What Matters and What Doesn't for Equity Markets?

NUVEEN ASSET MANAGEMENT

WEEKLY INVESTMENT COMMENTARY

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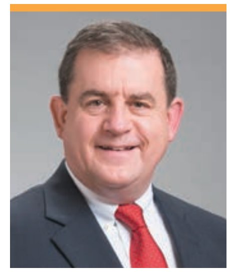
Investor attention remained focused on Washington, D.C. last week. The Senate passed a budget resolution, while President Trump is set to announce who he will select as the next head of the Federal Reserve. These factors, combined with ongoing solid economic data, allowed the so-called reflation trade to continue as higher-risk financial assets gained ground. U.S. equities notched their sixth consecutive week of gains, Treasury yields rose modestly, credit spreads declined and industrial metals gained ground.[1]

Key Points

- Equities enjoyed their sixth week of gains, as higher-risk areas of the financial market continue to outperform.
- Tax reform would likely provide additional upside for stocks.
- One risk we are watching is the possibility of a spike in Treasury yields that could disrupt the stock market.



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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.

Weekly Top Themes

1. **Earnings remain a solid tailwind for equity prices.** Just over 20% of S&P 500 companies have announced third quarter results. Earnings are beating expectations by 4.5% and revenues by 1.0%.[2] This compares to the long-term historical average of 4.7% and 0.3%, respectively.[2] Earnings per share are on track to rise 8% for the quarter.[2]

2. **The Fed's balance sheet normalization should have a limited effect on equity markets.** The Fed is not planning to alter the pace of normalization, which means the move is already priced into financial markets. Additionally, the relative size of the Fed's quantitative easing purchases was relatively modest. The Fed's asset purchases never exceeded net Treasury issuance, while the Bank of Japan's QE program was three times government bond issuance and the European Central Bank's was seven times issuance.[3] As a result, the wind-down from the BOJ and ECB may have more influence on financial markets.

3. **Equity prices do not depend on tax reform.** In our view, the current bull market has been based on improving economic growth, low inflation and improving corporate earnings and profits. Additional support from fiscal stimulus such as tax cuts would likely act as an additional positive factor.

4. **Regulatory changes from Washington should continue to support equities around the margins.** Although President Trump's legislative agenda has faltered, he has made progress on reducing regulations and lowering regulatory enforcement. These actions have generally been equity-friendly, especially for the energy and financial sectors.

5. **While a reasonable bearish case can be made for equities, we lean more bullish.** The bears point to overly optimistic earnings forecasts and rising valuations as reasons for a possible end to the years-long rally. In contrast, bulls

argue that low volatility and low-intra-stock correlation suggest comfort with ongoing market highs. While both views have merit, we believe fundamentals argue for a continuation of the current bull market for stocks.

The Reflation Trade Should Persist

Investors remain calm as equity prices continue to move higher against a backdrop of very low volatility. The Fed is starting to shrink its balance sheet, and will probably raise interest rates in December. Outside of the United States, other central banks are also contemplating rate hikes or ending quantitative easing programs. Yet, monetary policy remains accommodative and investors seem to be betting that central banks will become less aggressive at any hint of weaker economic growth.

We expect low interest rates, low inflation and moderate growth levels should continue to allow central banks to tighten policy slowly and carefully. At the same time, the Fed seems unconcerned about financial asset inflation or asset bubbles. While there may be pockets of asset bubbles in some areas of the equity, credit and real estate markets, such issues do not appear to be widespread. We do, however, see valuation problems in Treasuries and other government bond markets. Yields seem to be artificially low given economic growth and monetary policy conditions, and investors continue to engage in periodic flights-to-quality when economic data is not overly strong or the Fed is perceived to be backing away from higher interest rates. This could lead to a sharper rise in bond yields that could trigger a temporary setback in equities as well.

As long as the global economy remains solid, we think risk assets should continue to outperform. We may see a period of consolidation in markets at some point, but on balance, we continue to have a favorable view toward equities and think it makes sense to lean into the reflation trade. ■

2017 Performance Year to Date

	Returns Weekly	YTD
S&P 500 Index	0.9%	16.9%
Dow Jones Industrial Average	2.0%	20.3%
NASDAQ Composite	0.4%	24.2%
Russell 2000 Index	0.5%	12.4%
Euro Stoxx 50	-0.3%	26.1%
FTSE 100 (U.K.)	-0.9%	16.4%
DAX Index (Germany)	-0.4%	26.4%
Nikkei 225 (Japan)	0.1%	17.3%
Hang Seng (Hong Kong)	0.1%	33.5%
Shanghai Stock Exchange Composite (China)	-1.0%	16.6%
MSCI EAFE (non-U.S. developed markets)	-0.3%	22.0%
MSCI Emerging Markets	-0.5%	32.7%
Bloomberg Barclays U.S. Aggregate Bond (bonds)	-0.5%	3.0%
BofA Merrill Lynch 3-Month Treasury Bill (cash)	0.0%	0.6%

Source: Morningstar Direct and Bloomberg, as of 10/20/17. 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, as of 10/20/17 **2** Source: Credit Suisse **3** Source: Deutsche Bank

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.

A WORD ON RISK

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