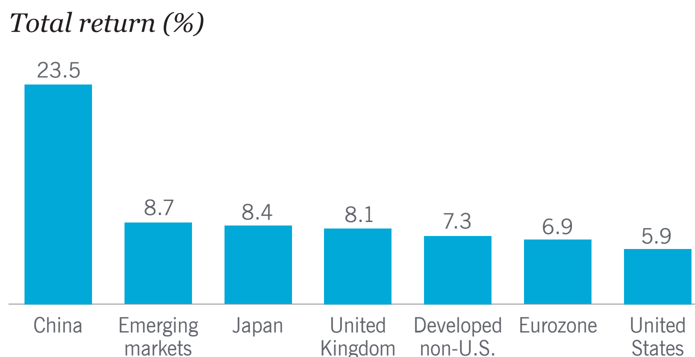
European markets rallied in the face of mixed economic data. On the continent, eurozone shares (+6.9%) overcame a seven-month low in economic output, while in the United Kingdom (+8.1%), manufacturing and service-sector activity remained in expansion territory. Elsewhere, Japan's Nikkei 225 Index (+8.4%) recouped a three-day, 15% plunge at the beginning of August amid U.S. recession fears.[4] That selloff was exacerbated by a sharp rally in the Japanese yen following the BoJ's late-July rate hike. The central bank's tightening triggered a scramble to close "carry" trades — whereby investors borrow money in a currency with low interest rates and invest it in another currency with higher yields or higher expected returns. Closing these trades forced traders to sell stocks and other assets to raise cash. The Nikkei regrouped, though, thanks to BoJ assurances that near-term rate cuts were likely.

Also in Asia, Chinese equities (+23.5%) surged, with all the gains coming in September. Stocks in China, representing about 28% of the MSCI Emerging Markets Index by market capitalization as of 30 September 2024, caught fire thanks to the PBoC's aggressive stimulus measures, which were announced to help the country meet its annual GDP growth target of "around 5%."

Other large EM countries posted mixed equity results. On the positive side, stocks in India (+7.3%) saw ongoing inflows from institutional investors and an upswing in retail participation, as its economy was supported by a strong labor market and rising business confidence. Brazilian equities (+7.1%) rebounded from a dismal first half of the year, with consumer sentiment hitting a one-year high and second-quarter GDP growth (+3.3%, annualized) topping forecasts. In contrast, Korean shares (-5.6%) lost ground amid struggles in the information technology sector, the largest constituent by market capitalization (43%) of the MSCI Korea Index as of 30 September 2024. On an EM regional basis, Africa (+15.7%), which includes a number of "frontier" markets, led the way, outperforming Asia (+9.5%) and Latin America (+3.8%). In contrast, EM Europe (-2.5%) lagged.

Figure 4: China leads EM equities to top spot

Total return (%)



Data source: Morningstar Direct, 30 Sep 2024. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: Japan:** Nikkei 225 Index; **United States:** S&P 500 Index; **eurozone:** MSCI Euro Index; **developed non-U.S.:** MSCI EAFE Index; **United Kingdom:** FTSE 100 Index; **emerging markets:** MSCI Emerging Markets Index; **China:** MSCI China Index. **It is not possible to invest directly in an index.**

OUTLOOK AND BEST INVESTMENT IDEAS

Investors lulled into a sense of contentment by the S&P 500's double-digit gain (+15.3%) with low volatility in the first half of 2024 were jolted in the first three trading days of August, when the index plunged on worrisome U.S. economic data and the unwinding of the yen carry trade. Accompanying this market downturn was a spike in the CBOE Volatility Index (VIX), a measure of implied volatility of the S&P 500. On 05 August, the VIX closed at 38.6 — its highest level since October 2020 and well above its long-term average of around 19 (Figure 5).

Given market hypersensitivity to disappointing economic data and heightened political uncertainty ahead of the U.S. election in November, we expect further bouts of volatility. In our view, this

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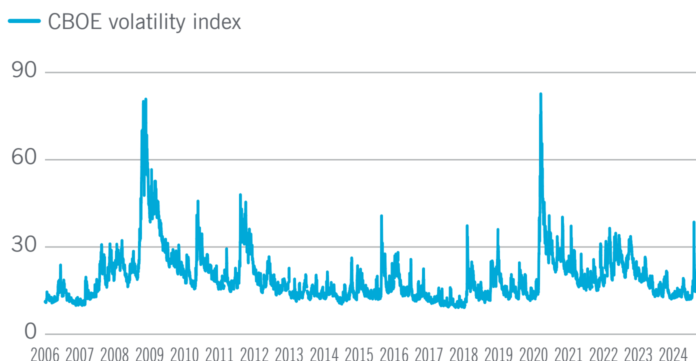
Figure 5: Dividend growers are better able to weather volatility

