

Mid-Year Outlook: Waiting to Move Beyond a Muddle-Through Economy



WEEKLY INVESTMENT COMMENTARY

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The Ride Continues but Markets Show Positive Signs

By focusing on current economic conditions — while giving due importance to the uncertainty created by Fed actions — we offer thoughts for consideration in evaluating “risk-on” investments:

- A decrease in Fed quantitative easing is not an economic hurdle
- We do not anticipate that Fed movements will undermine the economic recovery, since the Fed has stated interest rates will trail economic and earnings growth
- The near-term upside risk for U.S. Treasury yields appears limited
- There is support for corporate earnings and share prices since the cost of capital will remain below the return on capital
- We expect a gradual shift toward cyclical stocks and those levered to healthier and faster growing parts of the world

During the second quarter, bond yields rose sharply and global risk assets (equities, spread products and growth-sensitive currencies) corrected materially before recovering more recently. Fed policy is a major issue with broad global ramifications, and there is significant anxiety about Fed tapering and its eventual exit strategy. The sell-off in U.S. stocks in June was unlike any recent correction. It was not triggered by weaker economic growth or fears of a euro area breakup (as with previous episodes) but rather because 10-year U.S. Treasury yields have surged by approximately 100 basis points from May lows.¹ In other words, instead of being a shock absorber, the Treasury market was the culprit behind recent market volatility.

The perception that the Fed would begin normalizing monetary policy earlier than expected underpinned the sell-off in fixed income. At the FOMC meeting in June, Fed Chairman Ben Bernanke stressed that the economic outlook had improved, stating the increase in yields was justified by stronger growth. However, there is not much evidence U.S. growth has shifted materially higher. Although we expect growth to improve somewhat by early 2014, we continue to believe it will likely remain at 2% to 2.5% for the balance of the year due to the continued effect from the sequester, slower overseas growth and the adverse impact of rising mortgage rates on the housing market. Meanwhile, Personal Consumption Expenditures (PCE) inflation was 1.0% in May and market-based inflation expectations have declined.²



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

2013 Performance Year to Date

	Returns	
	Weekly	YTD
S&P 500	3.01%	19.16%
MSCI World Ex U.S.	3.93%	7.95%
MSCI Emerging Markets	3.08%	-8.76%

Source: Morningstar Direct, as of 7/12/13. All index returns are shown in U.S. dollars. Past performance is no guarantee of future results. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account. All indices are unmanaged and unavailable for direct investment.

One possible reason the Fed may be changing course is because of an increasing concern that a prolonged period of ultra-low rates will encourage the buildup of leverage in the financial system. Although there is probably some truth to this argument, it cannot be the whole explanation. The point of quantitative easing is to encourage investors to shift out of safe Treasuries and into more risky assets such as bank loans, corporate debt and equities. A more mundane explanation is that the Fed miscalculated the impact that its actions would have on Treasury yields.

Thus, the stakes remain high and many investors now fear a repeat of 1994, when the Fed exited too rapidly and caused Treasury yields to rise abruptly from overvalued levels and undermine the economic recovery. We believe these concerns are overblown. The Fed stated that its current exit strategy is contingent on stronger data, and policymakers want interest rates to trail well behind economic/earnings growth. Moreover, the central bank is aware that there is an asymmetric risk between deflation and inflation, and historically subdued price pressures provide policymakers with ample flexibility to move slowly.

Tactically, we believe the near-term upside risk for U.S. Treasury yields is limited. If economic data remain consistent with a sluggish economy, as we expect, yields will likely fall somewhat. However, the powerful bull-run in government bonds has ended, with yields backing up abruptly from

extremely overvalued levels. The sell-off in government bonds is extended and will probably transition into a trend marked by a gradual and persistent backup in yields. The global economy is strengthening slowly and will likely remain disinflationary. Finally, despite anxiety regarding tapering of U.S. quantitative easing, the Fed is not planning to tighten and is still determined to lag the improvement in growth.

Stocks corrected from overbought levels on the back of the backup in bond yields. However, the cost of capital will remain below the return on capital, supporting earnings and share prices. On June 3, we argued for sideways/corrective action in equities due to: an overbought technical condition, creeping complacency, uncertainty regarding Fed policy, China economic slowdown and the steep decline in the Japanese equity market. From the peak of the S&P 500 at 1687 on May 22 to the trough of 1560 on June 24, the market declined by 7.5 %.³

We do not expect additional downside moving into the third quarter. Beyond the short term, we find equities attractive in absolute terms and relative to competing assets. This should provide underlying support as investors gradually migrate away from traditional safe havens and toward risk assets. As current selling pressure subsides, we expect a gradual shift towards cyclical stocks and those levered to healthier and faster growing parts of the world. ■

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¹ Source: Bloomberg, as of 7/12/13. ² Source: Bureau of Economic Analysis, 6/27/13. ³ Source: Bloomberg, as of 6/30/13.

The **S&P 500 Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy. The **MSCI World Index ex-U.S.** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets minus the United States. The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

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