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Stocks approach new highs as risks remain elevated

U.S. equities rallied again last week, with the S&P 500 Index climbing 2.5% as it approached a new all-time high.¹ Economic data continued to come in ahead of expectations and corporate earnings results have not been quite as bad as feared. Investors are focusing on the positives and are looking past rising coronavirus cases and shaky fundamentals. Corresponding with this risk-on trend, value and cyclicals outperformed growth and momentum, with the industrials, financial and energy sectors leading the way.

HIGHLIGHTS

- **The economic recovery is continuing, but we expect it will be bumpier than what equity markets reflect.**
- **Stocks have been moving higher thanks to momentum, supportive policy and improving sentiment. But we are growing concerned that investors may be overlooking some key risks.**
- **With valuations appearing full, we expect markets could be in for a period of consolidation or a corrective phase.**



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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.

10 observations and themes

1) The labor market continues its strong recovery. The July labor market report showed an increase of 1.8 million new jobs and a drop in the unemployment rate to 10.2%.² Importantly, manufacturing hours worked rose 1.8%.²

2) Manufacturing activity is improving. In addition to the favorable jobs report, the ISM Manufacturing Survey rose from 52.6 in June to 54.2 in July, with a surge in new orders.³ This should bode well for industrial production and manufacturing-related profits in the coming months.

3) We still expect to see a new fiscal stimulus package. With the parties still far apart on specifics, President Trump issued a series of executive orders to keep unemployment benefits going and defer payroll tax collection. We still think legislation will ultimately be enacted that could provide between \$1.5 and \$2 trillion in additional stimulus.

4) Corporate earnings are likely to remain under pressure. Although second quarter results are beating their very low expectations by more than 20%, projections for the third quarter have barely risen and those for the fourth quarter remain flat.⁴ With stock valuations at already high levels, weak earnings could be a headwind for stocks.

5) The U.S. and China appear to be firmly entrenched in a cold war. The U.S. political approach to China has shifted dramatically over the past several years, and hostility toward China is growing in both political parties. We don't expect the U.S./China relationship to improve any time soon, which creates possible market risks.

6) President Trump's reelection prospects are diminishing. Coronavirus news dominates the headlines and the president's approval rating on handling the crisis remains low. It is looking more likely that Joe Biden will win the presidency, and the odds of a Democratic takeover of the Senate are rising. Such an outcome would likely create a less market-friendly environment.

7) Stocks have been highly resilient despite several key risks, including rising coronavirus cases, social unrest, a worsening U.S./China relationship and high valuations. Investors appear to be banking on more stimulus, a vaccine, improving earnings and the twin engines of "fear of missing out" (FOMO) and "there is no alternative" to stocks (TINA).

8) Stock market breadth is narrowing, which is a negative technical sign.¹ If market risks recede, the market could broaden, but we think a more probable scenario would be a near-term consolidation or correction before stock prices move higher.

9) The weaker U.S. dollar should help non-U.S. stocks. In particular, we think emerging markets will benefit. A weaker dollar usually means higher commodity prices, and many EM economies are highly commodity dependent.

10) The health care sector appears well positioned. Health care stocks have been outperforming, thanks to increased demand and favorable demographic trends (an aging population and growing middle class around the world). The sector has also provided downside protection during bear markets and recessions, as health care spending tends to remain resilient. We think the sector should continue to enjoy favorable tailwinds.

Investors should remain cautious

Investor confidence is buoyant, as reflected by stock prices approaching new highs, commodity markets rising and government bond markets remaining firm. Investors seem to believe that the economic recovery will continue, despite a rising number of coronavirus cases, and that fiscal and monetary policy will help protect against possible downside market risks. We also think that markets are pricing in the probability of widespread vaccine availability next year. In addition, the FOMO and TINA factors have been pushing stock prices higher.

In our view, investors may be overly optimistic. Much of the possible good news is already priced in to markets, and valuations are starting to look stretched. We believe the economic recovery will continue, but also expect it to be choppier than many expect. The recovery is fully in force, but the global economy remains on shakier footing today than it was at the start of the year.

Policy support remains crucial, but may be running out of steam. Additionally, even if we do see a vaccine available by early next year, we think global demand will remain below where it was at the start of the year for some time. Finally, it's also worth pointing out that a weakening dollar and surging gold prices are usually associated with rising market volatility.

Strong market momentum, favorable investor sentiment and supportive monetary and fiscal policy have all been driving markets higher since April. These factors remain in place and are important tailwinds. But fundamentals ultimately determine market performance. And with valuations looking full and corporate earnings likely to struggle, we think investors should be approaching markets with caution and selectivity.

2020 PERFORMANCE YEAR TO DATE

	Returns	
	Weekly	YTD
S&P 500	2.5%	4.9%
Dow Jones Industrial Avg	3.9%	-2.5%
NASDAQ Composite	2.5%	23.4%
Russell 2000 Index	6.0%	-5.2%
MSCI EAFE	2.0%	-7.2%
MSCI EM	1.0%	-0.5%
Bloomberg Barclays US Agg Bond Index	0.1%	7.8%
BofA Merrill Lynch 3-mo T-bill	0.0%	0.6%

Source: Morningstar Direct, Bloomberg and FactSet as of 7 August 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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For more information or to subscribe, please visit nuveen.com.

1 Source: Bloomberg, Morningstar and FactSet

2 Source: Bureau of Labor Statistics

3 Source: Institute of Supply Management

4 Source: Credit Suisse

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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