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Weekly Investment Commentary

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Stocks enjoy another banner week amid elevated risks

Stocks were up yet again last week, marking five consecutive weeks of gains.[1] The S&P 500 Index climbed 3.25%, again setting new record highs.[1] Along with solid economic data, the Federal Reserve announced that it would adopt a more flexible inflation-targeting approach. For the week, the communication services, technology and financial sectors led the way, while utilities, health care and energy lagged.

HIGHLIGHTS

- **Economic and earnings data continue to be less bad than many feared, improving investor sentiment and boosting stock prices.**
- **The downside is that markets appear to have already priced in a number of positives, meaning stocks could be vulnerable to disappointments.**
- **We expect the economy to continue to recover and think stocks should outpace bonds over the coming year, but the next few months could see higher volatility and possible downside risks.**

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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 Fed's new inflation targeting means monetary policy will become even more supportive for the economy and stocks. The central bank is moving toward targeting an average inflation level of 2%. This effectively means it will have higher inflation target for the next several years, giving it more flexibility to sustain asset purchase programs.

2) Inflation expectations could accelerate from here, but we don't expect an imminent rise. A number of factors could all increase the possibility of a stronger uptick in inflation, including the weaker dollar, higher commodity prices and sharply aggressive monetary and fiscal policies.

3) Ongoing Fed support has been critical to the rise in equity prices, but that in itself creates some possible risks. The Fed appears determined to convince markets that it will remain ultra-accommodative for the foreseeable future. Fed support has been the primary catalyst for the rise in equity and gold prices and the sagging dollar. Fed policy, however, could be creating a bubble that could end badly.

4) The labor market continues to improve. Unemployment claims fell by close to 100,000, to just over one million in the last reported week.[2] We expect the August employment report to show perhaps an increase of one million new jobs and an unemployment rate that could fall to 10% or below.

5) Economic and earnings growth prospects have been recovering. Recent data has been less bad than many expected. At this point, we think third quarter GDP growth could come in around 20% to 25% (compared to our earlier estimate of 15% to 20%), and our best guess for S&P 500 earnings is rising from $125 to $130 for 2020 and from $150 to $160 for 2021.

6) Prospects for future additional fiscal stimulus are looking uncertain. The new deadline for a deal seems to be September 30, when must-pass government funding legislation will be due. But at this point, the sides appear far apart and unwilling to compromise. It may take a negative market event or substantial shift in public opinion to change the current dynamics.

7) The U.S. is in the midst of several significant and interrelated disruptive events. The coronavirus pandemic, a sharp recession, civil unrest and an uncertain elections backdrop are all creating anxiety. A medical breakthrough could be a game changer, but for now we expect the election will hinge on how bad conditions get and how fast the economy rebounds.

8) Rising debt and deficit levels could eventually create problems. There is no doubt that excessively high budget deficits and debt-to-GDP ratios are unsustainable in the long term. But that has been the case since interest rates peaked in the early 1980s. So far, revenue levels and debt servicing have been manageable, but that could change someday.

9) Equities could come under pressure if interest rates rise. Given that earnings expectations have fallen this year, the increase in stock prices can be attributed to valuation multiple expansions. Given that stocks are a long-duration asset class, a bond market selloff and corresponding rise in rates would negatively affect stocks, which appear fully valued.

10) We think stocks are likely to outperform bonds over the next 12 months. Both asset classes have done well this year with a recovering economy, improving future earnings prospects and low interest rates. Both asset classes also look fully valued, but we think bonds are more overvalued than stocks.

Economic and political risks could drag on stocks

The economy is still recovering, but evidence is mounting that renewed lockdowns are slowing the rate of recovery. Stock markets have been pricing in an aggressive rebound in corporate profits, which will be tough to achieve if economic growth falters. Investors also appear to be banking on a coronavirus vaccine or medical breakthrough that would allow the economy to get back on track more quickly. But even with better news on the coronavirus treatment front, the economy will struggle to get back to pre-pandemic conditions since many sectors have been severely damaged. As such, we think stocks have already priced in what looks like a best-case scenario, meaning markets could be subject to negative surprises.

The policy backdrop could also create some headwinds for stocks. Monetary policy could still provide some market support (especially given the Fed's revised inflation targeting), but future stimulus must increasingly come from the fiscal side. And fiscal policy is slower acting and harder to launch, especially given current massive deficits and debt levels. Related, the political backdrop itself is highly uncertain during this unusually contentious election season. And those risks could escalate if we have an uncertain or contested result in November.

There are, of course, positives to consider as well. Economic conditions are improving and monetary policy support remains open-ended. At the same time, a lack of appealing alternatives has caused investors to continue investing in equities. However, there is ample room for disappointment and we think the next few months will be a risky environment for stocks. As such, we suggest investors continue to approach the markets with caution.

2020 PERFORMANCE YEAR TO DATE

	Returns	
	Weekly	**YTD**
S&P 500	3.3%	10.0%
Dow Jones Industrial Avg	2.6%	2.0%
NASDAQ Composite	3.4%	31.2%
Russell 2000 Index	1.7%	-4.6%
MSCI EAFE	1.7%	-4.3%
MSCI EM	2.8%	2.5%
Bloomberg Barclays US Agg Bond Index	-0.5%	6.6%
BofA Merrill Lynch 3-mo T-bill	0.0%	0.6%

Source: Morningstar Direct, Bloomberg and FactSet as of 28 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.

> ***"Stocks may have already priced in a best-case scenario, meaning markets could be subject to negative surprises."***

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1 Source: Bloomberg, Morningstar and FactSet

2 Source: Labor Department

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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