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Investment perspective and market outlook

31 December 2018

Ten Predictions

2019: Choppy and frustrating, but no recession

2018 RECAP:

2018 proved to be a "Tale of Two Cities" year, as investors were confronted with a range of contradictions: Unemployment ended the year at nearly a 50-year low and wages have been rising, yet fears of a recession have increased. And corporate earnings were amazingly strong while stock prices sank sharply into correction territory by the end of the year. Investors are now left to question whether solid fundamentals or growing uncertainty will shape the markets.

Ironically, 2018 was relatively calm until the fourth quarter. Outside of a brief correction in January and February driven by fears of rising interest rates, investors focused on an accelerating economy and strong earnings growth. Stock prices rose to record levels by the end of the summer.

U.S. economic growth was quite strong in 2018, helped in no small part by the 2017 tax cuts. At the beginning of the year, we believed real U.S. gross domestic product growth would reach 3%. This level was much higher than consensus estimates, but it did come to pass. We also expected corporate earnings growth to rise, but were surprised by the incredible S&P 500 earnings per share growth of 22.6% year over year.[1]

What happened over the last three months? Stocks may have reached overbought levels by the end of the summer, so it wasn't shocking to see a selloff. But the magnitude of the decline has been surprising. We see two primary drivers of the current selloff. First is a genuine fundamental issue of higher interest rates and inflation. Neither has been moving strikingly higher, but they have advanced over the last 12 months, compressing equity valuations. Second, consider a large list of worries: concerns over slowing economic and earnings growth and trade issues are the most prominent, but investors are also worried about Brexit, the Italian budget stalemate, falling oil prices, political dysfunction and uncertain Federal Reserve policy. With this somewhat confusing backdrop, we offer our 10 Predictions for 2019.

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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.

2019 Ten Predictions

1	The U.S. expansion becomes the longest in history despite GDP slowing to a still-above-trend increase of 2% to 2.5%.
2	Unemployment bottoms in 2019 while wage growth continues to rise.
3	The Treasury yield curve flattens and credit spreads widen due to late cycle concerns.
4	Corporate earnings growth estimates weaken for 2019 and 2020 as both revenue and profit pressures rise.
5	U.S. equities experience a positive return, but fail to reach record highs for the first time in 10 years.
6	Non-U.S. stocks outperform U.S. stocks as the dollar sags.
7	The information technology, financial and health care sectors outperform utilities, REITs and materials.
8	The annual federal budget deficit approaches $1 trillion, a level unprecedented absent a recession.
9	U.S. and global politics spark more market volatility as the cold wars within the U.S. and with China persist.
10	A double-digit number of Democrats run for president while President Trump is challenged within his own party.

2019 OUTLOOK

We have many questions, but we think it is fairly certain that the U.S. will not fall into recession in 2019. We don't see any signals that make a reasonable case for recession. The consumer sector looks strong, particularly the labor market. The corporate sector is solid, although corporate management teams have scaled back some plans due to trade concerns. And the government sector appears to be expanding, as spending is likely to rise. We expect growth will slow next year compared to 2018, but to a still-above-trend 2%+ level.

A CONFUSING AND CONFLICTED OUTLOOK

The bullish view...	...and the bearish
Solid earnings growth	Earnings uncertainty is high
Growth is slowing, not collapsing	Fed policy is too tight
Fed is becoming more dovish	Tariffs will slow growth
Trade issues could improve	Global growth is unbalanced
Correction has been broad-based	Financial market volatility could rise
Sentiment is very negative	Political uncertainty is pervasive
Valuations have improved	The end of the cycle is inevitable

However, we can easily make a bullish or bearish case for stocks. We could argue that recession fears will likely fade as data continue to be positive. Should that happen, stock prices could again rally on decent fundamentals, especially since valuations are more attractive now than they were a few months ago. Conversely, even if the economy continues to grow, investors will become increasingly concerned about slowing earnings growth. They will continue looking for reasons to sell, which could produce a trendless or even falling market into 2019.

But, at the end of the day, as professional investors we are obligated to make a call and lean toward a constructive view on equities. As the title of our predictions suggests, we think markets will remain choppy and frustrating and stocks will bounce around with extended runs and declines. Ultimately, we think the bullish factors will generally overpower the bearish ones.

We expect 2019 market performance will be stronger than 2018. We think a reasonable year-end target range for the S&P 500 Index would be around 2,650, meaning a decent gain for stocks. To get there, recession fears cannot be realized.

As volatility remains elevated, we think 2019 will be a difficult environment for investors. Remaining selective and tactical would seem to be the order of the day. Long-term investors may want to add to positions during periods of weakness and trim holdings during periods of strength.

Additionally, we point to several themes that we think may win out over the course of 2019. Specifically, we think focusing on factors such as high free cash flow, inexpensive valuations, the ability to grow top-line earnings and an eventual tilt toward non-U.S. sources of revenue would benefit investors.

KEY THEMES FOR 2019

The economy

- *U.S. growth may slow modestly, but we think the expansion should continue.*
- *The differential between U.S. and non-U.S. growth is likely to narrow.*
- *Trade issues aren't likely to go away any time soon and remain a threat to the global economy.*

The markets

- *Fundamentals should remain solid, and we expect investors will focus on the positives.*
- *Volatility will likely remain elevated and the year may prove painful for investors.*
- *We think stock prices will rise in 2019, and selectivity will grow in importance.*

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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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