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Q2 Outlook: The cycle strikes back

Everything's perfectly all right now. We're fine. We're all fine here now, thank you. How are you?

– Han Solo, Star Wars, 1977

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EXECUTIVE SUMMARY

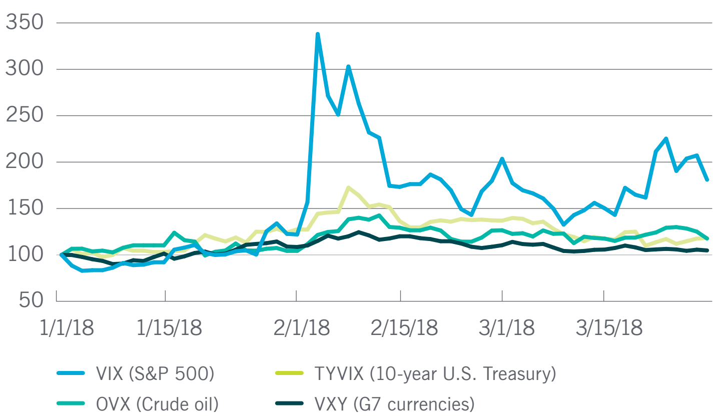
- Concerns about higher interest rates, inflation and U.S. trade policy produced a notable increase in market volatility during the first quarter of 2018.
- Economic fundamentals, however, look quite strong both at home and around the world, creating a stable backdrop for investors.
- Stronger earnings estimates—the product of improving growth and lower U.S. corporate tax rates—should help stocks recover from their recent correction.
- Even so, this economic expansion will not last forever. Recession risks, while low, are rising—thanks in part to an overabundance of federal stimulus that will help in the near term but presents risk in future years.
- Mis-valuations both within and across markets are no longer as prevalent, making it more difficult to capitalize on inefficient pricing. As a result, we are focusing more on other factors to determine our asset allocation strategy.

INTRODUCTION: A BRIEF REVIEW

"Sorry about the mess."

Financial markets came out of hyperspace and into a meteor shower in February, one that has only begun to clear up. The S&P 500 Index experienced its fastest-ever 10% fall from an all-time high as stock price volatility surged (Figure 1) and the 10-year U.S. Treasury yield touched its highest level since 2013. Just as volatility began to subside, two separate White House announcements of new, targeted import taxes—also known as tariffs—caused U.S. stocks to nearly retest their February lows in the last few days of the quarter.

Figure 1 – The recent volatility has primarily affected equity markets



Volatility indexed to 100 on 1/1/18.

Source: Bloomberg. *Indexes used include the CBOE S&P 500 Volatility Index (VIX), the CBOE/CBOT 10-year U.S. Treasury Note Volatility Index (TYVIX), the CBOE Oil ETF VIX Index (OVX), and the JPMorgan G7 Volatility Index (VXY).*

The first of our three primary themes for the second quarter is that the U.S. economy has now entered late-cycle mode—but that's not necessarily a bad thing for risk assets such as equities. Our second theme is that, late-cycle dynamics in the U.S. aside, there's still plenty of good news around the world, which continues to create attractive investment opportunities. Our third theme concerns asset allocation decisions, where pricing differences between stocks and bonds have narrowed dramatically in the U.S., providing a weaker signal for value-seeking investors. However, higher volatility and stronger cyclical forces are creating space for tactical investors to thrive.

THEME 1: LATE CYCLE HAS ARRIVED

"Good, I hate long waits."

An economy in the later stages of its expansion is generally running close to full capacity. This means that further increases in demand tend to produce stronger wage growth, since employers must pay more to attract new workers—and rising wages eventually feed through to higher prices. Inflation risk causes the Federal Reserve (or the bond market, if the Fed is perceived as lacking the credibility to handle such things) to tighten financial conditions by raising interest rates. More often than not, this tightening results in a recession.

