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Weekly Investment Commentary

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# Questions to consider as summer draws to a close

*As we move from the unofficial end of summer in the U.S., markets and investors appear to be at a crossroads. Stock prices are at all-time highs, but market breadth has narrowed. Policy support remains high, but has leveled off at a high degree of support. And we may be at the forefront of an environment of higher interest rates and possible inflation. We think stocks could be subject to some near-term risks, but we also see areas of opportunity — for those who know where to look.*

## HIGHLIGHTS

- **Stocks are at all-time highs thanks to the largesse of the Fed, but that largely reflects outsized gains by a handful of mega cap technology companies.**
- **We see a number of near-term risks: potentially higher interest rates, political uncertainty and, above all, a sense that markets have already baked in much of the good news.**
- **Long-term returns for stocks could be limited, suggesting that selectivity and active management could be required for investors to meet their investment goals.**


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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.

## Why are stocks at an all-time high?

Count us surprised that stocks have reached all-time highs so soon after the quickest-starting bear market in memory. A great deal of credit goes to the power of massive stimulus — both from the Federal Reserve and government spending and programs. Investor sentiment also improved more quickly than we expected. And near-zero interest rates have boosted the valuation of mega cap tech stocks to extraordinary levels.

This last point bears a closer look, since more than half of the market gains since the March 23 low are due to five companies: Apple, Amazon, Microsoft, Alphabet and Facebook.[1] As of now, these five stocks trade at an average of 40-times their 2020 earnings-per-share and 32-times their 2021 EPS.[1] This trend is due to a highly lopsided economy, where spending on restaurants, in-person entertainment and physical retail collapsed during the pandemic, while spending soared on things like technology, online shopping and streaming entertainment.

## What are the key risks?

Let's start with the positives. Equities enjoy powerful tailwinds: extremely accommodative monetary policy for the foreseeable future, a healing U.S. economy, improving industrial production around the world and very low inflation.

The downside is that stock markets appear to have already priced in this good news. We also think markets have priced in a probability of a COVID-19 vaccine before the end of the year. As a result, we think markets are vulnerable to disappointments and downside risks.

## Where are markets heading?

We have suggested for some time that stock prices should move higher over the coming year, but could be vulnerable to a correction or near-term setback.

What would be a likely catalyst for such an event? In our view, the most likely culprit would be a rise in bond yields. In particular, a 10-year Treasury yield closer to 1% would hurt the lofty valuations of the mega cap tech stocks and could cause a broader market pullback.

Since the stock market bottom and collapse in interest rates, we felt that government bonds looked overvalued and unappealing. Short-term rates are going to remain anchored at zero, but with economic growth improving, longer-term yields will likely drift slightly higher. Inflation expectations also suggest bond yields could rise. Inflation itself remains low, but we've already seen the peak of the deflationary shock. Rising commodity prices and the weakening U.S. dollar suggest core inflation could pick up by early next year.

The political backdrop also poses risks as we approach the election. Higher taxes and/or more regulatory scrutiny could also negatively affect stock prices.

### Where can investors find opportunities?

Based on current valuations and our outlook for interest rates, we still think stocks should outperform bonds over the next one-, five- and ten-year periods. But equity returns are likely to be mediocre versus the last several decades. Given current high valuations, we could reasonably expect annualized returns for stocks in the neighborhood of only 3% to 4%.

This environment will challenge investors struggling to generate the returns they need to meet their long-term goals. As such, we encourage investors to focus on selectivity across geographies, sectors, styles and especially individual stocks.

To start, investors should consider the scenario we outlined: Even a modest uptick in bond yields would shift market leadership away from technology, growth and momentum and toward value and traditional cyclical sectors. This trend could accelerate if economic growth continues to improve (and/or if a vaccine or coronavirus treatment proves effective). We also see growing opportunities outside the U.S. (especially in emerging markets) given relative valuations and a weakening dollar.

But the bottom line is investors are likely going to have to work harder, approach markets cautiously and partner with experienced professionals to meet their goals.

**2020 PERFORMANCE YEAR TO DATE**

| | Returns | |
|---|---|---|
| | **Weekly** | **YTD** |
| S&P 500 | -2.3% | 7.5% |
| Dow Jones Industrial Avg | -1.7% | 0.3% |
| NASDAQ Composite | -3.3% | 26.9% |
| Russell 2000 Index | -2.7% | -7.1% |
| MSCI EAFE | -2.1% | -6.2% |
| MSCI EM | -2.0% | 0.5% |
| Bloomberg Barclays US Agg Bond Index | 0.2% | 6.8% |
| BofA Merrill Lynch 3-mo T-bill | 0.0% | 0.6% |

Source: Morningstar Direct, Bloomberg and FactSet as of 4 September 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.

*“Stock prices should still move higher over the coming year, but could be vulnerable to a correction or near-term setback.”*

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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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