We Expect Modest Economic and Earnings Improvements

NUVEEN ASSET MANAGEMENT

WEEKLY INVESTMENT COMMENTARY

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Brexit Worries Will Remain in Focus

A couple of weeks after the U.K.'s Brexit vote, financial markets have calmed but investors are still faced with a great deal of uncertainty. The good news is that the economies in the U.S. and much of Europe were mildly accelerating before the referendum. We expect the U.S. will continue on a slow-growth path. Consumer spending in the U.S. should benefit from still-strong employment, rising wages, a firming housing market and pent-up demand in the form of savings.

European equities, not surprisingly, are likely to be the most adversely affected by Brexit, but growth-oriented markets such as emerging markets and Japan will also suffer comparatively, as global growth expectations weaken and deflation fears continue to increase.

The political implications of Brexit are arguably more important than the economic effects. Brexit raises questions about the EU model of economic unity. The political influence of populist leaders has been rising throughout the world in recent years, and we believe the possibility of a broader move toward nationalist, isolationist and protectionist policies would be a negative for global economic growth and risk assets, including equities. This trend bears watching.

Economic Growth Signals Are Mixed

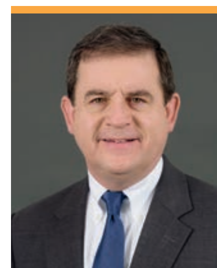
U.S. Treasury yields plummeted following the Brexit vote and have since moved into new record low territory. Normally, low yields are a sign that the economy is weakening (if not heading into recession) and/or that the country is facing deflation concerns. But the underlying economic fundamentals do not appear to match what yield levels are telling us.

The Federal Reserve Bank of Atlanta is estimating second quarter real gross domestic product growth will be 2.4% and the Federal Reserve Bank of New York's Recession Model is forecasting only an 8% chance of a U.S. recession over the next year. These forecasts appear wildly inconsistent with a 10-year Treasury yielding less than 1.4%. So which signal is correct? In our view, low Treasury yields should not be mistaken for a signal that the U.S. economy is in serious trouble.

At present, global forces are the main driver of U.S. rates, and risks are rising for a clash between international forces pushing yields lower and domestic signs of inflation pushing yields higher. Core inflation rose to an annual rate of 2.2% in May, the seventh consecutive month at a level of 2% or more.[1]

KEY POINTS

- The Brexit vote will have some negative long-term economic and market effects, but the U.S. economy should remain relatively solid.
- Corporate earnings are the key for equities, and we expect modest improvements over the second half of 2016.
- Returns are likely to stay low, but equities should outperform bonds.



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The U.S. economy is likely to be held back by weaker overseas growth (primarily through declining trade), but the U.S. economy should remain relatively solid. We expect GDP growth to average around 2% in the second half of the year, which would be consistent with the slow pace since the end of the Great Recession.

Returns May Be Low, but Equities Should Outperform

So where does all of this leave investors? The outlook for capital market returns over the next decade is largely a function of the starting point. Following a 30+ year decline in global bond yields, virtually all assets are expensive today by historical standards. For long-term investors, the implication is that prospective real and nominal returns will be low by historical standards, and the trade-off between risk and reward will be comparatively disappointing.

U.S. equity prices have recently advanced and are now approaching all-time highs. For stocks to make significant gains from here, we think it would require improving profit trends rather than multiple expansion. We continue to hope for profit improvements in the second half of 2016, but worry that the U.S. will disappoint as the corporate sector retrenches in response to the earnings contraction. Nevertheless, we think corporate profits can improve modestly as long as the U.S. avoids recession.

More to the point, equity markets appear more attractive than other asset classes. The current dividend yield of the S&P 500 Index is 2.2% (compared to less than 1.4% for the 10-year Treasury).[2] Furthermore, nearly two-thirds of S&P 500 companies yield more than the 10-year Treasury, while close to half yield more than the 30-year Treasury.[2] These are relatively bullish signals for equities. In other words, equities gains may be rocky, but the stock market is likely to lead this slow-moving parade. ■

2016 Performance Year to Date

	Returns	
	Weekly	YTD
S&P 500 Index	1.3%	5.5%
Dow Jones Industrial Average	1.2%	5.7%
NASDAQ Composite	2.0%	-0.3%
FTSE 100 (U.K.)	-2.2%	-4.9%
DAX Index (Germany)	-2.2%	-9.2%
Nikkei 225 (Japan)	-1.8%	-3.9%
Hang Seng (Hong Kong)	-1.1%	-3.6%
Shanghai Stock Exchange Composite (China)	2.1%	-16.8%
MSCI EAFE (non-U.S. developed markets)	-1.7%	-5.0%
MSCI Emerging Markets	1.2%	6.0%
Barclays U.S. Aggregate Bond (bonds)	0.6%	6.2%
BofA Merrill Lynch 3-Month Treasury Bill (cash)	0.0%	0.2%

Source: Morningstar Direct and Bloomberg, as of 7/8/16. 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.

"Equities currently yield significantly more than bonds, which is relatively bullish for stocks."

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1 Source: Labor Department **2** Source: FactSet

The **S&P 500 Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy. The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq. The **Nasdaq Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. **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 EAFE Index** is a free float-adjusted market capitalization weighted index designed to measure developed market equity performance, excluding the U.S. and Canada. The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. B**arclays U.S. Aggregate Bond Index** covers the U.S. investment grade fixed rate bond market. The **BofA Merrill Lynch 3-Month U.S. Treasury Bill Index** is an unmanaged market index of U.S. Treasury securities maturing in 90 days that assumes reinvestment of all income.

RISKS AND OTHER IMPORTANT CONSIDERATIONS

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