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Markets stumble, volatility surges... What happened?

David A. Chalupnik, CFA
Equities CIO, Nuveen Asset Management

Thomas (Tom) Franks, CFA
Equities CIO, TIAA Investments

The year 2018 proved an eventful one for global economies and capital markets. After solid and accelerating global growth in 2017 and into the first half of 2018, momentum waned amid deteriorating financial conditions. As a result, equity markets ended the year on a downbeat note. It was a particularly difficult year for investors in international equity markets, both developed and emerging.

KEY TAKEAWAYS

- Within U.S. sectors, health care performed best for the quarter, followed by utilities and consumer discretionary. Industrials, materials and energy lagged.
- We expect U.S. equities to generate a modestly positive return this year, with potential to surprise on the upside.
- Investors may consider high-quality equities with a moderately pro-growth stance, balanced with some defensiveness.

DRIVERS OF VOLATILITY RANGED FROM RISING RATES TO TRADE

Key catalysts of last year's market turbulence included rising U.S. interest rates, widening credit spreads, negative investor sentiment and a stronger U.S. dollar. European politics—particularly in the U.K., Italy and even Germany—were also a negative. But perhaps the greatest headline risk of 2018 was protectionism, primarily between the U.S. and China, the world's two largest economies. The tariffs they levied (and/or threatened to levy) on each other ballooned to cover billions of dollars' worth of trade.

While the actual economic damage from protectionism was muted, investors acknowledged that further escalation of the trade dispute would be problematic. Two additional risks that weighed on investor sentiment were a significant slowing of Chinese economic growth, together with the aging U.S. business cycle and its implications for corporate earnings and equity valuations.

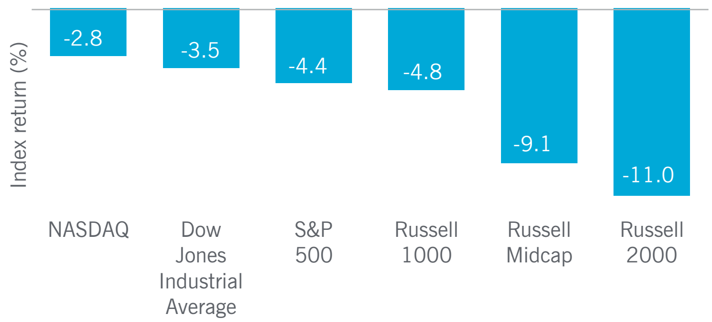
U.S.: The cycle is "old" but still breathing

We are mildly constructive on the outlook for the U.S. equity market in 2019. The main issue is whether the recent sharp selloff in equities is signaling an economic recession or is just an overdue (and painful) correction that will give way to another leg up. Our view is that the U.S. equity bull market is not yet done. We acknowledge that it has now reached a more mature phase, with several late-cycle dynamics appearing. But while the U.S. business cycle is at an advanced stage—one historically consistent with an economy that has no more than a year or two of expansion remaining—our assessment is that a recession is not imminent.

The most obvious indication that the expansion is mature? Extremely tight labor markets. More job openings exist in the U.S. than individuals looking for work, and the unemployment rate (3.9% as of December 2018) remains close to its lowest level in nearly 50 years. This labor-market strength has finally led to wage growth, which in turn has supported personal consumption. Another classic late-cycle signal is the flattened yield curve, portions of which actually inverted in late 2018. With economic growth peaking and oil prices falling far from their 2018 highs, we anticipate still-accommodative monetary policy from the Federal Reserve (Fed) in 2019. As a result, corporate earnings growth, while slowing significantly, should stay positive, thereby providing eventual support to equity prices.

