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Weekly Investment Commentary

21 September 2020

We expect the "rotational correction" in stocks to continue

Stocks fell for a third straight week for the first time in nearly a year. Mega-cap technology stocks again fell notably, with several high-profile names dropping close to 5%.[1] We appear to be beginning an unwinding of a trend that dominated much of 2020, when these same stocks drove markets to new highs. The cap-weighted S&P 500 Index has significantly outperformed the equal-weighted index this year, and we think the latter more accurately reflects an uneven recovery and several downside risks.[1]

HIGHLIGHTS

- **Internal market dynamics are shifting: Mega-cap technology companies are declining notably, while other areas are holding up better, a notable reversal of the trend we have seen through much of 2020.**
- **Markets remain overbought, in our view, and we expect this rotation and selloff to continue over the near-term.**
- **This is a time for selectivity and focusing on relative value.**

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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) Prospects for further fiscal stimulus are dimming. At this point, we think a major fiscal stimulus package before the election appears very unlikely. Should that be the case, a lack of extra unemployment benefits, additional support to small businesses and direct aid to state and local governments would likely detract from economic growth.

2) In fact, negative effects are emerging from a lack of new fiscal stimulus. In particular, August retail sales were weaker than expected and weekly unemployment claims stalled at elevated levels. These are the first readings since the $600-per-month federal unemployment benefits expired, and we could see further drags on demand.

3) Manufacturing, in contrast, continues to recover. The latest data on this front was the Empire Manufacturing Index, which rebounded to 17.0% in September from 3.7% in August, with strength across all components.

4) This difference between the manufacturing and consumer sectors could persist. Social distancing measures have much less downside effect on manufacturing, and that area of the economy is benefitting from key tailwinds, including China's stimulus-driven recovery, pent-up demand, depressed inventory levels and improving capital expenditures.

5) Investors appear to be pricing in a higher likelihood of a coronavirus vaccine than may be likely. Even if a successful vaccine is developed before the end of 2020, it will take many months before it would be widely available. This could present downside economic and market risks.

6) The corporate earnings outlook could be brightening. Unprecedented monetary support and U.S. dollar weakness has caused many corporate management teams to raise their forward guidance.

7) The Federal Reserve made it clear that rates will be zero-bound for the foreseeable future. At last week's policy meeting, the central bank indicated it isn't planning to raise rates through at least 2023.

8) Negative real interest rates have been propping up stock markets. Interest rates are at or near record lows and inflation expectations are starting to creep higher, forcing real rates further into negative territory. Rising interest rates and/or inflation could eventually present a headwind for stocks.

9) Internal stock market dynamics are shifting. The equal-weighted S&P 500 is on pace for its best month relative to the cap-weighted S&P 500 since 2009, reflecting the selloff in mega-cap stocks and broadening participation.[2] We think this shift could continue.

10) Many financial markets have been consolidating recent trends. Credit spreads have been tightening before pausing in recent weeks, while gold prices and the U.S. dollar are consolidating their respective upward and downward price trends. These technical indicators also suggest we could see additional consolidation and rotation within U.S. equities.

Stock selection looks increasingly important

The recent downside in mega-cap tech stocks has yet to affect other areas of the market. Investors appear convinced that ultra-supportive monetary policy will keep stock prices afloat, despite a failure to pass a new fiscal stimulus package and an economic backdrop that increasingly points to decelerating growth.

Regarding that latter point, the rebound has been underwhelming after an initial sharp bounce in early summer. Persistently high coronavirus infection rates are making it difficult to reopen schools and businesses, keeping economic activity depressed. Although governments and policymakers are loathe to return to mandated lockdowns, individuals are clearly not comfortable returning to pre-pandemic activities without a vaccine or notable medical breakthrough. Inflation could also pick up in the coming years, as disinflationary pressures start to fade and we expect an uptick in inflation around the world at some point.

This leads us to have a cautious near-term outlook toward stocks, focusing on areas of the market that still seem overvalued. Market action over the past few weeks reflects a shift away from growth and momentum (and particularly that handful of mega-cap tech stocks) and toward value and cyclicals. In other words, we're seeing less of a broad-based correction and more of a rotation correction.

We think this trend could still have legs and markets remain overbought. In the weeks ahead, we could see near-term bounces, additional volatility in both directions and ongoing internal market shifts. As such, we think investors should focus on selectivity, rotating out of overvalued areas and into more attractive areas that could be oversold and still offer value and positive relative earnings growth prospects.

2020 PERFORMANCE YEAR TO DATE

	Returns	
	Weekly	YTD
S&P 500	-0.6%	4.2%
Dow Jones Industrial Avg	0.0%	-1.4%
NASDAQ Composite	-0.5%	21.1%
Russell 2000 Index	2.7%	-7.0%
MSCI EAFE	0.8%	-4.1%
MSCI EM	1.6%	1.4%
Bloomberg Barclays US Agg Bond Index	-0.1%	6.9%
BofA Merrill Lynch 3-mo T-bill	0.0%	0.6%

Source: Morningstar Direct, Bloomberg and FactSet as of 18 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.

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1 Source: Bloomberg, Morningstar and FactSet

2 Source: Susquehanna Financial Group

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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GWP-1336536PR-W0920P