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# Fed fears and inflation jitters hammer global equities

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**Article Highlights**

- The S&P 500 Index falls 5.2% for the week, at one point plummeting more than 10% below its January 26 peak, marking an official correction. International developed- and emerging-market stocks also slump, but to a somewhat lesser degree.
- At 2.83%, the 10-year U.S. Treasury yield is little changed for the week. Its dramatic, 43-basis-point increase year to date reflects bond markets' improving assessment of U.S. economic growth and concerns about rising inflation.
- Eurozone and U.S. business survey data surge in January, adding to continued favorable trends in global growth.
- President Trump signs a bipartisan budget deal that stands to add $325 billion to the federal deficit over the next two years.
- Equity market fundamentals remain intact, and the scope of the recent decline in global stocks seems unwarranted, in our view.

**Quotes of the week:**

*"That's all right. These things gotta happen every five years or so, ten years. Helps to get rid of the bad blood. Been ten years since the last one." Peter Clemenza, from "The Godfather."*

Over the coming weeks, we'll take a closer look at economic and investment themes that will be key to understanding the dynamic market landscape. And in any given week, we'll present our featured topics in the context of the major themes listed below from the Nuveen 2018 Outlook:

- **U.S. economy:** Conditions are still running closer to "just right" than "too hot."
- **Global economy:** Overseas economies are improving, but the time for surprises is over.
- **Policy watch:** In an unusual twist, U.S. fiscal and monetary policies are diverging.
- **Fixed income:** Bond markets offer few places to run to, even fewer places to hide.
- **Equities:** Stronger corporate earnings growth should drive stock prices higher.

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## Equities: Earnings growth vs. fear factor

While daily news coverage fixated on big drops in the Dow Jones Industrial Average, a look beyond the past week's unsettling headlines reveals that U.S. companies have delivered solid fourth-quarter earnings. According to Bloomberg, with about 70% of S&P 500 companies reporting, 81% have delivered better-than-expected profits—a higher than usual percentage of "beats." Fourth-quarter earnings growth will likely come in somewhere between 12% and 15%, and we expect profits to surge another 15% for 2018 as a whole. This is roughly double the growth rate S&P 500 companies would have achieved without the benefits of corporate tax reform.

Meanwhile, the global economy shows no signs of slowing down. On February 7, the European Commission raised its 2018-2019 growth projections for the Eurozone. Supported by rising business confidence, the currency bloc began the year by registering its strongest monthly expansion in manufacturing and service-sector activity since June 2006, as measured by Markit's Composite Purchasing Managers' Index (PMI).

In the U.S., ISM's service-sector gauge jumped to 59.9 in January, well above the 50 mark separating expansion from contraction, with its employment sub-index surging to an all-time best.

Indeed, recent good economic news seems to have been more of a hindrance than a help to stock prices. It was the 2.9% jump in U.S. average hourly earnings (their fastest annual growth since 2009) that sparked the current wave of volatility in equities when the January employment report was released on February 2. That upside surprise triggered fears that the Federal Reserve will speed up its pace of interest-rate increases amid renewed inflation risk.

In response, the S&P 500 Index, which lost 3.9% the prior week, declined another 5.2% for the week ended February 9. It officially entered correction territory on February 8, having fallen by 10.2% from its recent high of 2,872.87 set on January 26. (A correction is usually defined as a pullback of at least 10% from a recent peak.)

Despite the current turmoil, in our view U.S. equities are not entering a bear market. The economy and corporate earnings remain in good shape, potentially providing tailwinds for stock prices. One month ago, we forecast a 2,900 year-end finish for the S&P 500. Nothing that's happened in 2018 thus far has caused us to change that outlook. That said, the road ahead will be bumpier than it was during the halcyon days of 2017, when stocks gained steadily amid serene, bond-like volatility.

For their part, bond markets have generally kept their cool in the current environment. Although returns have been negative of late, trading has been orderly. The 10-year U.S. Treasury yield was little changed for the week, closing at 2.83% on February 9. (Yield and price move in opposite directions.) If the 10-year yield were to break 3% in the coming weeks—a short timeframe for such a move—we would then expect heightened volatility in fixed-income markets.

## Policy watch: How will the Fed react to this equity market pullback?

Unless it deepens substantially from here, this week's market correction will likely not impact Fed policy. The Fed takes financial market conditions into account when deciding when and how much to raise interest rates, and stock prices and valuations certainly enter into this calculation. However,

despite the S&P 500's decline, conditions in most markets remain loose, warranting higher interest rates.

For example:

- Investment-grade credit spreads—the difference between yields on corporate bonds and those on U.S. Treasuries—are still tight. Since dipping to 85 basis points (0.85%) on February 1, spreads have ticked up but are still within earshot of their 2005 all-time low of 77 basis points. If investors were worried about the health of U.S. companies, they would demand higher yields to compensate for the added risk of holding these bonds.

- The labor market continues to show signs of strength, with the past week's first-time jobless claims hovering near a 45-year bottom.

- Inflation, while still short of the Fed's 2% target, is poised to move higher once the effects of tax cuts and increased fiscal spending kick in.

- The Fed's fourth-quarter Senior Loan Officer Opinion Survey (SLOOS) showed banks easing their lending standards for commercial and industrial loans, on net. While the easing wasn't dramatic, and demand for loans was static, loosening lending standards are an extraordinary development several years into a Fed hiking cycle.

Both we and the markets believe the Fed is on track to raise rates next month. If we are wrong, it will almost certainly be because financial conditions have materially deteriorated in the interim. In this environment of improving global growth and strong private sector balance sheets, that's not likely to happen—at least not enough to trouble new Fed Chair Jerome Powell and his colleagues.

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