Market insights

February 2018

Market Volatility: Insights for Investors

In light of recent market events, we've brought together insights from four Wells Fargo Asset Management thought leaders, representing the equity, fixed-income, and multi-asset spaces.

Eye on equities

Jeff Moser, CFA, Portfolio Manager
John Campbell, CFA, Portfolio Manager
Wells Fargo Asset Management

Last week's selloff and the follow-through selling have been overdue. The S&P 500 Index has been trading at all-time highs without as much as a 3% drawdown in 202 days. We believe the selling is in response to rising bond yields. Yields have risen in expectation of a faster pace of rate increases by the Federal Reserve to head-off potentially higher core inflation. This expectation is based on good economic growth and a strong labor market, including wage increases.

It is important to note the selling is not fundamentally driven, as we are currently in the middle of a very strong fourth quarter earnings reporting season. So far, with 50% of the S&P 500 Index's constituents reporting, 75% of companies have reported positive earnings-per-share (EPS) surprises, and 80% have reported positive sales surprises.

Investors should beware of sensational headlines noting the "largest point drop in history."

- A 1,000-point drop today, when the Dow is near 25,000, equates to a percentage decline of 4%.
- A 1,000-point drop 20 years ago, when the Dow was near 8,000, would have been a single day decline of 12.5%.

The multi-asset perspective

Dr. Brian Jacobsen, CFA, CFP, Senior Investment Strategist, Multi-Asset Solutions
Wells Fargo Asset Management

This feels more like a technical correction than anything fundamentally driven. What to do depends on how you were allocated before the sell-off began. We are staying the course with most of our allocations, as we're in it for the long haul and believe that we should stay the course until there are signs the fundamentals are deteriorating. For some of our strategies, we're viewing this as an opportunity to increase our exposure to risk, be it credit or equity risk.

We believe the market was reacting to three big forces: inflation, the Fed, and earnings. The employment report showed slightly faster wage growth. That could not only crimp profit margins, but it could push the Fed to hike faster. We think the spike higher in wage growth was actually temporary, so we'll likely see a moderation in wage inflation, rather than an acceleration. That could calm investors over whether inflation is picking up.

Related to this force was the second force: the Fed. If the Fed sees strong growth and faster wage inflation, then they may signal they want to hike four times instead of three times in 2018. That's not a big shift—and who knows if they'll actually hike that many times, as a lot can happen between now and even their next meeting—but a slightly less accommodative Fed likely isn't a great thing for equity markets.

The third force—which we take the most comfort in—is the fundamentals. Some big name companies simply disappointed investors with their earnings. Their stock prices were punished and that shows up in the indexes. Analysts have gotten so excited about good earnings for 2018, that it seemed to us the risk was to the downside, rather than to the upside, for earnings season.

Where we view more opportunity is in answering whether we will see a continuation of earnings growth. While analysts have been quick to ratchet up their 2018 EPS targets, they've actually lowered their expectations for long-term growth. We felt that because of this, 2018 would be more like a year walking in the wilderness for the markets and we may have to wait until 2019 for investors to be surprised to the upside with continued strong fundamentals.

Viewpoints on fixed income

Lyle Fitterer, CFA, Co-Head of WFAM Global Fixed Income; Managing Director, Head of Municipal Fixed Income
Wells Fargo Asset Management

Within fixed income, investors have been seeking more compelling yields. Yields are higher and the yield curve is steeper because of early signs of inflation. With new economic data that supports a higher level of inflation than previous lackluster estimates did, 10-year Treasury bond yields have risen to levels not seen since 2014. The front end of the curve, meanwhile, has risen as the Federal Reserve (Fed) has hiked its policy rate.

Volatility (changes in yields) requires investors to understand the nature of their goals for their fixed income assets and have a full understanding of their investments and risks. Investors with a sound strategy within fixed income and the discipline to buy more or simply hold through fixed income volatility have generally fared best. Too often such an increase in yields is followed by selling of fixed income.

We have positioned many portfolios with a modestly defensive duration posture, in hopes of capitalizing on increased volatility in 2018.

Mutual fund investing involves risks, including the possible loss of principal, and may not be appropriate for all investors. Consult a fund's prospectus for additional information on these and other risks.

Carefully consider a fund's investment objectives, risks, charges, and expenses before investing. For a current prospectus and, if available, a summary prospectus, containing this and other information, visit wellsfargofunds.com. Read it carefully before investing.

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