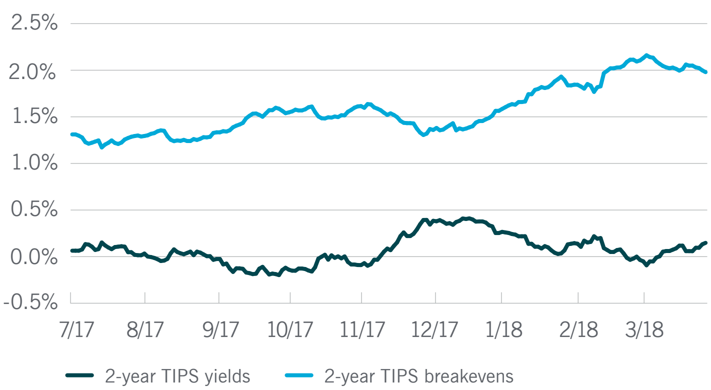
By the end of the second quarter of 2018, the U.S. economy will have been expanding for nine years. The current cycle has lasted as long as it has in part because the average growth rate has been so tepid. Cook a seven-pound leg of lamb at 350 degrees and it will cook in just under two hours. Cook it at 500 degrees and it'll be done a lot sooner than that, with potentially disastrous results. Stimulus from the $1.5 trillion Tax Cuts and Jobs Act of 2017 (TCJA), the effects of which are already being felt, plus over $300 billion in new federal spending through 2019, have turned up the temperature on U.S. economic activity.

New spending may allow the economy to run hotter, but it also raises the risk of overheating. We haven't experienced a sustained period of above-average growth and inflation at any point over the past 10 years. This environment brings with it the possibility of rising interest rates. Of course, the Fed has been raising rates since 2015. The pace of tightening, however, has been much more gradual than usual, which has allowed financial conditions to remain easy and real activity to strengthen in recent years. But a sharper and sustained rise in rates and inflation is a risk with which an entire generation of investors has never had to grapple.

This inexperience was on full display immediately following the February 2 release of January's average hourly earnings data, a popular, albeit imperfect, proxy for wages. When that metric showed an unexpectedly faster rate of growth, financial markets snapped into a late-cycle mentality. Importantly, however, one month later that same data showed slower wage gains and included a downward revision to the troublesome January figure.

Even so, concerns about rising rates and inflation continue to weigh on asset prices. Inflation and interest-rate risks are no longer one-sided. Bond markets now price in inflation close to the Fed's 2% target in the near term (Figure 2), despite the difficulty the Fed has had in hitting that level since 2008. A market that reflects evolving reality is likely healthier than one that constantly expects low inflation and falling interest rates. But that same market is likely to exhibit higher volatility and greater sensitivity to new data and policy shifts.

Figure 2 – Rising inflation expectations are a sign investors see the economy heating up



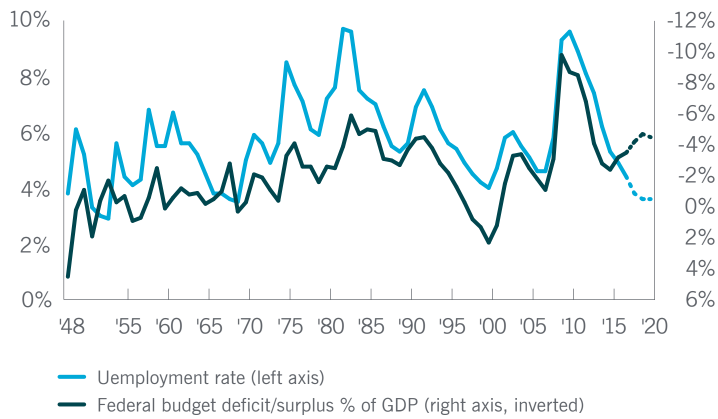
Source: Bloomberg. *TIPS breakevens are the spread between a Treasury inflation-protected security and a nominal U.S. Treasury of the same maturity. They are intended to capture inflation expectations in bond markets.*

U.S. economic policy

"I never ask that question until after I've done it"

Introducing fiscal stimulus nearly ten years into a cycle is experimental economy policy, to put it mildly. Running large federal budget deficits as the unemployment rate plunges toward (or even below) its natural rate is largely without precedent. In past expansions, deficits have shrunk or even turned to surplus as the unemployment rate falls close to 4%. But the reduced revenue from the front-loaded tax cuts and increased discretionary spending as part of the recent budget deal in Congress have broken that rule (Figure 3). Moreover, at the same time this is happening, the Federal Reserve looks likely to accelerate its pace of interest-rate hikes. Think about what happens to a car when you push down both the brake and the gas. Actually, you may not know, because most people haven't tried it. That's a pretty good descriptor of U.S. economic policy at the moment.

