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Investment perspective and market outlook

01 January 2018

Ten Predictions

2018: From nearly perfect to less perfect

2017 RECAP: A YEAR OF POSITIVE SURPRISES

From an investment perspective, 2017 may have been the first "perfect" year ever. The U.S. economy continued to slowly improve, with unemployment dropping to nearly a 20-year low.[1] Global growth expanded and became more synchronous, with Europe in particular showing strength. And while growth improved, inflation remained tame. This allowed global central banks to keep monetary policy accommodative, even as the Federal Reserve and other policymakers were slowly tightening.

At the beginning of 2017, we predicted another year of positive equity returns (an unprecedented ninth consecutive year).[1] That came to pass, but we were surprised by the degree. The equity-friendly environment caused stock prices, as measured by the total return of the S&P 500 Index, to increase every month for the first time in history.[1] We were also surprised by how low volatility dropped during the year. Non-U.S. equities provided strong returns, and in many cases outpaced the United States, especially in emerging markets. Other risk assets, such as fixed income credit sectors, experienced solid returns as well.

The biggest stock market story in 2017 was the string of seemingly never-ending positive earnings surprises, followed by constant upward earnings revisions. Memories of deflation and the Great Recession seemed to keep sentiment cautious and skeptical (if not outright bearish) as investors constantly underestimated earnings results.

So how long will the party last? U.S. equity valuation levels are being questioned, and while they are high relative to history, we think they remain reasonable versus other asset classes. Bull markets don't die of old age or over-valuation. Something negative, usually unwanted inflation, becomes the catalyst for a downturn. And serious negative factors seem absent in the 2018 outlook. With this backdrop, we offer our predictions for 2018.

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Bob Doll serves as a leading member of the equities investing team for Nuveen Asset Management, providing reasoned analysis through equity portfolio management and ongoing market commentary.

2018 Ten Predictions

1	**U.S. real GDP reaches 3% and nominal GDP 5% for the first time in over a decade.**
2	**Despite ongoing protectionism, the global expansion continues with the fewest countries in recession in history.**
3	**Unemployment falls to the lowest level in nearly 50 years as wage growth is the highest since the Great Recession.**
4	**The yield curve flattens (but does not invert) as the yield on the 10-year Treasury reaches 3% for the first time since 2014.**
5	**Stocks enjoy longest bull market in history but experience a 5+% correction after the longest period without one.**
6	**U.S. equity returns lag earnings growth for the first time in six years, the longest streak in decades.**
7	**Equities beat bonds for the seventh consecutive year for the first time in nearly a century.**
8	**Corporate capital expenditures increase at the expense of share buybacks.**
9	**Telecommunication services, information technology and health care outperform utilities, energy and materials.**
10	**Republicans lose the House, retain the Senate and further distance themselves from President Trump.**

2018 OUTLOOK

We're constructive toward equities as we enter 2018, but think conditions will become less-perfect than in 2017. We are calling for an environment of low inflation and interest rates, good earnings and earnings growth and solid economic growth. The effects of the recently passed tax reform bill should be a positive as well. Having said that, we think the environment is moving from nearly perfect to less perfect and from skepticism to optimism.

A SHIFT FROM NEARLY PERFECT TO LESS PERFECT

2017	2018
A good economy accelerating from 2016	A good economy decelerating into 2019
Low and steady inflation and yields	Low but rising inflation and yields
Corporate earnings surging past expectations	Corporate earnings meeting expectations
Investors awaiting the effects of tax cuts	Investors realizing the effects of tax cuts
Strong stock markets moving straight up	Decent stock markets moving up bumpily

What might such a transition look like? In 2017, economic growth was good and markets anticipated acceleration in 2018. In 2018, growth will likely remain good, but investors may anticipate deceleration in 2019. Inflation and bond yields might move from very low and flat to low but rising. Earnings growth surprised to the upside nearly nonstop in 2017. Expectations for 2018 are higher and likely to be met but not significantly exceeded. Investor sentiment and confidence is shifting from skepticism to optimism. And the political backdrop may move from messy to messier. As long as economic growth and earnings are relatively good (which they are likely to be), equities should be fine. But it may be difficult to advance at the same strong, smooth pace as 2017.

We also see signs of possible risks for the markets. Inflation is probably our biggest worry. Although we don't expect inflation to rise significantly this year, we expect it to climb. A key warning sign for a more adverse outlook would be an inverted yield curve and rising credit spreads that accompany rising inflation. Such concerns are probably premature, but they bear close scrutiny. Rising anti-trade protectionism would be a significant concern as well, especially if it could disrupt global economic growth.

Equity valuations are rising, but we don't expect that to be an issue in 2018. Overall fundamentals remain strong, which should help equities make additional gains. But while valuations tend not to matter as much in the short term, they matter significantly for long-term returns. Therein lies the problem. As the economic cycle progresses and the bull market continues, investors will inevitably experience more mediocre returns. For now, we are enjoying the upward momentum of the stock market. But we remain vigilant.

KEY THEMES FOR 2018

The economy

- *U.S. and global growth should continue to improve during 2018.*
- *Unemployment should continue falling, putting upward pressure on wage rates and inflation.*
- *The U.S. economy should enjoy the effects of tax cuts, but we do not anticipate much additional pro-growth legislation.*

The markets

- *Earnings growth may slow but should continue to push equity prices higher.*
- *Volatility is likely to climb and market gains will be tougher to come by than they were in 2017.*
- *In general, we prefer cyclical stocks over defensive ones and value styles over growth.*

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1 Source: Morningstar Direct, Bloomberg and FactSet.

The **S&P 500 Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy.

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