Market volatility follows no pattern (CBOE Volatility Index)



S&P 500® dividend growers vs. non-dividend payers

VIX monthly increase	Dividend growers average excess return (%)
>20%	1.18%
10–20%	0.12%
<10%	0.67%
Average (across all months when VIX increased)	0.75%

Data source: Ned Davis Research and Haver Analytics as of 30 Sep 2024. **Performance data shown represents past performance and does not predict or guarantee future results. It is not possible to invest directly in an index.**

backdrop favors defensive equities, especially dividend growers, which are more attractively valued and have been less volatile relative to the overall stock market, especially when stocks have been spooked by weak economic data. During the early August downdraft, the large cap Russell 1000 Growth Index tumbled more than -6%, while the S&P 500 Dividend Aristocrats Index took a much lighter hit, losing just over -2%.[5]

Meanwhile, though inflation has moderated, it remains above the Federal Reserve's 2% target. A continued downward trajectory may not be smooth, and it will take time for inflation to fully normalize. The combination of capital flexibility and balance sheet strength that dividend growth companies enjoy should help them mitigate inflationary input cost pressures, and thereby maintain or even expand profit margins — ultimately a plus for shareholders.

A balanced approach to equity portfolios

Against a backdrop of economic resilience, still-elevated interest rates and geopolitical challenges, we maintain our overall neutral stance on equities (Figure 8). Moving from cautious to higher-conviction optimism will depend on potential catalysts that include:

- Earnings growth and upside surprises, rather than multiple expansion, as the drivers of market gains
- Positive market breadth
- Further disinflation
- Easier financial conditions, including more Fed rate cuts
- A lower cost of capital

In the meantime, we're still focused on high-quality names that offer a combination of attractive valuations and good earnings growth prospects, with the potential to grow and defend their margins during a potential economic slowdown. These include software companies that benefit from resilient business models and enterprise- versus consumer-driven revenue flows.

Global infrastructure companies also merit consideration, both in the current environment and as long-term portfolio allocations. Since midyear, more rate-sensitive and economically resilient areas of the market such as infrastructure, which had stumbled during most of the Fed's March 2022–July 2023 tightening cycle, have relegated formerly top-performing tech stocks to the back seat. As shown in Figure 6, global infrastructure outperformed the broad global equity market by a sizable margin in the third quarter. Heading into year-end, a lower (and falling) rate environment could make capital-intensive sectors such as infrastructure look even more enticing to equity investors.

Economic and market developments have bolstered the rally in infrastructure equities and should underpin their continued outperformance:

- The fits and starts in the megacap tech rally have come at a time when valuations for infrastructure look quite attractive, relative to both broader markets and their own history.
- Structural growth themes, including burgeoning demand for energy to support generative artificial intelligence (AI) expansion and the onshoring/nearshoring of manufacturing operations by U.S.-based multinational companies, still offer compelling avenues for investment in infrastructure.

Additionally, amid decelerating economic growth, we like global infrastructure's historical resilience in down markets. This ability to weather challenging conditions is due largely to inelastic demand for the necessary functions and services provided by several global infrastructure industries, including electric utilities, waste companies and data centers. Since its inception in December 2001, the S&P Global Infrastructure Index has generated a downside capture ratio of just 80.5% versus the MSCI All Country World Index through 30 September 2024, according to Morningstar Direct.

Geographically, we think U.S. equities offer the best combination of defensive characteristics and growth opportunities. Trends in AI are powerful structural tailwinds for the U.S. In terms of market capitalization size, we prefer large caps over their smaller counterparts, which tend to lag when economic growth slows. Outside the U.S., Japanese banks are targeting a 9% return on equity and buying back shares, while high-dividend stocks like construction companies should remain relatively unscathed by potentially outsized moves in the yen, as these businesses are generally not exposed to big overseas projects.