Figure 3 – New stimulus comes as the labor market already appears tight



Source: Bloomberg, Goldman Sachs Research

Of course, while the federal government has reduced taxes broadly for corporations and individuals, it has also taken small steps to raise them for consumers of steel, aluminum, and an array of imports from China. The size of the negative economic impact from the recently announced tariffs will not come close to offsetting the positive effect from the TCJA. Nonetheless, fears of an escalating trade war were enough to short-circuit the recovery in equity markets and send interest rates down from their highs. We do not view such an escalation as a severe or imminent risk to the economy, particularly given the Trump administration's willingness to exempt select countries before the tariffs kick in. Even watered-down measures, however, may create enough uncertainty to affect business and consumer behavior.

Recession risk

"Never tell me the odds!"

Our use of the term "late cycle" should not be read as a call for an imminent economic contraction. Despite their climb since the beginning of the year, interest rates are still low by historical standards. There is no sign of significant stress on households, and corporate profits are set to grow well in excess of their 10-year average. So the probability of a U.S. recession in 2018 still looks exceedingly low—less than 10%. However, the odds begin to increase when we project out to 2019 or 2020, at which time the effect of fiscal stimulus should begin to wear off and the cumulative rise in interest rates will start to take its toll. We see a 25% probability that the U.S. will fall into recession next year, and a 50% probability that it will do so by the end of 2020.

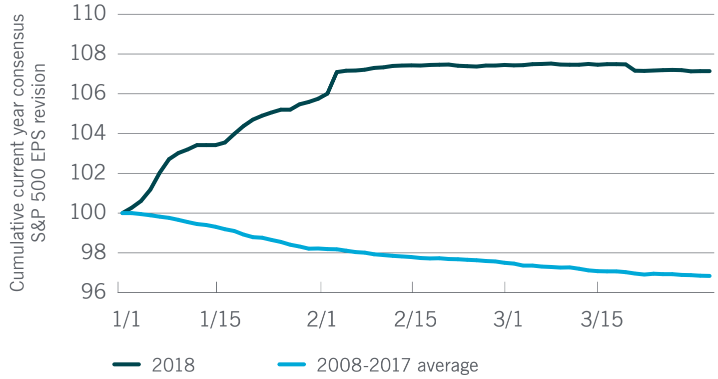
THEME 2: THERE'S STILL GOOD NEWS OUT THERE

"Instead of a big dark blur, I see a big light blur."

Fortunately, our second theme is a bit more upbeat than the first. Investors who focus only on rising U.S. interest rates and the aging U.S. equity bull market may miss some or all of the good news emanating from growing economies around the world. Yes, even the United States. From the Americas to Europe to Asia, economic policymaking is becoming more pro-growth, contributing to the synchronous and largely non-inflationary rise in global GDP.

We've just covered the potential pitfalls of U.S. policymaking, but we should also note that tax reform has already raised after-tax incomes for individuals and after-tax profits for corporations. Consensus forecasts for 2018 S&P 500 earnings are up over 7% in the first three months of the year, normally a time when analyst forecasts are being pared back (Figure 4). The surging "E" combined with a falling "P" in P/E (price-to-earnings) ratios has allowed valuations to retreat from their lofty levels at the start of the year. In the coming months, the S&P 500 has room to return to, and eventually exceed, its January 26 all-time high without becoming too expensive.