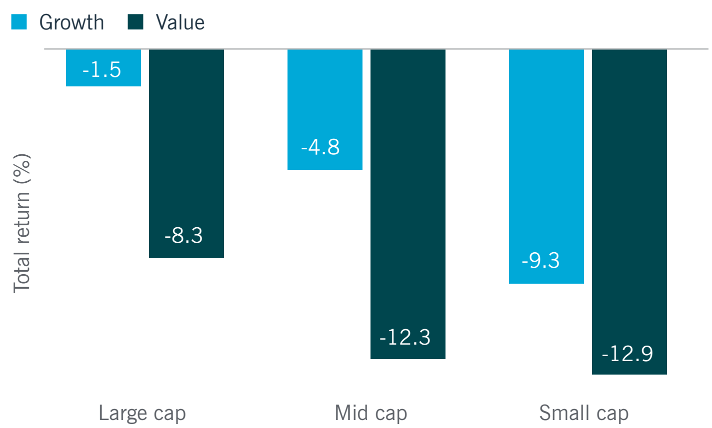
The U.S. dollar has strengthened mostly in response to risk aversion, evidenced by steep selloffs in global equities, high yield bonds and oil prices, along with a rally in Treasuries. At its December meeting, the Fed further reinforced its data-dependent stance and will not likely risk

U.S. indexes were broadly negative in 2018



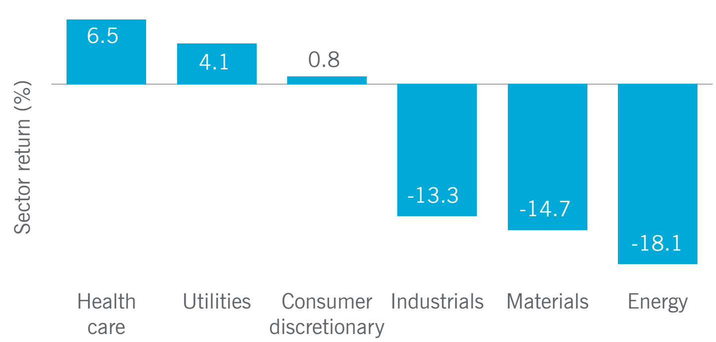
Data source: FactSet, 1 Jan 2018 to 31 Dec 2018. **Past performance is no guarantee of future results.** Indexes are unmanaged and unavailable for direct investment.

Growth fared better than value



Data source: FactSet, 1 Jan 2018 to 31 Dec 2018. **Past performance is no guarantee of future results.** Representative indexes: Large Cap: Russell 1000® Growth Index and Russell 1000® Value Index; Mid Cap: Russell Midcap Growth Index and Russell Midcap Value Index; Small Cap: Russell 2000® Growth Index and Russell 2000® Value Index. Indexes are unmanaged and unavailable for direct investment.

Health care performed best, energy the worst



Data source: FactSet, 1 Jan 2018 to 31 Dec 2018. **Past performance is no guarantee of future results.** Data based on GICS® sectors from the S&P 500® Index. Chart shows the three top- and bottom-performing sectors. Indexes are unmanaged and unavailable for direct investment.

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We maintain a selective, cautiously pro-growth bias in Europe ***over the next 6 to 12 months.***

jeopardizing the economic expansion by raising interest rates too much or too quickly. In our view, further rate hikes will occur eventually, but any action will likely be deferred until financial markets calm. Consequently, we look for U.S. dollar strength to moderate in 2019 as less aggressive monetary tightening by the Fed coincides with fading fiscal stimulus.

Given this backdrop, we expect U.S. equities to generate a modestly positive return this year, with potential to surprise on the upside. Investor sentiment has become extremely depressed, suggesting a significant amount of cash on the sidelines to fuel a rally. The equity market will likely stay volatile until we see some resolution to the U.S.-China trade dispute and improved confidence in the economic outlook. Our base case remains that the two countries will agree to a longer-term truce, although the path to such an outcome will be bumpy and involve periodic setbacks.

Europe: Growth story is damaged, not broken

The region’s political uncertainties once again made headlines through much of 2018, and we expect the drama to continue, particularly since the U.K. Parliament voted overwhelmingly on January 15 to reject Prime Minister Theresa May’s Brexit plan. The situation remains very fluid, with any number of possible outcomes—including a delay of the 29 Mar 2019 Brexit date and the offering of a second referendum to the British people.

