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Weekly Investment Commentary

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Despite prominent risks, our 2019 equity outlook is constructive

Investors enter 2019 facing a critical question: Does the sharp selloff in stocks that ended 2018 presage a pending economic recession, or does it represent merely a painful correction on the way to another uptrend? If pressed, we could make a case for either outcome, but we come down more on the optimistic view. We think volatility will remain relatively elevated, especially in the short-term, until we see more clarity around trade policy and other issues. But at the end of the day, we do not think conditions are in place to produce a recession and expect economic and corporate earnings growth should remain good enough to push stock prices moderately higher by the end of the year.

HIGHLIGHTS

- **Economic growth is likely to slow in 2019, but we don't expect a recession.**
- **Likewise, corporate earnings growth may trail off from the 2018 pace, but should remain positive.**
- **Investors probably need to see more clarity around trade and other issues, but the positive long-term outlook for stocks persists.**

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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.

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A mix of positive and negative signs

The steep decline in stock prices since early October implies a dire economic outlook. Our view is more upbeat. We think economic growth will moderate in 2019, but risks of a recession appear quite low given healthy consumption levels, a strong labor market and still-relatively-easy monetary policy.

Last week's economic data may serve as a good microcosm for the rest of the year. On Thursday, the ISM Manufacturing Index for December fell sharply from 57.9 to 54.1.[1] This was the steepest one-month drop since 2008.[1] The decline certainly contributed to a sense of woe, but the index remains in expansion territory.[1] That data was followed on Friday by a very strong labor market report showing a higher number of new jobs and a notable rise in wages.[2] All told, last week's economic data point to an economy in the latter stages of an expansion, but one that remains in an upward trajectory.

Federal Reserve policy has also been a source of concern, with some concerned that the Fed may have already gone too far in its rate-hiking campaign. Fed Chair Jerome Powell sounded a relatively dovish tone last week when he reinforced the notion that the Fed would remain data-dependent as it approaches any future rate hikes. More to the point, we think policy remains easy and believe the economy could withstand some additional tightening in 2019.

The equity outlook for 2019 is likely to hinge on corporate earnings results. As recently as September, the consensus expectation for 2019 S&P 500 earnings-per-share growth was around 13%.[3] That has since fallen to 8%.[3] We think that number may still be too high, and expect to see a growth level of closer to 5% or 6% by the end of the year. That would represent a significant reduction from last year's stellar number, but should still be good enough to help equity prices make gains this year.

Reasons for optimism…and pessimism

Although we remain mostly constructive, risks remain. We present the following reasons for optimism and pessimism, adapted from a recent JP Morgan Research report.[4] First, the positives:

1.) The economy may be slowing, but doesn't appear headed for recession.

2.) Likewise, earnings growth is slowing, but should remain positive for 2019.

3.) Equity valuations levels are quite a bit more attractive now than they were a year ago.

4.) The Fed is backing off its tightening campaign and is more dovish.

5.) The equity market decline has not been based on deteriorating fundamentals, but more on limited liquidity.

6.) The corporate sector remains healthy, with buybacks and dividend increases looking strong.

These points, however, can be matched with some negatives:

1.) Global growth is slowing and unbalanced

2.) High levels of corporate activity from late 2018 may have been "borrowed" from 2019 in anticipation of more tariffs.

3.) The earnings backdrop looks highly uncertain.

4.) Political and economic uncertainty could put a lid on valuations.

5.) Trade issues are a huge wildcard and are far from resolved.

6.) The rising deficit and debt ceiling battles could become an issue in 2019.

Near-term clarity is needed

Given all of these crosscurrents, where are markets headed? In the near-term, we think the sharp back-and-forth action of the last couple of weeks is likely to continue until investors start to see clarity on some important issues.

Chief among those may be trade. Investors are probably going to remain on edge until an actual solid trade deal between the United States and China is reached. There have been some positive signs on this front and at least negotiations are continuing. But both sides still seem a long way from agreement. Other geopolitical issues are also causing consternation, with the possibility of a messy Brexit also contributing to uncertainty.

The ongoing government shutdown is also contributing to volatility. Ending it would be good news, not necessarily because the shutdown is having serious negative economic consequences, but rather that it would produce a sense of confidence and predictability when it comes to Washington, D.C.

The coming environment should be (mostly) equity friendly

Over the longer-term, the direction of the stock market is likely to be determined by whether the economy sinks into recession. We don't expect that will happen. It may take some time, but we believe that still-positive economic and earnings growth should convince investors that now-lower equity valuations have made stocks look attractive. At this point, we think investor sentiment has become too negative, which is a good sign for future price action. We think cash is on the sidelines waiting to be invested, meaning there could be appetite for an additional risk-on rally.

Our call in 2019 is for positive economic and earnings growth and a slight uptick in inflation and bond yields. That's probably not a great environment for government bond markets, but it does look decent for stocks.

2018 PERFORMANCE YEAR TO DATE	Returns	
	Weekly	YTD
S&P 500	1.9%	1.0%
Dow Jones Industrial Avg	1.7%	0.5%
NASDAQ Composite	2.4%	1.6%
Russell 2000 Index	3.2%	2.4%
Euro Stoxx 50	1.5%	0.9%
FTSE 100 (UK)	1.8%	1.5%
DAX (Germany)	1.7%	1.7%
Nikkei 225 (Japan)	-0.5%	-0.5%
Hang Seng (Hong Kong)	0.4%	-0.9%
Shanghai Stock Exchange Composite (China)	1.0%	1.0%
MSCI EAFE	1.4%	1.0%
MSCI EM	0.3%	-0.1%
Barclays US Agg Bond Index	0.5%	0.2%
BofA Merrill Lynch 3-mo T-bill	0.1%	0.0%

Source: Morningstar Direct, Bloomberg and FactSet as of 4 Jan 2019. 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.

> *“We expect economic and corporate earnings growth should remain good enough to push stock prices higher by the end of the year.”*

For more information or to subscribe, please visit nuveen.com.

1 Source: Institute for Supply Management

2 Source: Bureau of Labor Statistics

3 Source: FactSet, Morningstar Direct and Bloomberg

4 Source: JP Morgan Research, *Bull/Bear Report, 4 Jan, 2019*

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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