Figure 4 – Tax cuts have boosted U.S. earnings expectations for 2018



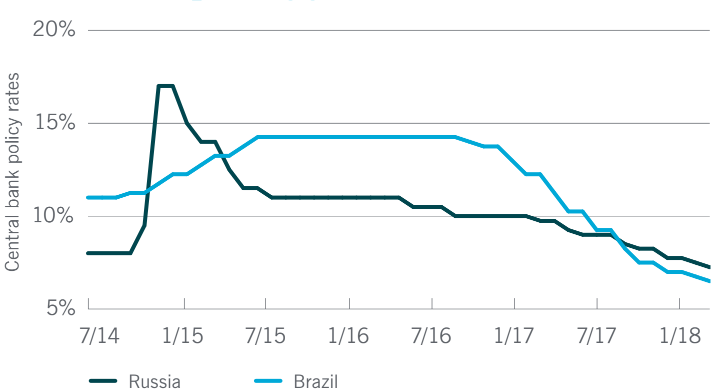
Source: Bloomberg

Tax reform has also created opportunities in an asset class many might not expect: municipal bonds. While the new law limited the deductibility of mortgage interest payments, state and local taxes, and other write-offs, it preserved the tax-free treatment of interest on most types of municipal issues. This, coupled with an expected drop in new issuance in 2018, should support municipals, even in a rising interest-rate environment. Munis have outperformed similarly rated taxable bonds year to date and continue to trade at attractive valuations compared to U.S. Treasuries and corporates.

Turning our attention overseas, prior to February, it had been two years since the last global equity market correction. That's long enough for many investors to have forgotten that it came about mainly as a result of financial risk in China and the possibility that accelerating capital outflows could bring about an economic crash. While its growth rate continues to slow from levels seen in the previous decade, China has managed to assuage concerns about its financial stability. It no longer needs to shed foreign reserves to support its currency against the threat of outflows. And while both the size and growth rate of China's debt remains a longer-run concern, its economic indicators have stabilized or strengthened this year. Indeed, China has provided an important source of stability for the region and the world, while also helping emerging market (EM) equities become the best-performing market segment in the first quarter.

Elsewhere in EM, more economies are experiencing faster growth and falling inflation, allowing central bankers to further reduce interest rates without stoking inflation or a currency crisis. Brazil and Russia, two countries whose equity markets we cited as among our most-preferred in our 2018 Outlook, are the best examples of this easy monetary policy (Figure 5). Brazilian and Russian equities were standout performers in the first quarter. We continue to look for Brazil's government to deliver meaningful economic reforms that will make it more attractive to foreign investors, and for Russia to sustain positive growth without relying on a further increase in commodity prices. Recent geopolitical tensions centered on trade and, in Russia's case, economic and political sanctions, will also have a significant impact. As it stands, we remain favorably disposed toward both EM equities and EM debt, with a specific preference for local-currency bond markets, which benefit from disinflation and stronger EM currencies.

Figure 5 – EM central banks are cutting interest rates amid improving growth and tame inflation



Source: Bloomberg

Relative to our expectations to start the year, Eurozone equities have been a disappointment. The sharp increase in the euro against other major currencies, along with the prospect of escalating protectionism, is a negative for Europe's large export sector. In addition, after being alive but in perfect hibernation for years after the global financial crisis, the continent's economy delivered convincing growth last year, boosting Eurozone assets. But further upside surprises to growth have been harder to find as expectations have risen.

The Eurozone economy is still strong, however, which—in a period of improving global growth—should support earnings and allow Eurozone stocks to rebound from a frustrating first quarter. This view hinges on surefooted policy from the European Central Bank (ECB), which has exhibited more confidence in Europe's recovery and seems likely to end its bond-buying program by year end. It will soon have to provide guidance around when it plans to start raising its target interest rate. The Fed waited over a year after the end of its quantitative easing program before it began to hike rates. Should the ECB move sooner than that, it could be seen as a policy error and jeered by markets.

THEME 3: VALUATIONS ARE NO LONGER AT EXTREMES

"You said you wanted to be around when I made a mistake. Well, this could be it."