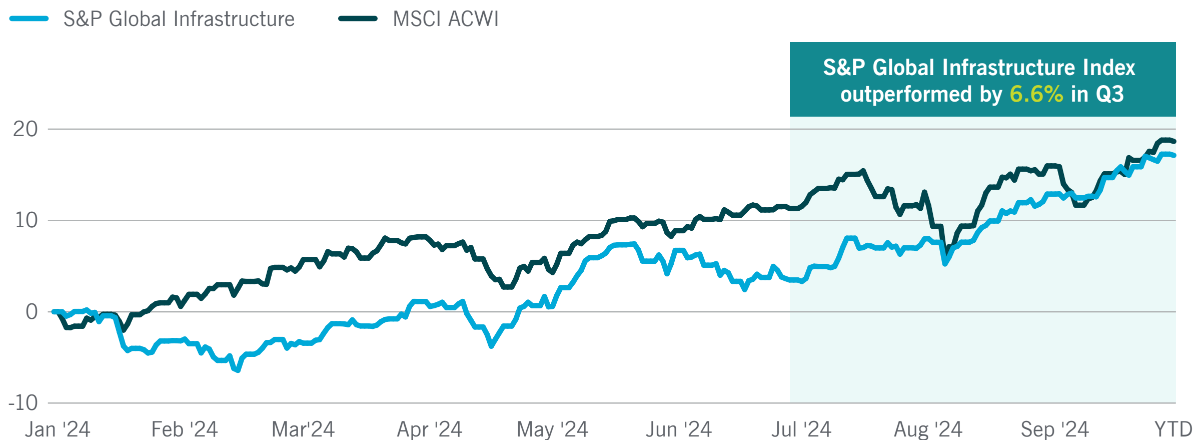
For investors with a higher risk tolerance, we have identified select EM opportunities, such as in Latin America's largest economy, Brazil. Brazilian stocks have demonstrated resilience, and their forward price-to-earnings (P/E) ratio looks inexpensive at 8.2x as of 30 September 2024, well below its 20-year average of 10.1x, according to FactSet.

Small caps face hurdles

Nuveen expects the Fed to maintain its easing bias, with the fed funds rate progressively declining to about 3.5% by mid-2025. Historically, small cap stocks have outperformed large caps following the first move in a Fed rate-cutting cycle. Why? Because smaller companies generally rely more on borrowing to finance growth and pay higher interest rates on that debt. When the Fed loosens

Figure 6: Rates and a murkier economic outlook have powered returns within listed global infrastructure

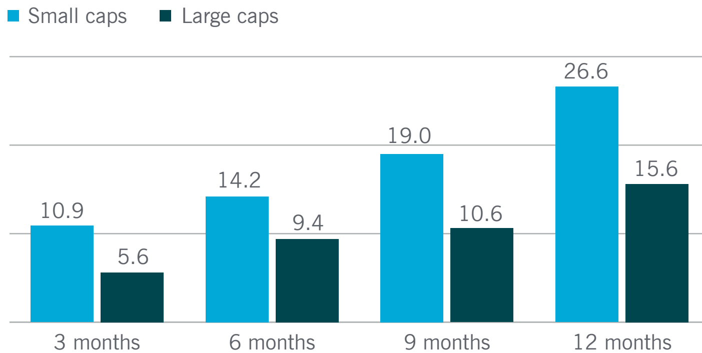
Listed global infrastructure vs. global stocks (%)



Data source: Morningstar Direct, 01 Jan 2024 - 30 Sep 2024. Daily net returns, in U.S. dollars. **Performance data shown represents past performance and does not predict or guarantee future results. It is not possible to invest directly in an index.**

Figure 7: The first cut's been the kindest … to small caps

*Returns (%) after Fed rate cutting commenced**



Data sources: U.S. Federal Reserve Board, Haver Analytics, Center for Research in Security Prices (CRSP), University of Chicago Booth School of Business, Jefferies. *Average returns based on past 13 rate-cut environments starting November 1957. Reflects the use of the fed funds rate from 1954 until 1963, the discount rate from 1963 until 1994 and the fed funds rate thereafter. **Representative Indexes: Large cap stocks:** Russell 1000 Index, inception date 31 December 1978; **small cap stocks:** Russell 2000 Index, inception date 1 January 1984. **Performance data shown represents past performance and does not predict or guarantee future results. It is not possible to invest directly in an index.**

policy, the cost of capital declines. A given small company can refinance at cheaper rates and use the proceeds to expand its business, which in turn can help boost its stock price. There's no guarantee history will repeat itself, but the initial cut this year could serve as a potential catalyst benefiting relative returns for small caps.

