

CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

2023: Shifting gears from inflation to recession

Bottom line up top:

Expect both more and less of the same in 2023. With 2022 approaching its curtain call, it's a safe bet there'll be more "boos" than calls for "encore!" from an audience of dispirited investors. The turning of the calendar signals a time to look ahead to where we think the economy and markets may be headed. I had the opportunity to do just that by sharing some of Nuveen's best ideas and estimates in this past weekend's edition of *Barron's*. Among the highlights:

- Overall, our near-term expectations remain unchanged in the wake of last week's U.S. Federal Reserve meeting. The much-anticipated smaller rate increase of +50 basis points (bps) was accompanied by an unexpected and sizable jump in the Fed's projected terminal rate for year-end 2023, which rose considerably, to 5.125%. And 17 of the 19 Fed governors called for a rate of more than 5% by the end of 2023.
- That relatively hawkish tone, however, does not substantively alter our views, as our core themes remain the same. We continue to call for:
 - Decelerating rate hikes in 2023, with a terminal rate estimate of 4.5%-4.75%
 - Slowing economic activity, likely resulting in a mild recession by mid-2023 and real GDP growth of only 1% following this expected shallow midyear contraction
 - A further downward trajectory for inflation as labor market conditions loosen and unemployment reaches the mid-4% range, although core PCE (likely falling to 3%) should remain above the Fed's 2% target

Against this backdrop, we reaffirm the portfolio construction views spelled out in our recent Global Investment Committee (GIC) 2023 Outlook.



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.

What goes up must come down. And we're not just talking inflation and interest rates. Consider:

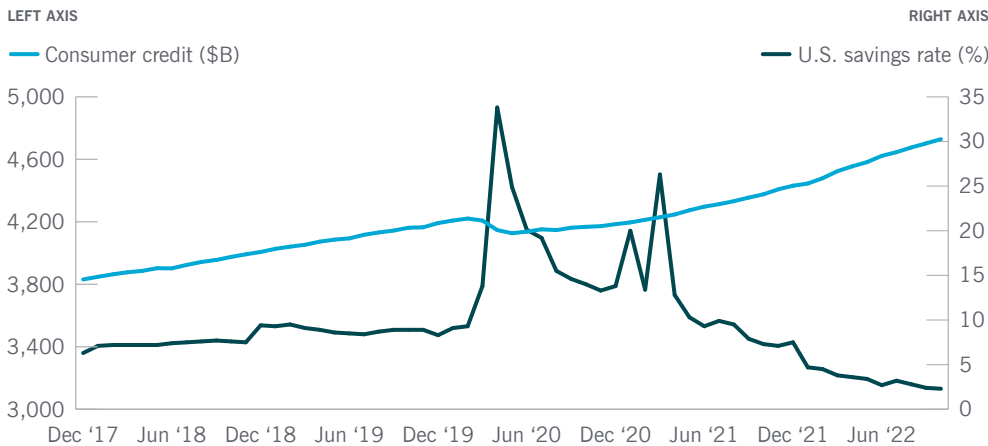
- **Earnings estimates** for the S&P 500 Index remain entirely too high for 2023, in our view. Recession — and the disinflation it will likely bring — will weigh on corporate revenue and earnings growth, but analyst estimates have thus far failed to reflect this distinct possibility. This could lead to further equity market volatility through the first half of 2023.
- **Household savings rates** have already experienced a return to earth, and with that has come a dramatic increase in the use of revolving credit, adding debt to consumer balance sheets (Figure 1).
- **The expected deterioration of economic activity and loosening of labor markets** are red flags for certain areas of equities, especially companies in the consumer discretionary sector.

Predicting the unpredictable. Historically, equity markets begin their recovery three to six months before the end of a recession. Of course, no one can forecast with certainty the future of markets, rates and inflation. But we think investors should keep a keen eye out for industries and sectors that are well-positioned for a recessionary and post-recessionary economic environment. Below we offer our perspective on areas of the market that fit that category.

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FIGURE 1: THE DROP IN SAVINGS IS LEADING TO A SHARP RISE IN CONSUMER CREDIT

Consumer credit versus U.S. savings rate



Data source: Bloomberg L.P., 31 Oct 2022. Consumer credit is represented by the Federal Reserve Consumer Credit Total Outstanding Amount Index. The U.S. savings rate is based off a percentage relative to disposable income.