We are increasingly convinced that the U.S. economic cycle is in its later stages. However, because we think the chance of a recession in the next 12-24 months is still low, we continue to maintain a risk-on stance in our multi-asset portfolios. U.S. stocks should be well-supported over the balance of 2018 by the surge in earnings fueled by the drop in corporate tax rates. But late-cycle challenges and lingering policy concerns—e.g., Fed hikes, tariffs, diplomatic challenges—may forestall an increase in market valuations, limiting further gains to the level of earnings growth.

In fact, based on at least one measure—the equity risk premium—U.S. stocks now look about neutrally valued against U.S. Treasuries. (The equity risk premium is the additional return one expects to earn on stocks versus bonds over the long term based on current pricing.) It has fallen from multi-decade highs back in 2009 to its long-term average (Figure 6). Looking at this from the opposite perspective, given the recent rise in yields, many types of high-quality bonds like U.S. Treasuries now have a larger cushion against rising rates than they have for several years.

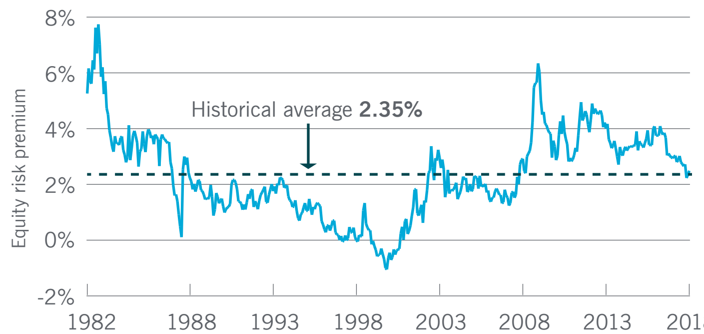
While disparities in valuation no longer provide a compelling reason to prefer U.S. stocks over bonds, there are three other factors that do point us in that direction:

- Potential economic overheating presents a greater risk to bonds than to stocks, at least in the near term.
- The global economic upturn and the cut in corporate tax rates are more supportive of stock prices than of bond prices.
- Because we are not limited to the U.S. in our equity portfolios, we can take advantage of wider risk premiums overseas, including in our most-preferred markets, the Eurozone and EM.

Real estate is another area in which valuations no longer look as compelling as they once did. Capitalization rates ("cap rates"), which compare a property's net operating income to its market value, are still higher than Treasury yields, but that spread has narrowed since the earlier years of the cycle. Given the increase in supply and the inching up in vacancy rates in most sectors, total returns should settle into the mid-single digits in 2018. We still believe there is distinct value in owning real estate even as its cycle matures—particularly in the industrial sector, given the likely increase to private investment in the next few years.

Valuation has also become a less useful guide for allocating across taxable fixed-income sectors. Despite coming off their January lows, U.S. corporate credit spreads to Treasuries remain within sight of their tightest levels of the cycle. This means that investors who prefer taking credit risk to interest-rate risk are being paid less for doing so. Because many of the lower-rated parts of the corporate bond market outperformed in the first quarter, we increasingly prefer higher-quality issues, helping us to take a somewhat more defensive stance in multi-asset portfolios.

Figure 6 – U.S. stock-bond valuation is back to normal



Sources: Bloomberg, Nuveen, Robert Shiller and Cleveland Fed. *The equity risk premium is calculated as the difference between the Shiller Earnings Yield and the real 10-year U.S. Treasury yield.*

CONCLUSION

"Don't get excited."

While the worst of the volatility from the first quarter appears to have subsided, we don't expect markets to revert to the historic calm they exhibited in 2017. Late cycle is here. U.S. equity valuations, though significantly less expensive than they were at their January highs, remain pricey compared to the rest of the world. Interest rates have stabilized at higher levels and seem likely to move gradually higher still. But there's still plenty of good news all over the world for investors who know where to look. And despite the length of the U.S. expansion, we continue to adopt a risk-on position in our asset allocation.

For more information, contact your financial advisor, or visit us at nuveen.com.

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