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Weekly Investment Commentary

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The bull market should continue, but risks may be around the corner

The risk-on theme continued for a third straight week, as the S&P 500 Index rose 0.9%.[1] Once again, Treasury prices fell while the yield curve flattened.[1] Investor sentiment appears to be improving, with some moving money into the stock market based on fears that they may have missed the rally. Tax reform continues to push markets higher, but we think improvements in corporate earnings expectations have been the primary driver of returns.

HIGHLIGHTS

- **Stock prices have surged to start 2018 as both investor sentiment and market fundamentals have improved.**
- **We think warning signs are growing and cite rising bond yields and inflation as the chief risks for equities.**
- **We also think this bull market still has room to run and that investors should stick with a pro-growth bias.**

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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 ***The "melt up" in equity prices has been driven by both sentiment and fundamental improvements.*** Expectations for corporate earnings in 2018 were high before the tax bill and are now moving even higher.[1]

2 ***Companies have several equity-friendly plans for their tax windfalls.*** When asked in a recent survey how they would use their cash, the top answers were: 1) increase capital expenditures, 2) pay down debt, 3) increase dividends, 4) hold more cash and 5) raise wages.[2]

3 ***Wage rates appear to have room to rise before pressuring corporate profit margins.*** Wages usually grow about 4% year over year before they cause margin pressure.[3] With wage growth only at 2.5%, there appears to be room for this business cycle to continue.[3]

4 ***Rising Treasury supply may put upward pressure on yields.*** Rising budget deficits and the Federal Reserve's balance sheet unwinding may cause U.S. Treasury supply to nearly double this year.[4] Yields have been rising as investors priced in better economic growth, and increased supply may accelerate this trend.[1]

5 ***Stocks may be fairly valued, but that doesn't mean this bull market is over.*** At the beginning of the year, we pegged 2,800 as a fair value for the S&P 500 Index. The index has already reached this level before the end of January.[1] But that doesn't mean prices can't still rise, since bull markets rarely stop at fair valuation.

6 ***Growing market breadth is supportive for stocks.*** At the midpoint of January, 41% the S&P 500 companies reached a new three-month high, the broadest reading of the new-high list since 2013.[4] Historically, such broadening has been associated with a continuation of bull markets.[4]

7 ***Rising inflation remains the chief risk facing equities.*** Rising investor optimism, sustained synchronized global growth and a tightening labor market all point to inflation moving higher.

We are not yet seeing warnings signs that would signal a correction

Over the past 18 months, investor sentiment appears to have come full circle. In mid-2016, deflation fears reigned and investors seemed eager to embrace negative news. Since that time, however, optimism toward economic growth, earnings growth and stock market prospects have become the main investment themes. The most recent example of this trend is the incredibly positive reaction to last month's tax bill, which has caused investors and analysts to forecast increasingly higher earnings results even as valuations are growing less attractive.

Such an environment causes us to take pause and examine the risks. Earnings expectations are quite high. While we think they can still be met, the higher expectations rise, the harder it will be for results to beat estimates.

More worrisome for us are developments in the bond market. Short-term yields have already been rising quickly and longer-term yields are starting to follow. We don't see warning signs yet, but as the 10-year Treasury yield approaches 3%, the more concerned we would be that rising yields could cause negative pressure on stock prices. Similarly, we expect rising inflation could cause problems, especially if the pace of economic growth improvements is interrupted.

But while these risks are rising, we do not think they have reached critical levels. Market fundamentals remain sound, breadth is improving and valuations are not yet stretched. As such, we think investors should stick with a pro-growth investment stance, but should increasingly be on the lookout for warning signs.

2018 PERFORMANCE YEAR TO DATE

	Returns	
	Weekly	**YTD**
S&P 500 Index	0.9%	5.2%
Dow Jones Industrial Average	1.1%	5.6%
NASDAQ Composite	1.0%	6.3%
Russell 2000 Index	0.4%	4.1%
Euro Stoxx 50	1.8%	6.0%
FTSE 100 Index (U.K.)	0.7%	3.1%
DAX Index (Germany)	2.3%	5.8%
Nikkei 225 Index (Japan)	1.2%	6.4%
Hang Seng Index (Hong Kong)	2.7%	7.7%
Shanghai Stock Exchange Composite Index (China)	2.7%	7.2%
MSCI EAFE Index	1.3%	5.0%
MSCI Emerging Markets Index	2.0%	6.4%
Bloomberg Barclays U.S. Aggregate Bond Index (bonds)	-0.4%	-0.9%
BofA Merrill Lynch 3-MonthTreasury Bill (cash)	0.0%	0.1%

Source: Morningstar Direct, Bloomberg and FactSet as of 19 Jan 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.

"Equity risks appear to be rising, but they have yet to reach critical levels."

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1 Source: Morningstar Direct, Bloomberg and FactSet. 2 Source: ISI Evercore survey, 16 Jan 2018. 3 Source: Deutsche Bank Research 4 Source: Strategas Research

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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