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TEN PREDICTIONS FOR 2018: 2Q UPDATE

# Stocks stuck in the crosscurrents

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

# *The U.S. economy appears to be accelerating*

**AFTER A RELATIVELY SLOW START TO THE YEAR, U.S. ECONOMIC GROWTH APPEARS TO BE PICKING UP.** The labor market in particular has been a source of strength: Unemployment dropped to 3.75% in May, its lowest level since December 1969.[1] Consumer spending has also been improving, with May retail sales climbing 0.8%, the fastest pace in six months.[1] We expect second quarter real gross domestic product growth could be close to 4% and around 3% in the second half of 2018. Growth in other parts of the world has trailed off, especially in Europe and China. The Index of Leading Economic Indicators is gaining strength in the U.S., but appears to be slowing in most of the rest of the developed world.[2] Overall, however, the global economy continues to grow.

**ONE OVERLOOKED AREA OF THE ECONOMY HAS BEEN ESPECIALLY STRONG: SPENDING ON CAPITAL EXPENDITURES.** Companies have been unwilling to commit to capital expenditures (CapEx) since the start of the current economic recovery, but that is starting to change. Capex has risen sharply in 2018, driven by a combination of tax cuts and capex expensing changes, rising corporate profits, less regulation, low financing costs and the need to replace old and unproductive capital equipment. Strength in the capex space should bolster the economic expansion by sustaining growth in goods-producing jobs and promoting labor force participation. More importantly, rising capex levels should continue supporting productivity growth.

**AS ECONOMIC GROWTH PICKS UP, INFLATION IS ALSO RISING.** Wage growth has ticked up slightly since the start of the year, and consumer prices have been starting to rise. The May Consumer Price Index increased 2.8% year over year while core CPI rose 2.2%.[1] We believe those levels will end the year around 3% and 2.5%, respectively. Given current levels of real growth, this means nominal GDP growth is likely to be over 5% for all of 2018. A combination of stronger growth and rising inflation means the Federal Reserve will probably continue increasing interest rates. The Fed has hiked rates twice already this year, and markets are expecting an additional two increases in 2018 and three more in 2019. Rising inflation and interest rates are not yet presenting problems for economic growth or the stock market, but they bear watching.

**THE OTHER KEY RISK ON INVESTORS' MINDS IS RISING TRADE PROTECTIONISM.** We think the prospects for an all-out, 1930s-style trade war remain low, but the recent G7 meeting ––and subsequent announcements of new tariffs are not encouraging. We are holding out hope that heightened tensions are more about negotiating ploys and trade issues can de-escalate. But trade issues present a serious possible risk to the global economy and financial markets, both in terms of potential actual damage as well as the rising uncertainty about trade policy.

**KEY INDEX PERFORMANCE**

| TOTAL RETURNS | 2Q18 | YTD |
|---|---|---|
| S&P 500 Index | 3.4% | 2.7% |
| Dow Jones Industrial Average | 1.3% | -0.7% |
| NASDAQ Composite | 6.6% | 9.4% |
| Russell 2000 Index | 7.8% | 7.7% |
| Euro Stoxx 50 | -1.8% | -3.3% |
| FTSE 100 (UK) | 3.1% | 0.6% |
| DAX (Germany) | -3.4% | -7.5% |
| Nikkei 225 (Japan) | -0.2% | 0.6% |
| Hang Seng Index (Hong Kong) | -2.5% | -2.1% |
| Shanghai Stock Exchange Composite (China) | -13.7% | -14.5% |
| MSCI World Index (ex U.S.) | -0.5% | -2.4% |
| MSCI Emerging Markets Index | -7.9% | -6.5% |
| Bloomberg Barclays U.S. Aggregate Bond Index | -0.2% | -1.6% |
| BofA Merrill Lynch 3-Month Treasury Bill (Cash) | 0.5% | 0.8% |

Source: Morningstar Direct, Bloomberg and FactSet as of 30 Jun 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 indexes are unmanaged and unavailable for direct investment.

