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Weekly Investment Commentary

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This looks like a correction. Not the end of the bull market

By any measure, stock markets have had a rough time of late. The S&P 500 Index fell 4.1% last week, capping off its first three-week downturn since 2016.[1] The index also experienced its first 1%+ drawdown since June and the first seven-day decline since the January/February correction.[1] With all eyes on the market, we'd like to focus this week on three key questions: What were the main causes of last week's selloff, what has changed (and what hasn't) and what can investors expect from here?

HIGHLIGHTS

- **We do not believe we are witnessing the start of a new equity bear market. Current conditions look like a typical bull market correction.**
- **Interest rates and inflation are moving higher, however. While this presents more risks, we do not think they are yet rising to the point that economic growth would suffer.**
- **Volatility may remain elevated in the near term, but we believe stock prices should rise and equities will outperform bonds over the coming year.**

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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.

Three principal causes of last week's selloff

1) Uncertainty over Federal Reserve policy: Earlier this month, Fed Chairman Powell said Fed policy was "far from neutral" and indicated the central bank may choose to move past neutral as it raises rates. Fears of interest rates rising too far and too fast (combined with climbing bond yields) unnerved investors who feared that corporate borrowing costs would be rising.

2) Worries over corporate earnings: All indications are that third quarter earnings results should be strong, but are unlikely to match the lofty results from the first half of the year. This has caused some to focus on the negatives and worry about "peak earnings" being in the rearview mirror. At the same time, corporate guidance has been pointing to such issues as high labor and freight costs, as well as climbing raw materials and commodity prices.

3) Technical factors that exacerbated the selling: Similar to what occurred earlier this year in January and February, programmatic and quantitative trading, as well as forced selling from leveraged funds and investors, appear to have accelerated the pace and magnitude of the declines.

What changed recently? And what hasn't?

1) Monetary policy is undeniably shifting. We are moving from an environment of unprecedented low rates and quantitative easing to tighter monetary policy. Dislocations during such a shift should be expected. It appears that the stock market, in some senses, "caught up" to these shifts as investors reassess Fed policy.

2) Rising rates and inflation may be causing tighter financial conditions. There seemed to be a widespread assumption that the Fed would raise rates to somewhere between 2.5% and 3% before pausing. Powell's recent comments suggested rates could climb higher, especially if inflation pressures mount.

3) Interest rates have risen more quickly than is typical. Stocks can usually handle gradual increases in interest rates. Over the last month, however, bond yields spiked faster than normal, helping to trigger the current dislocation.

4) Stimulative fiscal policy is putting more upward pressure on inflation and providing cover for the Fed to be more hawkish. Tax cuts and increased federal spending are boosting growth, which is raising the prospects of an overheating economy.

5) We do not see signs of serious economic or financial problems. We have seen interest-rate-related equity selloffs in the past. We think this one looks similar and should be relatively short-lived.

6) We are not seeing a correlated decline in equity prices and bond yields. We think investors should worry if and when both stock prices and interest rates drop, but this isn't happening now.

7) U.S. markets have been a relative safe haven. U.S. stocks have fallen around 7% from their all-time highs.[1] In contrast, other developed markets are off around 15% and emerging markets have sold off more than 20% since their highs in January.[1]

Bond yields are likely to continue rising

Since the Great Recession, investors have gotten used to very low interest rates and extremely accommodative monetary policy. This remained true even as signs of economic recovery and expansion began to take hold. That environment appears to be changing, and bond yields have now spiked to the point where they have caused an equity market selloff.

Bond market bulls would view this backdrop as a sign that the global economy cannot withstand higher borrowing costs and the Fed and other central banks are being too aggressive. We take the opposite view and believe the time of emergency low rates has long since passed. We also believe we are more than overdue for a higher interest rate environment considering the strength of both real and nominal economic growth.

This is not to say that the yield increase we have seen over the past month is likely to continue. The recent equity market weakness should slow down rate increases, although we don't expect much more downside in rates and yields. Economic growth is continuing to improve, and we expect inflation to climb modestly. Likewise, we expect the Fed to continue raising interest rates unless we see a significant financial blowup. If the Fed moves too slowly, it risks causing a more significant rise in inflation. At this point, we think the Fed should be more concerned with the possibility of the economy overheating than a potential growth slowdown.

But this expansion and equity bull market do not appear over quite yet

We think stocks could likely be messy for a while longer. But we think prices should begin to rise again over time. The key will be for investors to believe that rising yields and higher interest rates are not restricting economic growth. We also think we may need to see some combination of an easing in U.S./China relations, a recovery in global manufacturing levels or less volatility in the bond market for equity sentiment to improve.

In any case, we do not believe economic or corporate fundamentals have deteriorated meaningfully. In other words, we see no sign of the monetary or economic conditions necessary to end the current cyclical expansion. It is important to remember that economic cycles do not end simply because they are getting old. A recession needs a catalyst. In the current environment, our best guess is that the culprit will eventually be rising inflation that forces the Fed to tighten policy enough to slow economic growth. We don't expect that to happen any time soon, however. We expect inflation pressures will rise over the next 12 to 18 months, and the Fed still has more room to raise interest rates.

As such, we expect stock prices to climb unevenly from here and believe equities will outperform bonds over the next year. From a positioning standpoint, we think it makes sense for investors to maintain neutral or higher weights to equities within their portfolios and continue to believe that bonds will remain vulnerable to further irregular increases in interest rates.

2018 PERFORMANCE YEAR TO DATE

	Returns	
	Weekly	YTD
S&P 500	-4.1%	5.1%
Dow Jones Industrial Avg	-4.2%	4.3%
NASDAQ Composite	-3.7%	9.5%
Russell 2000 Index	-5.2%	1.7%
Euro Stoxx 50	-4.1%	-9.5%
FTSE 100 (UK)	-3.8%	-8.4%
DAX (Germany)	-4.4%	-14.2%
Nikkei 225 (Japan)	-3.2%	1.9%
Hang Seng (Hong Kong)	-2.8%	-11.1%
Shanghai Stock Exchange Composite (China)	-8.3%	-24.1%
MSCI EAFE	-3.9%	-7.1%
MSCI EM	-2.0%	-13.3%
Barclays US Agg Bond Index	0.4%	-2.1%
BofA Merrill Lynch 3-mo T-bill	0.0%	1.4%

Source: Morningstar Direct, Bloomberg and FactSet as of 12 Oct 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.

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1 Source: FactSet, Bloomberg and Morningstar Direct

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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