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Weekly Investment Commentary

15 June 2020

A sharp risk-off trade returns

Stocks snapped a three-week winning streak as markets sank sharply last week.[1] Worries about an uptick in coronavirus cases, the Federal Reserve's downbeat assessment of long-term economic growth and President Trump's declining poll numbers all contributed to negative sentiment. But the main cause of the decline appears to be a realization that stock prices have been rising too fast since the March lows, becoming disconnected from the negative economic and earnings news. As part of this broader risk-off trade, Treasury yields fell, the dollar rose after sinking for a few weeks, gold advanced and oil prices declined.[1]

HIGHLIGHTS

- **Stock prices appear to have gotten ahead of themselves. Last week's sharp pullback could represent the start of a more prolonged period of higher volatility and market churn.**

- **We expect the global economy to improve this year, but at a slow and uneven pace.**

- **Long-term trends suggest stocks could continue to make gains, but we need more clarity around economic growth, earnings prospects and especially virus treatments and vaccines.**

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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.

Seven observations and themes

1) Last week's downturn was prompted by excess on the part of individual investors. Market dynamics and valuation levels suggest that individual investors have recently been increasingly pouring money into stocks that are highly leveraged to economic reopening.[1] In particular, we saw a notable rise in the stock prices of lower-quality companies that had weak balance sheets and faced bankruptcy risks. A significant part of last week's selloff came from these areas of the market.[1]

2) Stocks also came under pressure as the "reopening versus rising infections" debate increased. There is growing concern that the United States pushed to reopen its economy too quickly. These worries are compounded by a sense that many Americans are becoming overly lax about social distancing and protective measures such as wearing masks. In particular, investor sentiment took a hit last week in light of rising virus cases in areas that mostly avoided the initial wave in the South and Sunbelt states.

3) Investors are concerned about rising taxes after the November elections. President Trump's job approval rating has plummeted over the last month, falling from 49% in May to 39% in the latest Gallup poll. From an investment perspective, the key issue concerns prospects for corporate tax rates. According to a Goldman Sachs analysis, Joe Biden's proposal to raise the federal tax rate on domestic income from 21% to 28% would reduce 2021 S&P 500 earnings by $20 per share. Investors are also closely watching prospects for a tougher regulatory environment, an ambitious climate change agenda and higher government spending.

4) The Fed adopted an extremely dovish tone in its meeting last week. In particular, Chairman Powell indicated that the Fed expected to keep rates at zero through at least 2022.

5) We don't expect a shift in Fed policy until we see inflation pressures. The Fed has two key mandates: maintaining full employment and stable inflation. With unemployment levels extremely high and inflation well below its 2% target, there is no reason to expect the Fed to back off of its highly supportive monetary policy stance.

6) We expect interest rates will slowly and modestly rise later this year. Although yields fell last week over economic concerns, we still expect the 10-year Treasury yield to cross the 1% mark by the end of 2020. A combination of improving sentiment, better global economic growth, improved market liquidity and rising inflation expectations should put some upward pressure on rates.

7) Likewise, we think the value of the dollar should fall. After peaking in late March, the trade-weighted value of the U.S. dollar fell by more than 5%.[1] We could see periodic periods of strength similar to last week, but improved global growth and the decline of U.S. rates relative to the rest of the world suggest the dollar should continue to drift lower. A weaker dollar would likely benefit non-U.S. stocks.

Positives and negatives for the stock market

Overall, positives and negatives appear roughly balanced. On the positive side, we point to 1) Fed support, 2) Strong internal market dynamics, 3) Lots of cash on the sidelines, 4) A bumpy but improving economy and 5) A lack of alternatives. On the negative side: 1) Terrible second quarter economic and earnings growth, 2) Worries about rising infections, 3) U.S. and global political uncertainty, 4) High valuations and 5) A market that became significantly overbought.

Stocks may be in for a prolonged period of churning and volatility

Policymakers have decided to reopen economies despite ongoing virus risks, as the damage from shutdowns risked becoming permanent. At this point, most of the world's major economies are running at various speeds and the bars for enacting new economic lockdowns appear increasingly high. Looking ahead, we think the global economy will slowly improve, but at a modest and uneven pace after the initial reopening bounce. Corporations will be cautious about risk taking and demand levels will be uncertain given the unknowns around the outlook for infection rates. It is also unclear how serious economic headwinds could become if we see significant virus spikes later this year. Successful treatments and/or a vaccine are still needed to provide that clarity.

From an investment perspective, financial markets appear to have gotten ahead of themselves since the lows of late March. Massive monetary and fiscal stimulus measures have been a significant positive, but we were growing increasingly concerned that stock prices reflected unrealistic economic and earnings growth prospects, especially as we do not expect earnings to return to pre-coronavirus levels any time soon. Global equities (especially in the U.S.) appear to have reached overbought levels, and last week's decline looks to be the start of a corrective or at least churning phase.

Looking back on our list of positives and negatives, the good news is that the positives represent longer-term trends, but the bad news is the negatives could dominate for the time being. More clarity around the severity of the coronavirus itself or news about treatments and vaccines would go a long way toward removing near-term uncertainty. We also think investors should keep a close eye on political risks, including a possible rise in protectionism.

2020 PERFORMANCE YEAR TO DATE

	Returns	
	Weekly	**YTD**
S&P 500	-4.7%	-5.0%
Dow Jones Industrial Avg	-5.5%	-9.2%
NASDAQ Composite	-2.3%	7.4%
Russell 2000 Index	-7.9%	-16.3%
MSCI EAFE	-4.2%	-11.8%
MSCI EM	-1.5%	-10.7%
Bloomberg Barclays US Agg Bond Index	0.7%	5.7%
BofA Merrill Lynch 3-mo T-bill	0.0%	0.6%

Source: Morningstar Direct, Bloomberg and FactSet as of 12 Jun 2020. 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.

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1 Source: Bloomberg, Morningstar and 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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