The Year Ahead: Optimistic for Now, But Risks Are Rising

NUVEEN ASSET MANAGEMENT

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Accelerating Growth Could Trigger Inflation Pressures

Economic growth has been generally solid through 2017, and we expect a modest pickup to around a 2.5% real growth rate next year. The probability of tax reform combined with slowly tightening monetary policy will likely cause tightening in overall financial conditions and put more pressure on an already-tight labor market. At this point, we think a recession is unlikely, but that may change as 2018 progresses. The shape of the yield curve may provide warning signals. While it's impossible to predict recessions with precision, we don't expect the start of a recession until the second half of 2019 at the earliest. Should the current expansion continue for another 18 months, it would make it the longest on record.[1]

Outside of the United States, the eurozone should maintain growth above 2% and may surpass the U.S. during the next downturn. In China, policymakers are struggling to avoid financial problems caused by high private levels of debt and supply excesses. We think China will muddle through over the coming years and maintain solid growth levels.

As global economic growth accelerates, investor attention should increasingly turn to inflation. Inflation levels have remained surprisingly low, allowing the Fed to continue cautiously tightening. This has benefitted equity markets. Looking ahead, we expect inflation to pick up in 2018. Wages have been kept low through globalization, technological changes and the lingering impact of the Great Recession. We don't anticipate a dramatic acceleration in inflation, but it will likely rise enough to keep the Fed on track to continue increasing rates.

We Expect Volatility From the Political Backdrop

The domestic and geopolitical backdrop will no doubt continue to affect financial markets in 2018. We think it is extremely likely that the Republicans will enact tax reform, but it is unclear how much that will help them in the midterm elections. We think the Democrats may well capture the House of Representatives, which could set the stage for some epic battles with President Trump.

Elsewhere, we are looking to see whether Chinese authorities are willing to implement increased financial regulation and purge excess capacity in the industrial sector. We're also watching ongoing tensions with North Korea, trade protectionism and rising conflict between the United States and Iran. All of these issues could potentially rattle financial markets.

KEY POINTS

- The factors behind this equity bull market – decent economic growth, strong corporate earnings, low inflation and easy monetary policy – should continue into 2018.
- We believe holding overweight positions in equities makes sense, but we may shift that view as 2018 progresses.

Robert C. Doll, CFA

Senior Portfolio Manager, Chief Equity Strategist

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.

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Timing the End of the Equity Bull Market?

Given this backdrop, we expect the equity bull market to continue—at least for now. While gains have been uneven, we expect stocks will continue to outperform bonds over the coming months. We believe the long-term bull market in government bonds ended in mid-2016, and yields should continue to experience upward pressure. Additionally, with the 10-year Treasury yield less than 50 basis points higher than the S&P 500 Index dividend yield, stocks look relatively attractive.[2] Fixed income credit sectors should continue to do relatively well, but these market areas may struggle if and when financial conditions tighten during the coming year.

Equity markets are in a similar situation. U.S. stocks are more expensive today in terms of earnings and book value than at any time since the tech bubble of the late 1990s.[2] We still think equities are inexpensive relative to bonds, but that would change if rates move higher. Corporate earnings growth has been impressive given slow economic growth, but future expectations are high and may be tough to exceed.

Will the potential upside in stocks outweigh the downside risks? In general, equity bear markets are usually associated with recessions. And since we don't expect a recession before 2019 or 2020, we think equities still have room for gains. The conditions that have promoted equity prices remain in place (reasonable economic growth, strong corporate earnings, low inflation and accommodative monetary policy), so we think it makes sense to continue overweighting stocks, at least for now.

We would grow increasingly cautious if equity prices continue rising over the first part of next year, as valuations would likely become more stretched. At this point, it would be premature to suggest underweighting risk assets such as equities and fixed income credit sectors. But if economic and market conditions evolve as we expect, we would likely shift in that direction in the second half of 2018. ■

2017 Performance Year to Date

	Returns	
	Weekly	YTD
S&P 500 Index	0.4%	20.7%
Dow Jones Industrial Average	0.5%	26.1%
NASDAQ Composite	-0.1%	28.4%
Russell 2000 Index	-1.0%	13.5%
Euro Stoxx 50	0.6%	25.5%
FTSE 100 (U.K.)	0.4%	16.8%
DAX Index (Germany)	1.0%	27.7%
Nikkei 225 (Japan)	-1.4%	24.7%
Hang Seng (Hong Kong)	-1.4%	34.3%
Shanghai Stock Exchange Composite (China)	-1.2%	13.5%
MSCI EAFE (non-U.S. developed markets)	0.1%	22.7%
MSCI Emerging Markets	-0.5%	31.7%
Bloomberg Barclays U.S. Aggregate Bond (bonds)	0.0%	3.3%
BofA Merrill Lynch 3-Month Treasury Bill (cash)	0.0%	0.8%

Source: Morningstar Direct and Bloomberg, as of 12/8/17. 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: Bureau of Economic Analysis **2** Source: Morningstar Direct, Bloomberg & FactSet

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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