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Weekly Investment Commentary

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Three risks that could (eventually) end the bull market

As Americans return from vacations and prepare for the change of seasons, equity markets have offered something of a surprise. After remaining range-bound since February, stocks have broken to new highs as investor optimism has been on the rise. The U.S. stock market has quadrupled since its 2009 lows, economic growth remains solid and earnings are rising.[1] We remain constructive and don't want to call for a premature end to the party. But as markets continue to rise, we think investors should start paying closer attention to possible triggers that will, at some point, start dominating market-related conversations.

HIGHLIGHTS

- **With stock prices rising and again at or near record highs, we think it is worthwhile to consider the possible risks that could end this bull market.**
- **We're not calling for a near-term end to the increase in equity prices, but we think investors should be more aware of risks as stock prices climb.**

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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.

Investment conditions are growing less certain

On balance, conditions look attractive for stocks. Prices are at all-time highs, stellar earnings results are expected to continue, inflation remains contained and interest rates remain low. Consensus expectations are that the next recession won't occur before 2020 or even later.[1] These positive factors suggest that risk assets, including stocks, still have ample upside.

Beneath the surface, however, we are becoming more cautious about the economic and market outlook. The consensus may be wrong about the next recession, and inflation and rates will certainly move higher as growth continues to improve. The Federal Reserve may become too aggressive about tightening monetary policy. The U.S. political environment is growing less certain, both regarding trade policy and the overall stability of the Trump Administration. Geopolitical issues also present risks, ranging from a messy Brexit process, rising populism in Europe and elsewhere, increasing tensions between the U.S. and Iran, and the prospects for a diplomatic setback on the Korean peninsula.

We also see fundamental risks: improving earnings reaching their end, rising equity valuations, narrowing credit spreads and growing sovereign and corporate debt levels. While this doesn't mean an end to the equity bull market, we think risks are worth paying attention to. We highlight three in particular:

Risk 1: The next recession may be closer than many expect

Economists are notoriously poor at forecasting the timing of recessions. It could be argued that the Fed has failed to correctly forecast any recession in its history, and private economists don't have a much better track record. The U.S. economy remains quite strong, but that is typically the case a couple of years before a recession.

One recession indicator that tends to be reliable is the shape of the yield curve, since recessions typically follow about nine months after the yield curve inverts. The yield curve remains positive but flattening. It is likely to invert sooner rather than later as long as the Fed continues raising rates.

We don't see signs of an imminent recession, but late cycle pressures appear to be building. We're hearing anecdotal stories about labor shortages and supply bottlenecks from corporate management teams. And wage growth is slowly climbing and could accelerate. The Labor Department's employment cost index rose 2.8% in the second quarter, the fastest pace in a decade. We expect inflation will continue to slowly rise (and perhaps accelerate slightly), which will put additional pressure on the Fed to raise interest rates.

Risk 2: Trade tensions remain a serious economic and market threat

Tariffs are taxes. They result in greater inefficiencies between the producers of goods and prospective consumers, and can potentially act as a broader drag on global economic growth. Perhaps more importantly from an equity investing perspective, current trade uncertainty is complicating forward planning for corporate management teams and causing some to delay capital spending plans.

President Trump believes the current U.S. trade deficit is caused by unfair trade practices. It may be true that countries like China play by different rules when it comes to issues like copyright protection, but trade balances mainly reflect relative economic growth and exchange rates. The great irony when it comes to the president's trade policies is that actions such as tax cuts and efforts to boost private investment spending are more likely to boost the trade deficit since they put upward pressure on the U.S. dollar. This is no doubt why President Trump has been railing against higher interest rates. In any case, increasing tariffs won't change the underlying dynamics of the U.S. trade deficit. And more to the point, we don't expect trade issues to be resolved any time soon.

Risk 3: Earnings expectations may be too high

Corporate earnings and profit margins have been exceptionally strong in the first half of the year. And analysts remain very bullish about prospects for future earnings. At present, consensus expectations are for S&P 500 earnings to rise 14% over the next 12 months and long-term earnings to increase by 16% per year.[2] That growth level was only exceeded during the 1990s tech bubble, and we think it seems extremely high.[2]

As interest rates and wage pressures rise, we think earnings growth is bound to slow. The benefits of the 2018 tax cuts will fade over time, while borrowing and labor costs are rising. A slowdown in earnings (and/or earnings results disappointments) could remove a major tailwind for equity prices.

Equity prices should keep rising for now, but increasing caution is warranted

There may be a "perfect" time to invest in equities: when markets are cheap, earnings expectations are overly pessimistic and monetary policy is highly accommodative. In fact, that pretty well describes 2009. The environment looks quite different today. Valuations may be somewhat stretched, earnings expectations are highly optimistic and the Fed is tightening.

What does that mean for stocks? As we stated earlier, we don't expect the equity bull market to change in the near-term. We think the fundamentals favor equities on balance, and we expect stock prices will be higher in one year. Returns may be meager compared to what investors experienced over the last decade, but we still believe stocks will outperform bonds and cash over that same time period.

Sir John Templeton famously said, "Bull markets are born in pessimism, grow on skepticism, mature on optimism and die on euphoria." At this point, it feels to us like this market is still in the optimism phase, meaning investors would still need to grow euphoric before we see its end. As such, we remain in the constructive camp. But we caution investors that the risks we have been discussing will at some point begin dominating the investment conversation.

2018 PERFORMANCE YEAR TO DATE

	Returns	
	Weekly	**YTD**
S&P 500	1.0%	9.9%
Dow Jones Industrial Avg	0.8%	6.7%
NASDAQ Composite	2.1%	18.3%
Russell 2000 Index	0.9%	14.3%
Euro Stoxx 50	-1.3%	-3.9%
FTSE 100 (UK)	-1.1%	-4.4%
DAX (Germany)	-0.5%	-7.7%
Nikkei 225 (Japan)	1.3%	2.9%
Hang Seng (Hong Kong)	0.9%	-4.6%
Shanghai Stock Exchange Composite (China)	-0.5%	-20.0%
MSCI EAFE	0.3%	-1.9%
MSCI EM	0.6%	-6.9%
Barclays US Agg Bond Index	-0.1%	-1.0%
BofA Merrill Lynch 3-mo T-bill	0.0%	1.2%

Source: Morningstar Direct, Bloomberg and FactSet as of August 31 2018. 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 indices are unmanaged and unavailable for direct investment.

"We don't want to call for a premature end to the bull market, but we think investors should start paying closer attention to possible downside risks."

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1 Source: Morningstar Direct, Bloomberg and FactSet

2 Source: IBES

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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Risks and other important considerations

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