

14 December 2020

Rising virus cases take a toll on the economy and markets

Stock markets again hit record highs early last week on optimism surrounding vaccine approvals, but momentum trailed off as attention shifted toward the breakdown in fiscal stimulus negotiations and rising global economic restrictions. The S&P 500 Index was down 1% for the week, but small cap stocks advanced for the sixth consecutive week. Among sectors, only energy and telecommunications made it into positive territory, with the REITs and financial sectors faring the worst.

HIGHLIGHTS

- **Stocks sagged last week as investors focused on the near-term risks of additional economic lockdowns in the face of the worsening global coronavirus pandemic.**
- **We think investor optimism may be too high over prospects for long-term corporate earnings. A number of possible downside risks, including economic disappointments and rising interest rates, could drag on profits.**
- **Nevertheless, we expect the global economy to expand after enduring a rough patch over the next several months.**



Robert C. Doll, CFA
*Senior Portfolio Manager
and Chief Equity Strategist*

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.

10 observations and themes

1) Economic lockdowns are taking a toll on the labor market. Initial jobless claims rose to nearly a three-month high for the week ended December 5, with weakness centered in states and regions most affected by the coronavirus pandemic. We expect the labor market will experience additional pressure until the pandemic gets under control, but also think a strong bounce-back is likely when restrictions are lifted.

2) The European Central Bank made it clear that it will remain hyper-accommodative for the foreseeable future. The ECB (along with other central banks) believes the economic impact of the pandemic will endure long after the virus starts to get contained.

3) We could still see a fiscal stimulus deal in 2020, but time is running out. It appears Congress may be honing in on relatively modest package of around \$750 billion that would include more support for small businesses and extended unemployment benefits. Any near-term deal will likely exclude aid to state and local governments favored by Democrats and corporate liability protection favored by Republicans.

4) The Georgia runoff elections are likely to result in a divided government in Washington. Polling indicates the races are extremely tight, but we think it would be very difficult for Democrats to win both races and take control of the Senate.

5) We expect environmental regulations will increase in the coming years. President-Elect Biden campaigned on a far-reaching environmental platform. And even without Democratic control of the Senate, President Biden will be able to tighten fuel economy standards, set ambitious targets for reducing carbon emissions and encourage states to implement their own measures.

6) Brexit drama is unlikely to be resolved any time soon. We could see an agreement before the end of the year, or we could see yet another delay to implement the Brexit decision that is now four-and-a-half years old.

7) Corporate profits should jump in the fourth quarter, sparking the broader economy in 2021. Profits could hit an all-time high in the current quarter, which should translate into future jobs growth and rising capital expenditures.

8) Expectations for corporate profits in 2021, however, could be too high. At present, the consensus expectations for first quarter growth are more than 15% for the first quarter, close to 45% in the second quarter and 22% for the year as a whole. We think these numbers ignore the possible risks of fiscal policy gridlock, difficulties in vaccine distribution and rising interest rates.

9) Investor optimism may be elevated, but it also may be too early to call for a period of equity market consolidation. Trying to adjust portfolios by timing specific market moves is almost always a fool's errand. But momentum tends to wane before corrective phases begin and it remains quite high.

10) Improving economic growth in 2021 should favor cyclical and non-U.S. stocks. We think an environment of stronger and more synchronized global growth, ongoing monetary and fiscal stimulus and a weaker U.S. dollar should relatively benefit these areas of the market.

Two risks to consider: higher rates and rising inflation

Optimism remains extremely high as investors focus on prospects for a better outlook in 2021, while ignoring likely near-term economic disappointments that could deepen as the pandemic continues to get worse. In addition, we think investors are not paying enough attention to two possible risks that could start to affect stocks: rising interest rates and growing inflation pressures.

Markets are currently pricing in the likelihood that bond markets will remain stable and yields will hover at or near historic lows for years to come. We think these assumptions will start to get challenged in 2021. Rates will likely start to move unevenly higher, with long-term economic growth likely to improve and central bankers and other policymakers around the world doing everything they can to engineer more inflation.

In the recent past, interest rate spikes were dramatic enough to trip up stock markets even with nonexistent inflation pressures, which occurred periodically in 2018. It has not been easy for policymakers to generate inflation in recent years, but we expect many will be surprised by an uptick in inflationary pressures in the coming decade.

From an equity perspective, we think long-term earnings expectations may be too high given this backdrop. Earnings will likely recover noticeably in the coming year or so as the economy improves, but long-term expectations beyond that time appear inflated (especially in the U.S.). Stocks should still make gains in the coming years, but investors may need to temper their expectations and focus on being more selective.

2020 PERFORMANCE YEAR TO DATE

	Returns	
	Weekly	YTD
S&P 500	-1.0%	15.4%
Dow Jones Industrial Avg	-0.5%	7.7%
NASDAQ Composite	-0.7%	39.1%
Russell 2000 Index	1.0%	16.0%
MSCI EAFE	-0.5%	5.3%
MSCI EM	1.3%	15.1%
Bloomberg Barclays US Agg Bond Index	0.4%	7.2%
BofA Merrill Lynch 3-mo T-bill	0.0%	0.7%

Source: Morningstar Direct, Bloomberg and FactSet as of 11 Dec 2020. All index returns are shown in U.S. dollars. Past performance is no guarantee of future results.

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“Rising inflation pressures could be a surprise to many in the coming years.”

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Endnotes

Sources

All market data from Bloomberg, Morningstar and FactSet

Employment data from the Department of Labor

Earnings data from FactSet

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