Portfolio considerations:

For equities, the best offense is a good defense — in the near term.

Heading into year-end, we continue to prefer defensive equity positioning, allocating to **dividend growth stocks** and **U.S. public infrastructure**, which can serve as a hedge against sticky inflation. This preference may evolve over the next 12 to 18 months, as we think certain subsectors of **U.S. technology** will look increasingly attractive, particularly **semiconductors** and **software**.

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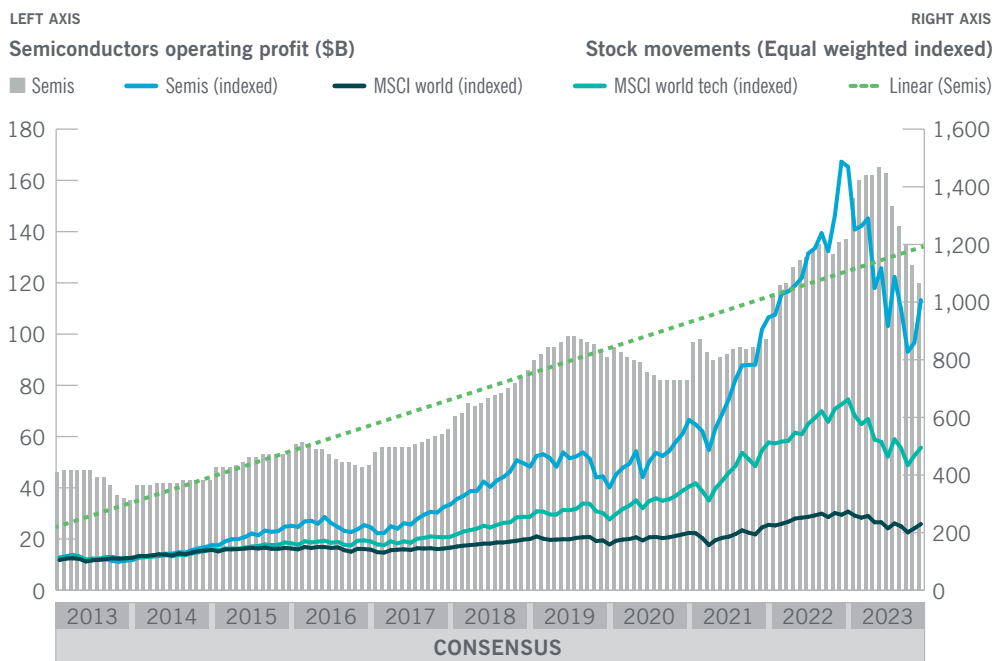
We expect consumer resilience to weaken over the first half of next year.

The sharp rise in interest rates during 2022 has hit longer-duration stocks like those in the technology sector particularly hard because their cash flows are further out. With the bulk of Fed's hikes behind us and the dot plot signaling a fed funds rate of 5.125% by year-end 2023, it may be time to start dollar-cost-averaging into sectors that have been hurt the most this year.

Semiconductors recently experienced their seventh consecutive month of negative earnings revisions. Historically, downward earnings cycles in this subsector have lasted six to nine months (Figure 2), so we may be reaching the end of this cycle. Based on company comments and reports, January could bring the final round of earnings cuts, setting up semis nicely for a potential recovery in 2023.

FIGURE 2: SEMICONDUCTORS HAVE SEEN NEGATIVE EARNINGS REVISIONS, BUT COULD BE WELL PLACED FOR 2023

Semiconductor earnings versus stock performance



Data source: FactSet, 15 Dec 2022. Performance data shown represents past performance and does not predict or guarantee future results.

Software is another subsector we find attractive, as its cash flows are more linked to enterprise revenue than to the consumer. We expect consumer resilience to weaken over the first half of next year, with a personal savings rate that has already dropped to its lowest level since 2007 and unemployment likely to rise. Enterprise software revenue is linked to enterprise contracts, which tend to have more consistent recurring revenue and could serve as a source of quality growth within a portfolio's equity allocation.

Lastly, we believe the **materials** sector may provide select opportunities to identify businesses that can protect margins during an economic downturn by maintaining lower input costs and pricing power.

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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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