Yet at the same time, we would proceed with caution. Small caps tend to lag when the U.S. economy slows, and we believe a recession, albeit a mild one, is likely sometime next year. The Atlanta Fed's GDP Now tracker, which provides a running estimate of real GDP growth based on incoming economic data, edged down from +2.8% in late July to +2.5% by quarter-end, pointing to a decelerating pace of growth for the third quarter.

The market's concentration falters

For much of the year, the S&P 500 rallied on the strength of only a few stocks — notably the mega cap Magnificent 7 (Alphabet, Amazon, Apple, Nvidia, Meta, Microsoft and Tesla).[6] The market's lack of breadth was further evident in the first six months of 2024, when only 25% of the S&P 500's constituents outpaced the broader index. In the third quarter, however, the market rally showed signs of broadening, as about 60% of index names outperformed.[7] Meanwhile, the equal-weighted version of the S&P 500 gained +9.6% for the quarter, versus +5.9% for the standard, market-cap weighted version.[8] This broader participation is an encouraging sign given concerns that U.S. equities could be vulnerable to a pullback if the small group of stocks that had propped up the S&P 500 were to stumble.

A sound investment approach supports our outlook

Volatility and uncertainty present challenges for investors. But it is during these periods that investors may benefit most from a flexible investment approach supported by rigorous, bottom-up research, careful stock selection and thoughtful portfolio construction — which together can provide confidence and make a favorable impact on long-term financial goals.

Our equity heat map (Figure 8) provides perspective and detail on specific areas of the markets that we like on a relative basis. It isn't intended to represent a specific asset allocation, but rather to answer the question, "What are our highest conviction equity views over the next 12 months?"

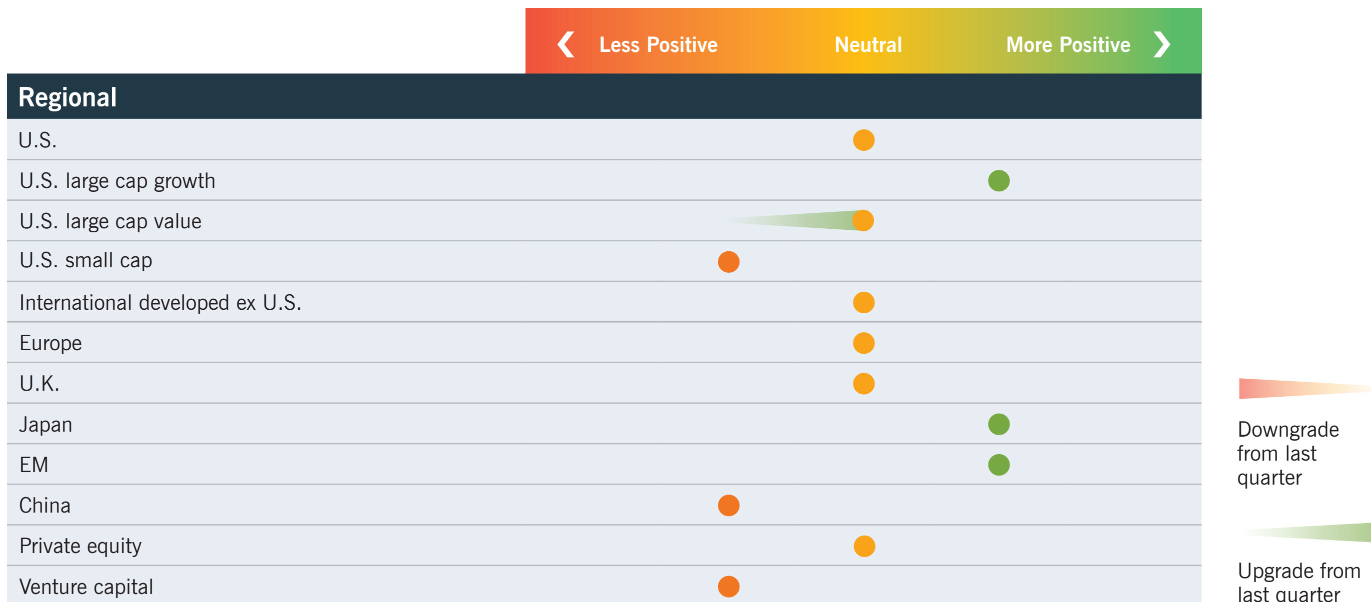
The earnings outlook: Optimistic, with caveats

S&P 500 earnings per share (EPS) estimates for the third quarter at +4.2% year-over-year look solid, albeit lower than they were when the quarter began. If these estimates are realized, it would mark the fifth consecutive quarter of positive earnings growth for the index, according to FactSet. Looking further ahead, analysts expect EPS growth to reach double digits in the fourth quarter of 2024 (+14.6%), and in the first (+14%) and second (+13.3%) quarters of 2025.