The Italian government scored what appears to be a pyrrhic victory by delivering a fiscally accommodative budget to Brussels at the eleventh hour. But the damage to confidence has already been done, and a recession in Italy is likely underway. Whether the existing coalition survives 2019 is now a question. The anti establishment Five Star Movement and the Northern League party are once again surging in the polls and leadership.

For the eurozone overall, we expect economic activity will stay on a slower growth trajectory, although momentum should gradually strengthen. The drag from temporary factors (such as disrupted car production in Germany due to new global emissions standards) is fading, while the ongoing recovery in labor markets and tailwinds from a weaker euro are all potential positives.

We see other reasons for measured optimism in Europe. Despite occasional trade tensions, the U.S.-European armistice on tariffs should largely hold. Moreover, European fundamentals remain generally solid, with continued employment gains and some increases in wage growth leading to higher consumer confidence. At the corporate level, businesses are expanding and bank loan growth has picked up. Lastly, the European Central Bank ended its quantitative easing (QE) program in December 2018.

On balance, though, Europe remains vulnerable. Neither domestic nor global growth may be strong enough to drive the region’s equity markets higher, and the long-term resilience of its banking system is still in question. Against this backdrop, we are maintaining a selective, cautiously pro-growth bias over the next 6-12 months.

China: Deal or no deal?

China has returned to the center of global investor attention. Its economy has downshifted materially since mid-2018, with industrial production missing expectations, both export and import growth slowing substantially, and retail sales decelerating to their weakest pace in 15 years. In addition, China’s stock markets and currency were down sharply for the year.

Until a more definitive truce emerges in the trade war with the U.S., the principal risks are declining activity among private-sector manufacturers and the subsequent impact on private consumption. Slower global growth and an eventual payback from recent export “frontloading" ahead of potential tariff escalation in 2019, together with tighter financial conditions, mean the Chinese economy and equity markets likely face stiff headwinds.

Nonetheless, we believe worries about an economic "hard landing" are overdone. The past year's slowdown in China was driven primarily by a pullback in infrastructure spending, which now shows signs of recovery after robust local government investment. This recovery should help offset softer housing construction levels in the months ahead. And China's financial system remains stable, with supportive monetary policy.

Overall, we are still constructive on China. The primary catalyst for a stock market recovery would be a resolution to the trade dispute with the U.S. In the meantime, Chinese companies have been refocusing supply chains to other countries, such as Vietnam. From an investment perspective, we continue to emphasize domestically focused companies in the technology and health care sectors, where we see an attractive combination of growth and inexpensive valuations.

Japan: Lots of questions

Japanese equities remain sensitive to the ebbs and flows of foreign buying and selling. And foreign investors have been major sellers of late, despite respectable, albeit slowing, earnings growth and improving domestic fundamentals.

In addition, as long as fears of a synchronized global slowdown and anxiety over China's increasingly visible soft patch persist, cyclical concerns will predominate in Japan, providing a continued headwind for its equity market. Investors will also start to focus on the increase in the sales tax from 8% to 10%, scheduled to be implemented in October 2019. This increase, originally set to take effect in October 2015 but delayed twice, could be postponed again by Prime Minister Shinzo Abe if investor sentiment turns too negative.

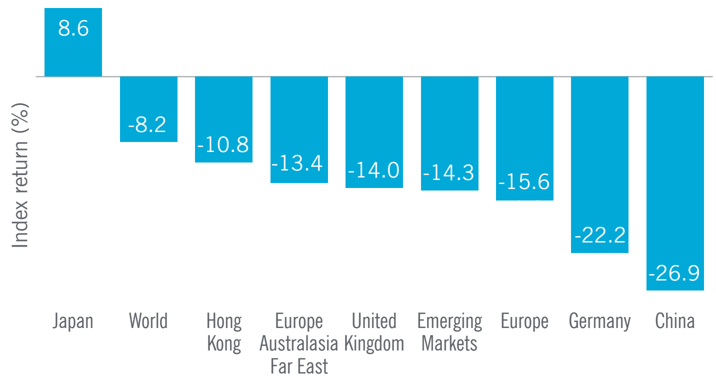
Given this environment, the Bank of Japan (BoJ) will feel no obligation to end quantitative easing. Despite the flattening of global yield curves, the 10-year Japanese government bond yield is still artificially held down by the BoJ through its so-called yield curve control policy. The main positive for Japan's domestic economy is the tightening labor market, with wage growth rising in June to its fastest pace since 1974. In another sign of a strengthening economy, the Tokyo office vacancy rate dropped to a 27-year low of 1.98% in November.