# *Stocks: One step forward, one step back*

**THE FIRST MONTH OF 2018 LOOKED A LOT LIKE MOST OF 2017, AS STOCK PRICES ROSE CONTINUOUSLY WITHOUT MUCH VOLATILITY.** That changed drastically in early February, as stocks experienced a 10% correction on fears of rising interest rates, higher inflation and new trade restrictions.[3] Stocks have been in the midst of a frustrating one-step-forward, one-step-back mode ever since. The S&P 500 Index peaked at 2,875 in late January and fell to a low of 2,532 at the bottom of the February correction.[3] Since that point, stocks have remained in that broad trading range as volatility has risen.

**DESPITE THAT BACKDROP, U.S. EQUITY MARKETS HAVE MADE MODEST GAINS SO FAR THIS YEAR.** The S&P 500 Index rose 3.4% in the second quarter and is now up 2.7% for the year.[3] Thanks to outperformance in the technology sector, the Nasdaq Composite was up 6.6% for the quarter and has advanced 9.4% for the year. [3] From a style and capitalization perspective, small cap stocks and growth have been leading the way. The Russell 2000 Index jumped 7.8% for the quarter and is now up 7.7% for the year.[3] And the Russell 1000 Growth Index (up 7.3%) is comfortably ahead of the Russell 1000 Value Index (down 1.7%) so far this year.[3]

**OUTSIDE OF THE UNITED STATES, MANY AREAS OF THE GLOBAL EQUITY MARKET HAVE BEEN STRUGGLING.** Stocks in Europe and China experienced selling pressure over the last few months based on concerns over slowing economic growth. Emerging markets equities were also hit hard in the second quarter, thanks in part to a stronger U.S. dollar.

**IN OTHER ASSET CLASSES, WE HAVE BEEN SOMEWHAT SURPRISED BY THE BEHAVIOR OF THE BOND MARKET.** The 10-year U.S. Treasury yield broke through the 3% level in May, but has since retreated back below 3%.[3] As of the end of the second quarter, the yield stood at 2.86%.[3] In this environment, bond prices again lost ground in the second quarter, with the Bloomberg Barclays U.S. Aggregate Bond Index down 0.2% for the quarter and off 1.6% for the year.[3] Yields are being held back by still-very-low interest rates in other countries and an ongoing sense of risk aversion among investors. But from a fundamental perspective, we think upward pressure on yields is likely to continue. Economic growth is increasing, inflation is rising, the Fed is hiking rates and nominal growth is likely to reach 5% by the end of the year. This environment is inconsistent with the 10-year Treasury yielding less than 3%. Something has to give, and we expect yields will rise, putting more downward pressure on bond prices.

| EQUITY SECTORS TOTAL RETURNS | 2Q18 | YTD |
|---|---|---|
| Consumer Discretionary | 8.2% | 11.5% |
| Consumer Staples | -2.2% | -8.9% |
| Energy | 13.5% | 6.8% |
| Financials | -3.2% | -4.1% |
| Health Care | 3.3% | 1.8% |
| Industrials | -3.2% | -4.7% |
| Information Technology | 7.1% | 10.9% |
| Materials | 2.6% | -3.1% |
| REITs | 6.1% | 0.8% |
| Telecommunication Services | -0.9% | -8.4% |
| Utilities | 3.7% | 0.3% |

Source: Morningstar Direct, Bloomberg and FactSet as of 30 Jun 2018. Equity Sectors are classified using the Global Industry Classification Standards (GICS) based on the S&P 500. 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 indexes are unmanaged and unavailable for direct investment.

**SCORECARD**
*Overall Scoring*

| | |
|---|---|
| ✓ | HEADING IN THE RIGHT DIRECTION |
| ? | TOO EARLY TO CALL |
| ✗ | HEADING IN THE WRONG DIRECTION |

## From nearly perfect to less perfect

*Our overall theme for the year has been that we expect 2018 to be "less perfect" than 2017. We see continued decent economic growth and corporate earnings, as well as low but rising inflation and yields. At the halfway point of 2018, the year is mostly shaping up as we expected.*

