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Weekly Investment Commentary

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Equities tread water, although fundamentals look sound

Equity markets struggled to gain clear direction last week. Investors focused on geopolitical issues, particularly U.S./China trade negotiations and the on-again-off-again prospects for a summit with North Korea. Other issues included the sustainability of the U.S. and global economic expansions, rising bond yields, the spike in oil prices and Federal Reserve policy. The S&P 500 Index rose 0.3% for the week.[1] Income-oriented sectors, technology and consumer discretionary led the way, while energy and materials were laggards.[1] Treasury markets also gained ground as the 10-year Treasury yield fell back below 3%.[1]

HIGHLIGHTS

- **Stock prices and bond yields are being held back due to mounting geopolitical risks, especially trade issues. Trade risks remain contained for now, but have the potential to damage the economy and financial markets.**
- **As long as these risks don't materially worsen, we think the economic expansion should continue and corporate earnings should improve, which is a solid backdrop for stock prices.**

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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. ***Improving corporate earnings have made equity valuations more attractive.*** Estimates for 2018 earnings-per-share growth have been advancing sharply since the beginning of the year. S&P 500 2018 earnings expectations have improved by almost $14 (or 9%) since the start of the year, pushing the forward price-to-earnings multiple down to about 15.5.[1] As a result, equities have cheapened, reflecting geopolitical risks and the dual headwinds of rising interest rates and inflation.

2. ***Trade tensions have eased in recent weeks, but risks remain.*** Prospects for new tariffs appear to be off the table, at least for now. A key question going forward will be how seriously Chinese officials take the issue of intellectual property protection.

3. ***Some aspects of the technical backdrop for equity markets are looking more risky.*** In particular, we are concerned about the proliferation of highly leveraged ETFs, highly correlated quantitative strategies and a general lack of liquidity. We don't see a specific catalyst for a sharp selloff in the immediate term, but are concerned that markets could be vulnerable to a quick and dramatic fall as occurred in early February.

4. ***Long-term U.S. demographic trends could become worrisome.*** 2017 marked the second consecutive year of sharply falling fertility rates, extending a deep decline that began in 2008.[2] Last year, fertility rates fell 3%, the largest annual decline since 2010 when families were bearing the brunt of the Great Recession.[2] In countries like Japan, declining fertility rates tend to be an economic negative, affecting everything from entitlement programs, productivity and labor force growth.

5. ***Republicans' prospects in the upcoming midterm elections appear to be improving.*** It is early in the political season, but polling data for the GOP has been improving. We still think the odds favor the Democrats taking the House of Representatives, but the Senate looks as though it will stay in Republican hands.

Equity prices are likely to continue churning, but should eventually move higher

Higher levels of geopolitical uncertainty has caused a rise in market volatility this year. It has also helped keep a lid on both Treasury yields and stock prices, despite the stellar corporate profits backdrop.

For the past several months, the main geopolitical issue has been a rise in trade protectionism. Rising protectionism tends to be a lose/lose proposition for all parties. But the Trump Administration seems determined to stick with harsh trade rhetoric, both to call attention to the large and rising current account deficit and to appease the president's base. The president is eager to point to a political "win" before the midterms, and Chinese officials appear willing to grant modest near-term concessions. The world has avoided a serious trade war so far, and economic sentiment is holding firm. But the situation could escalate quickly. For now, we think trade-related risks remain contained, but could represent a significant economic and market issue should things change for the worse.

For now, we think global financial markets will remain in the current churning range. Assuming the geopolitical backdrop doesn't worsen and derail the economic expansion, we expect the Fed to continue slowly raising rates, bond yields to climb and the U.S. dollar to firm modestly over the coming months. Treasury yields are experiencing upward pressure in this environment, but are unlikely to break out strongly to the upside since investors remain focused on downside risks.

Within equities, we see few negative technical signs other than the ones cited previously. Small cap stocks have been outperforming this year, and high yield bond spreads remain relatively low—the reverse tends to be the case when markets are facing a pronounced risk-off phase. Stock prices are treading water during a longer bull market phase. This should bode well for equities over the long term.

2018 PERFORMANCE YEAR TO DATE

	Returns	
	Weekly	YTD
S&P 500 Index	0.3%	2.6%
Dow Jones Industrial Average	0.2%	1.1%
NASDAQ Composite	1.1%	8.2%
Russell 2000 Index	0.0%	6.4%
Euro Stoxx 50	-2.5%	-0.7%
FTSE 100 Index (U.K.)	-1.8%	0.9%
DAX Index (Germany)	-2.1%	-2.9%
Nikkei 225 Index (Japan)	-1.0%	2.3%
Hang Seng Index (Hong Kong)	-1.1%	3.0%
Shanghai Stock Exchange Composite Index (China)	-1.4%	-2.9%
MSCI EAFE	-1.6%	0.1%
MSCI Emerging Markets Index	0.0%	-1.2%
Bloomberg Barclays U.S. Aggregate Bond Index (bonds)	1.0%	-2.0%
BofA Merrill Lynch 3-MonthTreasury Bill (cash)	0.1%	0.6%

Source: Morningstar Direct, Bloomberg and FactSet as of 25 May 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.

"For now, we expect equities to continue treading water, but we believe markets remain in a long-term bull market."

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1 Source: Morningstar Direct, Bloomberg and FactSet

2 Source: National Center for Health Statistics

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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