The key lingering problem is that inflation remains well below the BoJ's 2% target. If deflationary sentiment continues in 2019, it will be a negative for Japanese equities. Additionally, the credibility of Japan's stock market in the eyes of global investors may be reduced as the BoJ continues its equity buying program.

Asia: Down but not out

Southeast Asia has absorbed many of the punches thrown in the U.S.-China trade battle, while also contending with a firmer U.S. dollar and the Fed's interest rate hikes. Given these conditions, labor market slack and excess capacity in the heavy industrial sectors will likely remain headwinds in 2019. Adding to the uncertainty is politics, as several elections are scheduled for early this year. The most significant is likely to be in Thailand, which in February will hold its first national vote since the military coup in 2014.

Japan showed positive returns in 2018



Data source: Morningstar Direct, Bloomberg, L.P., 1 Jan 2018 to 31 Dec 2018. **Past performance is no guarantee of future results. Representative indexes: China:** Shanghai Stock Exchange Composite; **Emerging Markets:** MSCI Emerging Markets Index; **Europe/Australasia/Far East:** MSCI EAFE Index; **Europe:** Euro Stoxx 50 Index; **Germany:** DAX Index; **Hong Kong:** Hong Kong Hang Seng Index; **Japan:** Nikkei 225 Index; **United Kingdom:** FTSE 100 Index; **World:** MSCI World ex U.S. Index. Indexes are unmanaged and unavailable for direct investment.

Elsewhere, after a year in the foreign policy limelight, South Korea faces several challenges on the economic front in 2019. Export growth may be hampered by a slowing global economy and a weakening information technology cycle. Domestically, given the recent reshuffling of the government's economic team, we expect fiscal policy to ease and labor market regulations to be softened somewhat. These moves would help alleviate recent labor market weakness, which markets would likely view positively.

For Asia as a whole, we see four potential factors that could boost sentiment in the region despite the uncertainties:

- Signs that the Fed will pause its interest rate increases
- Improvement in U.S.-China trade relations
- China's economic growth outperforming expectations
- Emerging market (EM) growth exceeding that of developed markets

Many Asian countries have seen recent improvement in their financial health. The downdraft in the region's markets came early in 2018, and greater stability has returned. Equities look inexpensive, with catalysts to drive growth expansion.

Emerging markets: Modest recovery means be selective

In 2018, the selloff in EM assets began with the equity market correction in early February and accelerated in mid-April as the U.S. dollar strengthened, leading to currency crises in Turkey and Argentina. As global growth showed signs of weakening, investor sentiment soured on international equity markets more broadly, but in aggregate EM returns lagged those of developed foreign markets.

In 2019, we expect some improvement in EM economic growth following sharp deterioration in 2018. Many EM countries are still early in their economic cycles and potentially can outgrow their developed market counterparts. EM equity valuations have clearly reverted from the "expensive" territory they inhabited at the start of 2018 and are now are at their lowest levels since 2014. While we don't view valuations as the catalyst for EM equities to outperform, we do think lower valuations are an important contributor to attractive risk/reward potential because of their possible upside.

Within emerging markets, selectivity is crucial. We currently see opportunities in Asia, where markets have sold off more than in other EM regions due to the U.S.-China trade conflict. We're also optimistic that the Chinese government is willing and able to ease policy to prevent a hard landing, while becoming increasingly likely to resort to more traditional investment-based stimulus, if necessary. India has been buffeted by swings in oil prices and stresses in the financial sector but continues to post healthy growth. In fact, growth is accelerating thanks to an economy that is more domestically focused and thus less exposed to global trade concerns. Looking ahead, the country faces a pivotal national election in the April to May timeframe, with the ruling Bharatiya Janata Party (BJP) under pressure after a string of weak state election results.