| | | |
|---|---|---|
| 1 ✓ | **U.S. real GDP reaches 3% and nominal GDP 5% for the first time in over a decade.** | First quarter economic growth came in at a relatively slow 2.2%, but current expectations are for second quarter growth to be close to 4%.[4] We expect growth to rebound and accelerate, especially given the strength in the labor market, a tailwind from additional fiscal stimulus and rising capital expenditures. With inflation climbing modestly, we also believe nominal growth should climb. |
| 2 ✓ | **Despite ongoing protectionism, the global expansion continues with the fewest countries in recession in history.** | Rising trade protectionism remains a threat to the global economy, and has increased in recent weeks. So far, however, the world economy has looked past these issues. While growth in some parts of the world may be slowing, the overall world economy remains in very good shape. |
| 3 ✓ | **Unemployment falls to the lowest level in nearly 50 years as wage growth is the highest since the Great Recession.** | The first half of this prediction has come to pass, as unemployment is down to 3.75%, matching its lowest rate in 50 years.[1] Wage growth has slowly risen from 2.5% to 2.7% this year, and we expect it will get to 3% by the end of 2018.[1] |
| 4 ✓ | **The yield curve flattens (but does not invert) as the 10-year Treasury yield reaches 3% for the first time since 2014.** | Bond yields remain surprisingly low, yet the yield on the 10-year Treasury crossed the 3% mark earlier this year and peaked at 3.11% on 17 May.[3] The spread between the 2-year and 10-year Treasury yield narrowed from 52 basis points to 33 by the end of the second quarter.[3] We expect both modest flattening of the yield curve and unevenly rising yields to continue. |
| 5 ? | **Stocks enjoy longest bull market in history but experience a 5+% correction after the longest period without one.** | The second half of this prediction already happened in February when stocks experienced their first significant correction since 2016.[3] Should equity markets make it to August 22 this year without the bull market ending, the first half of this prediction will come true as well.[5] |

> *In this environment, we prefer companies with domestically sourced earnings and those with the ability to utilize high levels of free cash flow.”*

**6** ✓

**U.S. equity returns lag earnings growth for the first time in six years, the longest streak in decades.**

So far, this prediction is probably our “most correct” of the year, since earnings growth has been amazingly strong while stock prices have advanced only modestly. Estimated 2018 earnings-per-share growth for S&P 500 companies stands at 20.1% year over year, while the S&P 500 Index has returned 2.7%.[3] It would take a massive collapse in earnings and/or a sharp jump in prices for this prediction to move into the “wrong” column.

**7** ✓

**Equities beat bonds for the seventh consecutive year for the first time in nearly a century.**

As of the end the second quarter, the S&P 500 Index was up 2.7%, while the Bloomberg Barclays U.S. Aggregate Bond Index was down 1.6%.[3] We expect both markets to remain volatile over the next six months, but given the economic growth, earnings and inflation backdrop, we think this prediction is likely to remain correct.

**8** ?

**Corporate capital expenditures increase at the expense of share buybacks.**

Capital expenditure levels are picking up, which is boosting productivity and should help continue the economic expansion. As of May, the Institute for Supply Management is forecasting capex spending will be up an incredible 10.1% in 2018.[6] Share buybacks have also increased, however, which makes this prediction a bit muddled. Should capex levels continue to pick up, we may be able to mark this one correct by the end of the year.

**9** ✓

**Telecommunication services, information technology and health care outperform utilities, energy and materials.**

This prediction is barely trending in the right direction so far. A basket of our most-favored sectors is up a bit more than 1.4%, while a basket of our least-favored is trailing at just under 1.4% at the halfway point of the year.[3] Assuming economic growth continues to improve, we think this prediction should be correct by the end of the year.

**10** ?

**Republicans lose the House, retain the Senate and further distance themselves from President Trump.**

Political futures are about as volatile as equity markets, and five months can be a lifetime for politics. Absent a significant shift in the political landscape, however, we expect Democrats will be able to take the House of Representatives in November, although the Senate is less likely to see a leadership change. Many Republicans have been distancing themselves from the president, with the latest divide coming from President Trump’s immigration policies.

# *What will it take for stocks to post new highs?*

**AS LONG AS THE U.S. ECONOMY CONTINUES TO EXPAND AND EARNINGS CONTINUE TO IMPROVE, WE THINK EQUITIES CAN STILL MAKE ADDITIONAL GAINS.** This raises the obvious question: How long will the economy expand? In our experience, the lead time between a yield curve inversion and the peak in stock prices is about nine months. And it usually takes about nine months after a peak in stock prices before the onset of a recession. The yield curve is flattening (but hasn't inverted yet), although if current trends continue, that may mean a yield curve inversion in the first quarter of 2019. That would translate into a recession occurring in mid-2020. Of course, we could see events like mounting credit issues, faster moving inflation or an escalation in trade issues that could push this time forward, but mid-2020 seems like a reasonable guess.

