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Weekly Investment Commentary

20 February 2018

Stocks recover ground as the focus returns to fundamentals

Stocks rebounded last week as investors appeared to return their focus to improving economic growth and solid corporate earnings. The S&P 500 Index jumped 4.4% and experienced its best week in more than five years.[1] While stocks remain down for the month, they are back in positive territory for the year.[1] Volatility also declined last week as markets calmed down slightly. Treasury yields rose last week as the yield curve flattened. At one point, the 10-year Treasury yield climbed to 2.94% before declining.[1] While we may see further market volatility, it appears the worst of the recent correction is in the rearview mirror.

HIGHLIGHTS

- **Stocks bounced back strongly last week, experiencing their best weekly gains in more than five years.**
- **Interest rates and inflation are both likely to continue rising, which could contribute to additional market volatility in the months ahead.**
- **Overall economic and market fundamentals remain stable, which suggests that equity prices can still move higher.**

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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.

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Weekly top themes

1 ***The recent spikes in volatility have been due in part to technical market factors.*** As markets started to fall, bid/ask spreads widened and highly leveraged low-volatility strategies were forced to unwind.[1] In our view, this accelerated selling and contributed to the panic-like conditions early in the week.

2 ***Rising inflation pressures could act as an ongoing headwind for stocks.*** Improving wage growth was one catalyst that sparked the current correction. We expect this trend will continue putting upward pressure on inflation and bond yields. A combination of tax cuts and significant federal spending increases may accelerate these developments.

3 ***Last week's budget deal removes short-term uncertainty from the markets, but could cause longer-term issues.*** The package will add significant additional short-term stimulus and boost defense spending, which could cause an increase in both economic growth and inflation. It also makes the nation's troublesome fiscal problems even worse. Additionally, the spending package greatly reduces the risk of another budget fight, but probably eliminates any chance of an infrastructure deal.

4 ***Despite the market turmoil, economic fundamentals remain sound.*** Leading indicators and corporate earnings trends point to a continuation of the economic expansion and bull market. Warning signs to the contrary would include widening credit spreads and/or tightening financial conditions, but those have not materialized.

5 ***Corporate earnings continue to improve.*** With more than 80% of S&P 500 companies reporting results, earnings-per-share are up about 15% and sales are up in the high single-digits.[2] At this point, 81% of companies are beating earnings expectations, the highest level in eight years.[2]

Volatility is likely to remain elevated

The long-term outlook for stocks appears unambiguously positive in our view. Global growth is strong, corporate revenues are rising, profit margins are high and corporate tax cuts are providing additional tailwinds. One caveat to this optimistic outlook is that corporate earnings estimates are becoming more variable and volatile. This variability partially reflects uncertainty over how tax cuts will affect earnings, but it is also due to rising interest rates and inflation, which could eventually become negatives for corporate earnings.

To us, this represents the biggest risk to stocks. It shouldn't be surprising that the recent sharp correction was precipitated by a strong inflation reading. And rates and inflation appear to be in the midst of an important inflection point, with both rising from very low levels. This has the potential to contribute to greater periods of volatility in the months ahead.

This does not mean we are calling for an end to the current bull market or that we will see the extreme back-and-forth we experienced in recent weeks. Indeed, it is possible that we have already seen the low (around 2,525 for the S&P 500 Index) and the high (around 2,875) this year.[1]

One of our key investment themes for 2018 has been our belief that as economic growth improves, both yields and inflation would rise, causing more volatility. Such an environment can still be good for stock prices, but the road ahead is likely to remain bumpy as economic fundamentals continue to shift.

2018 PERFORMANCE YEAR TO DATE

	Returns	
	Weekly	YTD
S&P 500 Index	4.4%	2.5%
Dow Jones Industrial Average	4.4%	2.4%
NASDAQ Composite	5.4%	5.0%
Russell 2000 Index	4.5%	0.6%
Euro Stoxx 50	5.0%	1.5%
FTSE 100 Index (U.K.)	5.1%	-1.1%
DAX Index (Germany)	4.8%	-0.3%
Nikkei 225 Index (Japan)	3.8%	1.3%
Hang Seng Index (Hong Kong)	5.5%	3.9%
Shanghai Stock Exchange Composite Index (China)	1.4%	-0.8%
MSCI EAFE	4.3%	1.4%
MSCI Emerging Markets Index	5.0%	3.7%
Bloomberg Barclays U.S. Aggregate Bond Index (bonds)	-0.2%	-2.1%
BofA Merrill Lynch 3-MonthTreasury Bill (cash)	0.0%	0.2%

Source: Morningstar Direct, Bloomberg and FactSet as of 20 Feb 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.

"Rising yields and inflation remain risks for stocks, but we believe equity prices can continue to advance."

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1 Source: Morningstar Direct, Bloomberg and FactSet. 2 Source: Department of Labor

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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