Meanwhile, net profit margins for the S&P 500 are forecast at +12.1% in the third quarter, in line with the +12.2% second-quarter result and higher than their five-year average of +11.5%.

These tailwinds have analysts calling for S&P 500 price gains of +9.4% over the next 12 months. That's well below 2024's year-to-date total return of +22.1%, but still a healthy advance. Among sectors, energy (estimated +20.5% price gain), communication services (+13.5%) and information technology (+13.2%) are expected to lead, with utilities (+3.2%) and consumer staples (+3.4%) lagging.

Figure 8: Equity style and geographic preferences heading into the fourth quarter of 2024



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We're cautiously optimistic about this performance outlook. Our view is tempered by valuations, which have become less attractive during the 2024 rally. As of 27 September, the forward 12-month P/E ratio for the S&P 500 has risen to 21.4x, well above its 5-year (19.5x) and 10-year (18.0x) averages, according to FactSet. In addition, the U.S. economy faces potential headwinds from key segments, including consumer spending (due to depleted household savings and increased use of credit) and the housing market (still plagued by steep home prices). Geopolitical concerns are also on our radar, as outlined in the following section.

RISKS TO OUR OUTLOOK

A number of factors have already pushed volatility higher this year: U.S. recession fears, shifts in the macroeconomic landscape and an unusually busy global election season. Potential repercussions from the escalation of hostilities in the Middle East could add to market jitters. Specifically, if the proxy war between Israel and Iran intensifies, or if the conflict widens further, the effects would be more severe.

Regarding the U.S. election, we expect investors to remain on edge as 05 November approaches, rattled by the spread of misinformation due to the AI boom, multiple military conflicts around the globe and hot button political issues such as U.S. tax policy. If the results lean Republican, the expiring 2017 Trump-era tax cuts would likely be extended or made permanent. In contrast, a more Democratic result may bode well for the expansion of clean energy tax credits.

In terms of the U.S. economy, we anticipate the pace of growth will continue to slow over the balance of 2024, with a mild recession occurring sometime in 2025 as our base case. This deceleration dynamic is evident in the data on several fronts. After several consecutive quarters of upside surprises, some key indicators are showing softness, including consumer spending, which makes up about 70% of GDP. Additionally, manufacturing activity is contracting, and the housing market is challenged by lack of affordability and still-high mortgage rates.

Markets may cheer continued disinflation, but a further decline in prices toward the Fed's 2% target might lead to the unwanted effect of lower corporate revenues. That, combined with stubbornly high labor costs (i.e., rising wages), could also weigh on profits.

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For more information, please visit us at nuveen.com.

Endnotes

1 Trading Economics
2 Trading Economics
3 Morningstar Direct
4 Morningstar Direct
5 Morningstar Direct
6 References to specific company stocks should not be construed as recommendations or investment advice.
7 Reuters. 30 Sept 2024
8 Morningstar Direct

Sources

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Because infrastructure portfolios concentrate their investments in infrastructure-related securities, portfolios have greater exposure to adverse economic, regulatory, political, legal, and other changes affecting the issuers of such securities. Infrastructure-related businesses are subject to a variety of factors that may adversely affect their business or operations, including high interest costs in connection with capital construction programs, costs associated with environmental and other regulations, the effects of economic slowdown and surplus capacity, increased competition from other providers of services, uncertainties concerning the availability of fuel at reasonable prices, the effects of energy conservation policies and other factors. Additionally, infrastructure-related entities may be subject to regulation by various governmental authorities and may also be affected by governmental regulation of rates charged to customers, service interruption and/or legal challenges due to environmental, operational or other mishaps and the imposition of special tariffs and changes in tax laws, regulatory policies and accounting standards. There is also the risk that corruption may negatively affect publicly funded infrastructure projects, especially in emerging markets, resulting in delays and cost overruns. In addition, investing internationally presents certain risks not associated with investing solely in the U.S., such as currency fluctuation, political and economic change, social unrest, changes in government relations, differences in accounting and the lesser degree of accurate public information available, foreign company risk, market risk and correlation risk. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

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