In Latin America, Brazil and Mexico also offer opportunities. Positives for Brazil include a more market-friendly government, low inflation and interest rates, and a recovering job market that should continue to support consumer spending. In addition, greater clarity of economic policy may boost consumer confidence. As for Mexico, we think economic policy uncertainty has already been priced into equities. However, positive developments—including stronger economic growth, healthier consumer spending (due to a low unemployment rate), wage gains and relatively low inflation—may not be.

Overall, we expect modestly positive equity returns across the major EM countries in 2019, with stock selection being essential.

OUTLOOK

To navigate these markets, be active

The first several months of the new year are likely to be bumpy. As global central banks take away the “punchbowl” of quantitative easing, we think markets will be more volatile and returns lower, even as the global economy continues to grow. Such an environment will require investors to be more selective, with a greater focus on capital preservation. Simply “buying the market” won’t work.

Because cyclical stocks have been oversold relative to defensive shares, investors may be well-served by favoring high-quality equities with a moderately pro-growth stance, balanced with some defensiveness. Thus, overweighting the communication services, financials, health care and information technology sectors could be an appropriate strategy. Underweighting industrials may also be prudent, as earnings growth will likely disappoint amid slowing factory orders and decreased demand for commodities. In addition, defensive “interest rate-sensitive” sectors such as utilities and real estate look overbought and therefore expensive. Globally, any alleviation of the various political, trade or policy risks discussed previously could potentially favor equity markets outside the U.S., given their scope of underperformance in 2018 and recovery potential in 2019.

For more information, please contact your financial professional or visit our website.
U.S. investors: nuveen.com ***Non-U.S. investors: nuveen.com/global***

Endnotes

Sources

Index Performance: FactSet

European Corporate Earnings: I/B/E/S

U.S. Corporate Earnings: Standard & Poor's

Employment: RBC Global Asset Management

Russell Indices: FactSet, Russell Investments

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Glossary

Euro Stoxx 50 is an index of 50 of the largest and most liquid stocks of companies in the eurozone. **FTSE 100 Index** is a capitalization-weighted index of the 100 most highly capitalized companies traded on the London Stock Exchange. **Deutsche Borse AG German Stock Index (DAX Index)** is a total return index of 30 selected German blue chip stocks traded on the Frankfurt Stock Exchange. **Nikkei 225 Index** is a price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange. **Hong Kong Hang Seng Index** is a free-float capitalization-weighted index of selection of companies from the Stock Exchange of Hong Kong. **Shanghai Stock Exchange Composite** is a capitalization-weighted index that tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. **MSCI ACWI-All Country World (ex U.S.) Index** is a market capitalization weighted index designed to provide a broad measure of global equity market performance excluding the U.S. **MSCI EAFE Index** is a free float-adjusted market capitalization weighted index designed to measure developed market equity performance, excluding the U.S. and Canada. **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. **Russell 1000® Index** is an index of approximately 1,000 of the largest companies in the U.S. equity markets. **Russell 1000® Growth Index** measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher expected growth values. **Russell 1000® Value Index** measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. **Russell 2000® Index** measures the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. **Russell 2000® Growth Index** measures the performance of the large-cap growth segment of the Russell 2000 Index. **Russell 2000® Value Index** measures the performance of the large-cap value segment of the Russell 2000 Index. **Russell Midcap Index** is a market capitalization weighted index comprised of 800 publicly traded U.S. companies with market caps of between $2 and $10 billion. **Russell Midcap Growth Index** measures the performance of the large-cap growth segment of the Russell Midcap Index. **Russell Midcap Value Index** measures the performance of the large-cap value segment of the Russell Midcap Index. **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq. **Nasdaq Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. **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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