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Weekly Investment Commentary

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Investors focus on the negatives as stocks' trading range continues

Equities suffered their largest weekly decline in two years last week, with the S&P 500 Index dropping -5.9%.[1] The market focused mainly on risks associated with ramped up tariff rhetoric, which led to fears that the United States was on the verge of entering an all-out trade war. Investors were also concerned about prospects for more aggressive monetary policy tightening and signs of economic weakness. The technology and financials sectors led the way down, with mega-cap tech stocks hit particularly hard.[1] Energy companies, in contrast, fared better on a relative basis.[1]

HIGHLIGHTS

- **Stock prices suffered their biggest weekly loss in two years as investors focused on several key downside risks.**
- **Mounting trade protectionism could represent a serious problem for the economy and financial markets, but we think the rhetoric doesn't match the reality.**
- **Market fundamentals remain solid over the long-term, but near-term caution may be warranted.**

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Bob Doll serves as a leading member of the equities investing team for Nuveen Asset Management, providing reasoned analysis through equity portfolio management and ongoing market commentary.

Are investors overly pessimistic about downside market risks?

While fundamentals haven't changed significantly, volatility has picked up recently and stocks have been trading in a broad range between their early February highs and the low established in last month's correction.[1] The U.S. and global economies appear on sound footing, inflation pressures appear contained, the labor market remains strong, corporate earnings are solid and interest rates have been rising only modestly. Given this divergence between our views and market behavior, we think it makes sense to focus on why we think some risks may be overstated.

1) Trade issues are more rhetoric than reality, at least for now: Current trade issues appear to be more about appearance than actual policy shifts. True, President Trump's steel and aluminum tariffs went into effect last week, but key trading regions were granted waivers, including Mexico, Canada, Argentina, Brazil, Australia, South Korea and the entire eurozone. Likewise, the president's latest statements about more trade restrictions still require policy specifics.

Taking a step back, it seems that most of the trade discussion is about political posturing rather than economic reality. President Trump has essentially fired a series of warning shots at China and it is unclear what the specific follow-throughs may be, especially when it comes to trade disputes with other countries.

In reality, China would have much more to lose than the United States in a full-fledged trade war. In 2016, 23% of China's exports ($480 billion) went to the United States while only 8% of U.S. exports ($115 billion) went to China.[2] As a result, the Chinese economy depends more heavily on the United States than vice versa. We think Chinese officials will look for a win/win scenario that allows President Trump to claim a domestic political victory while doing little actual damage to the Chinese economy. And indeed, news over the weekend indicated that U.S./China trade negotiations were making progress.

The risk, of course, is that an actual trade war could be wildly unpredictable and the outcome could spin out of anyone's control. Such a scenario could present more serious concerns for financial markets, but we peg the odds of that occurring as relatively low.

2) The United States can withstand additional interest rate increases: As widely expected, the Federal Reserve hiked rates last week and pointed to a strengthening U.S. economy. Although the Fed might increase rates slightly faster than earlier anticipated, interest rates remain historically low and remain well below a neutral level given economic growth and inflation trends. We do not believe rates will rise sharply or dramatically enough to derail the equity bull market.

3) The U.S. economy may be leveling out, but does not appear to be slowing: Relatively weak retail sales figures have led economists to expect a slight slowdown in first quarter growth.[3] Other areas of the economy, such as the labor market and manufacturing, remain strong.[4] This indicates to us that growth should rebound in the second quarter.

4) Political uncertainty is unlikely to act as a sustained drag on stocks: The ongoing Robert Mueller investigation and revolving door of White House officials makes it seem that President Trump is surrounding himself with loyalists who may not provide unbiased advice. While these events add to political uncertainty, they shouldn't affect market fundamentals. We expect any downside market reaction to be relatively limited.

5) Recent underperformance of mega-cap tech stocks does not mean the bull market is ending: Concerns are understandable, since this area of the market has been a stalwart leader for years. But we think this reflects growing divergence between areas of the market rather than a leading indicator for the market as a whole.

Caution toward stocks is warranted until more clarity emerges

It is possible that we are wrong about any or all of the above points. Trade issues or other political issues could worsen, the Fed could make a policy mistake, economic growth could take a turn for the worse or the stock market could experience broader and more pronounced weakness.

We are mainly focusing on the issues of near-term changes in actual trade policy and the direction of interest rates. For the former, we expect cooler heads will prevail and at the worst we will see modest retaliatory trade actions from other countries. For the latter, we are somewhat reassured that bond yields have leveled off after a sharp spike in February.

Until more clarity emerges, we are approaching equity markets cautiously. We would not be surprised to see relatively high levels of volatility continue, and we may not be out of the woods with the current correction.

Longer-term, however, we retain a relatively optimistic view toward stock markets. We do not believe we are approaching an economic recession or an imminent equity bear market. We expect that, over time, stock prices will again be able to climb the wall of worry.

2018 PERFORMANCE YEAR TO DATE

	Returns	
	Weekly	YTD
S&P 500 Index	-5.9%	-2.8%
Dow Jones Industrial Average	-5.6%	-4.3%
NASDAQ Composite	-6.5%	1.5%
Russell 2000 Index	-4.8%	-1.4%
Euro Stoxx 50	-3.4%	-2.9%
FTSE 100 Index (U.K.)	-1.8%	-4.8%
DAX Index (Germany)	-3.5%	-5.4%
Nikkei 225 Index (Japan)	-3.9%	-2.9%
Hang Seng Index (Hong Kong)	-3.8%	1.2%
Shanghai Stock Exchange Composite Index (China)	-3.3%	-1.8%
MSCI EAFE	-2.6%	-2.5%
MSCI Emerging Markets Index	-3.4%	1.5%
Bloomberg Barclays U.S. Aggregate Bond Index (bonds)	0.0%	-2.0%
BofA Merrill Lynch 3-MonthTreasury Bill (cash)	0.0%	0.3%

Source: Morningstar Direct, Bloomberg and FactSet as of 23 Mar 2018. All index returns are shown in U.S. dollars. Past performance is no guarantee of future results. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account. All indices are unmanaged and unavailable for direct investment.

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1 Source: Morningstar Direct, Bloomberg and FactSet. 2 Source: Geopolitical Futures, 22 March 3 Source: Commerce Department 4 Source: Institute for Supply Management

The **S&P 500 Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy. The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq. The **Nasdaq Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. The **Russell 2000 Index** measures the performance approximately 2,000 small cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. **Euro Stoxx 50** is an index of 50 of the largest and most liquid stocks of companies in the eurozone. **FTSE 100 Index** is a capitalization-weighted index of the 100 most highly capitalized companies traded on the London Stock Exchange. **Deutsche Borse AG German Stock Index** (DAX Index) is a total return index of 30 selected German blue chip stocks traded on the Frankfurt Stock Exchange. **Nikkei 225 Index** is a price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange. **Hong Kong Hang Seng Index** is a free-float capitalization-weighted index of selection of companies from the Stock Exchange of Hong Kong. **Shanghai Stock Exchange Composite** is a capitalization-weighted index that tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. **MSCI EAFE Index** is a free float-adjusted market capitalization weighted index designed to measure developed market equity performance, excluding the U.S. and Canada. The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. **Bloomberg Barclays U.S. Aggregate Bond Index** covers the U.S. investment grade fixed rate bond market. The **BofA Merrill Lynch 3-Month U.S. Treasury Bill Index** is an unmanaged market index of U.S. Treasury securities maturing in 90 days that assumes reinvestment of all income.

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