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Equity markets breathe a bit easier as trade fears ease and earnings season arrives

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This past week’s market highlights:

• Receding trade-war fears help the S&P 500 Index return 2% for the week. Energy stocks surge, with the price of oil reaching a four-year high amid concerns over a potential U.S. strike on Syria. Europe’s STOXX 600 Index (+1.62%) rallies for the third consecutive week.

• Rising oil prices also support high-yield bonds, which handily outperform other taxable fixed-income sectors. Demand for Treasuries is dampened by the past week’s largely “risk on” mood. The yield on the bellwether 10-year note climbs 5 basis points (0.05%), to close at 2.82% on April 13.

• Are people spending or saving their tax cuts? The March retail sales report (due on April 16) should provide some insight. Based on the University of Michigan sentiment index released this past week, consumers remained confident in April despite their unease over the potential economic impact of U.S. trade policies.

• Although annual inflation readings warmed up in March, they’re not as robust as they first appear. The Consumer Price Index rose 2.4% as February 2017’s weak number rolled off the year-over-year comparison. Stripping out food and energy costs, so-called “core inflation” was up 2.1%, its strongest showing in more than a year.

Quote of the week:

“Hey, Toreador. She signals. We head for the edge. The first guy who jumps—chicken!”
– Buzz, “Rebel Without a Cause”

As part of our new format, we are presenting our featured weekly topics in the context of the major themes listed below from the Nuveen Q2 Outlook:

• **U.S. economy**: Late cycle has arrived.
• **Global economy**: There’s still good news out there.
• **Policy watch**: In an unusual twist, U.S. fiscal and monetary policies are diverging.
• **Fixed income**: Bond markets offer few places to run, even fewer places to hide.
• **Equities**: The bull market’s not over, but expect plenty more volatility.
• **Asset allocation**: Valuations are no longer at extremes.
Equities: As earnings season begins, expect a boost from corporate tax cuts

After a volatile first quarter in equity markets, a Friday-the-13th kickoff for earnings announcements may seem like a bad omen. Nevertheless, analysts appear to be welcoming this season in earnest. Since the start of 2018, they’ve raised their S&P 500 earnings estimates by 5.4%—the biggest quarterly increase on record, according to FactSet, which started tracking the data in 2002. Company managements have also been enthusiastic, providing positive guidance at twice the rate of their five-year average. More typically, companies prefer to lower expectations before earnings season and then surprise investors on the upside.

Overall, the consensus estimate for first-quarter earnings growth is 17.1% year over year—a rate we believe will continue throughout 2018. Bolstered by a solid global economy, healthy revenue growth, and higher cash flows stemming from December’s corporate tax cut, earnings should continue to increase in 2019, albeit at a slower (7%) pace. With the aggregate effective tax rate for S&P 500 companies falling from 27% to 19%, profits will get a boost over the next several quarters.

That said, disentangling the effects of tax cuts from underlying company fundamentals will be challenging. We think the cuts by themselves could add 5%-7% to earnings in 2018, but whether they continue to support profits growth beyond this calendar year depends largely on how companies use the extra cash to support increased productivity. Hiring workers, raising wages, or boosting capital expenditures are all methods that could help. Yet companies seem to prefer to use their tax windfalls to pay down debt, repurchase shares, increase dividends, and pursue mergers and acquisitions. While these measures would benefit shareholders and companies, their broader economic impact is less clear.

A robust first-quarter earnings season, if it materializes, should assuage investor concern that the market has become stretched. The magnitude of earnings increases may help investors shift their focus from macro concerns (e.g., rising interest rates, the possibility of slowing economic growth, or the threat of a trade war) back to fundamentals. For our part, we’ll be paying close attention to managements’ use of cash, and what that might imply for longer-term economic growth.

Asset allocation: Time to dial down risk a bit?

In our second-quarter Outlook, we stated that the chance of a recession in the next 12-24 months is low, as the late-stage U.S. economic expansion—along with the investment opportunities that accompany it—still has some room to run. That remains our view. However, despite the past week’s broad equity-market rally, investors may find it harder to justify maintaining a large “risk-on” position within a portfolio, at least based on valuations alone.

U.S. stocks look about neutrally valued against U.S. Treasuries, as measured by the equity risk premium—the additional return investors expect to earn on equities versus a “risk-free” alternative (U.S. Treasuries) over the long term, based on current pricing. This premium now stands at around 4%-5%, down sharply from a high of 8%-9% back in 2009. But while disparities in valuations may no longer provide a compelling reason to prefer U.S. stocks over bonds, other factors still point in that direction.

- First, potential overheating of the economy presents a greater risk to fixed income than to equities, at least in the near term. That’s because stocks have often performed well in
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Rising-rate environments—periods generally associated with strong economic conditions under which top-line corporate revenue can grow. In contrast, the increase in financing costs triggered by higher rates tends to act as a headwind for bond issuers. Moreover, as the risk-free yield rises, riskier borrowers typically have had a harder time raising capital.

- Second, stocks have a history of rallying in the late innings of economic cycles, as earnings improve amid strong growth conditions. For example, the Energy and Materials sectors, whose performance is closely tied to the price of raw materials, have frequently benefited from inflationary pressures and continued solid demand.

Like equities, real estate has seen a tempering of its relative appeal over fixed income as bond yields have risen. The spread between capitalization rates ("cap rates")—which compare a property's net operating income to its market value—and Treasury yields has narrowed since the earlier years of the cycle. However, compared to real estate's historically high valuations versus bonds in 2005-2007, the asset class continues to look quite compelling. In our view, there is distinct value in owning real estate even as its cycle matures—particularly in the industrial sector, where private capital investment is likely to increase in the next few years.

Valuation has become a less useful guide for allocating across taxable fixed-income sectors, as well. 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, it might be time for higher-quality issues to lead the way. These securities may get a second-quarter lift amid continued depressed supply in the market.

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