**CORPORATE EARNINGS GROWTH HAS BEEN STELLAR, BUT SHOULD START TO SLOW NEXT YEAR.** First quarter earnings growth came in at an exceptionally strong 25%.[3] The rest of the year almost certainly won't hit that pace, but should still be somewhere close to 20%. We do think, however, that earnings growth is likely to slow in 2019. Our best guess is for growth of around 6% next year given the effects of rising inflation and wage growth pressures that could crimp profit margins.

**FOR NOW WE EXPECT EQUITIES WILL REMAIN IN THEIR CURRENT TRADING RANGE.** This range (2,532 – 2,875 for the S&P 500 Index),[3] may well represent this market's lows and highs for the next several months and possibly all of 2018. At some point, stocks will pierce either barrier, and we think a breakout to the upside is more likely given the massive tailwind of strong earnings. But this would require some easing in market headwinds, particularly when it comes to trade-related issues.

**GIVEN AN ACCELERATION IN U.S. ECONOMIC GROWTH AND A POSITIVE CORPORATE EARNINGS ENVIRONMENT, WE CONTINUE TO BELIEVE A PRO-GROWTH INVESTMENT STANCE MAKES SENSE.** We think the budding bear market in government bonds is likely to continue, while we expect equity prices will rise unevenly over the coming year. At the same time, we think the advance in equities will narrow and volatility will climb as liquidity conditions tighten. As such, investment selectivity is likely to remain critical. In particular, we favor companies that generate most of their earnings domestically, cyclical sectors over defensive areas and companies that have the ability to generate (and intelligently use) free cash flow.

> ***"At some point, stocks will break out of their trading range, and we think an upside breakout is more likely given the massive tailwind of strong earnings."***

# *Key themes for investors*

## MATCHING GOALS TO INVESTMENTS

*As investors review their portfolios with their financial advisors, we offer the following themes as guideposts:*

**Maintain an overweight in equities, but be cautious:** Equity market volatility is likely to continue, and we are cautious about the near-term outlook for stocks. Longer term, we believe that while this bull market is aging, age alone does not predict the end of a bull market. Solid economic growth and decent corporate earnings should help equity prices rise.

**Focus on selectivity:** Gains will likely be narrower and more focused on specific companies and investment styles, so selectivity will be crucial. We continue to focus on companies that generate free cash flow and raise dividends. We are also focusing on companies with more domestic sources of earnings.

**Selection also matters in fixed income:** With low yields and the prospect of modestly rising rates, fixed income investing has become more challenging. Investors may want to rely on active managers with the flexibility to respond to market changes and the investment acumen to remain ahead of their peers in uncertain markets. We think focusing on credit sectors (including high yield) over government-related sectors makes sense, and we also see value in municipal bonds.

**Alternatives can play multiple portfolio roles:** Alternative assets, including real assets, real estate and other investments, may provide diversified sources of risk, return and/or income. Alternative strategies such as long/short or a market neutral approach may have a low historical correlation to long-only, benchmark-oriented investments.

### *Characteristics we look for when evaluating companies:*

- *Free cash flow can provide flexibility to raise dividends, buy back shares and reinvest in the business.*
- *Companies with the ability to generate unit growth may be advantaged over those that lack pricing power.*
- *Economic sensitivity and above-average secular growth may help insulate against market fluctuations.*

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**1** Commerce and Labor Departments **2** Conference Board **3** Bloomberg, FactSet and Morningstar Direct **4** Bureau of Labor Statistics **5** Bank of America Merrill Lynch Research **6** Institute of Supply Management and Cornerstone Macro Research

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### Index definitions

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 of 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 a 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. The **MSCI World Index ex-U.S.** is a free-float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed markets minus the United States. 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. The **Russell 1000® Value Index** measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The **Russell 1000® Growth Index** measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

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