

Market comment for the week of June 22, 2018

Hello Mr. Hyde

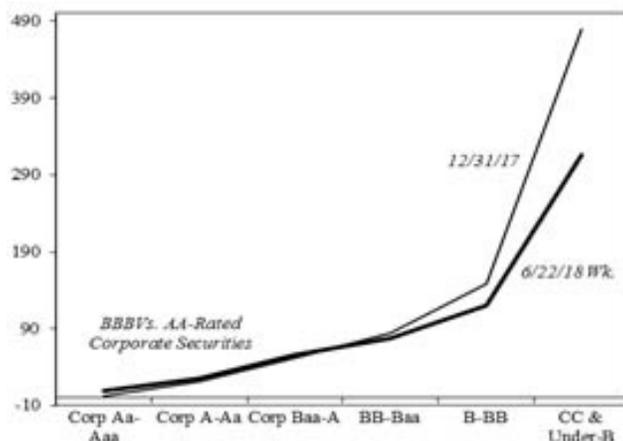
Gary Schlossberg

Whistling softly past the graveyard. A Dr. Jekyll year of tax cuts and lighter regulatory touch in 2017 has given way this year to a worrisome Mr. Hyde combination of economically debilitating trade protectionism and restrictive immigration policy. The market's slow-motion acceptance of a looming trade war was apparent on the week in a stepwise descent that left the S&P 500 at a 2½-week low, despite Friday's oil-led rebound on an unexpectedly modest output accord by major producers and first signs of a European growth recovery from its recent soft patch. The S&P 500's first weekly decline in four still left it within striking-distance 4.1% of its late-January peak in the kind of narrow, shallow sell-off across 7 of 11 sectors and just 84 of 125 industry groups typically lacking conviction. The positive spin to what, thus far, has been a grudging decline in U.S. stocks and other risk assets is strong economic growth underpinning a consensus S&P 500 earnings-growth forecast above 20% in the second half. The negative spin to the market's resilience is an overly optimistic outlook for proliferating and deepening trade disputes on the assumption that tit-for-tat restrictions are just a bargaining ploy.

The stock market's interest-sensitive sectors were given a new lease on life by a flight-related decline in bond yields reacting to global uncertainties, extending to a decline in the benchmark 10-year Treasury note to less than 2.9% for the first time in two months. Yield-sensitive utilities were among the chief beneficiaries of the bond rally, supported, as well, by their low international exposure. The lower 10-year rate combined with a firmer 2-year yield to leave the gap at a new decade low in a further flattening of the yield curve (or path traced by interest rates at various maturities), hitting financial services particularly hard through a prospective squeeze on net interest margins (a proxy for bank profitability).

The "credit-quality" curve shadows a "flattening" Treasury yield curve

Yield differences in basis points



Source: ICE BofAML.

Shadowing the Treasury yield curve has been a further flattening of the credit-quality curve, elevated at the investment-grade front end since the start of the year by increased supply, and compressed at the back, non-investment grade end by more subdued issuance and by close ties to resilient stocks. Lower rates also knocked the dollar off a near 12-month high at mid-week, not enough, however, to prevent broad commodity price declines across grains, precious and industrial metals. Even with a bumpy ride in the past month, however, a year-to-date return of more than 6.5% on the S&P Goldman Sachs commodity index exceeded the S&P 500's gain by over 2½ percentage points.

The fault line of worsening trade relations runs through the entire stock market, as trade-policy concerns compound worries over slowing global growth and dollar strength. Frontline industrials and materials producers, most exposed to trade restrictions, unsurprisingly were driven to the bottom of the S&P 500 performance rankings by the latest trade-policy news. The Russell Top 50 index, loaded with large U.S. multinationals, was down to a December 2016 low against an unweighted S&P 500 index implicitly giving greater weight to smaller, less globally exposed companies in the benchmark. More to the point has been the increasingly noticeable under-performance in recent weeks by stocks of internationally exposed companies against those of their more domestic oriented counterparts, leaving their relative value at its cheapest since March 2017 according to Goldman Sachs style-group indexes. Overseas, greater exposure to trade protectionism and geo-political uncertainties left developed-country and emerging-market stocks with a weekly decline more than double and nearly triple that of the S&P 500, respectively.

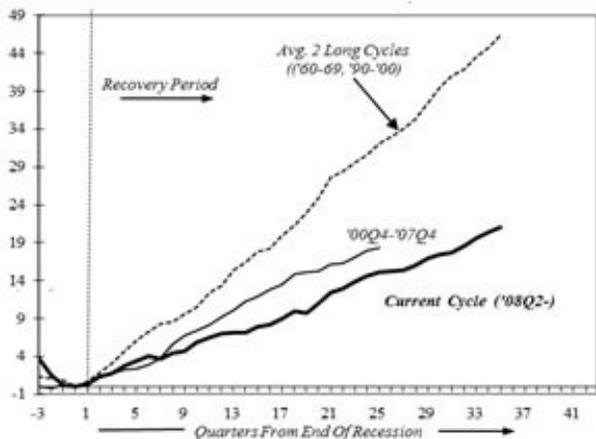
Magnifying the potential market impact of a trade war is the backdrop of a sea change in central-bank policies exposing investors to an unwinding of financial distortions from decade-long, aggressive stimulus, compounded by multiple risks attached to threatened trade restrictions. Still unclear to investors is the full extent both of tariff and of non-tariff trade barriers, their composition and effect on complicated supply chains, the impact on world trade growth, and its historic role as a locomotive for economic expansions. Also at risk is the future of the World Trade Organization (WTO) and other institutions charged with maintaining open markets for global goods and services. The dollar is among the more visible means by which world trade uncertainties can morph into more systemic economic and financial threats, with increases broadly deflationary through their effect on commodity prices, the burden of dollar debt repayments by overseas borrowers, and on local financial liquidity in emerging and other markets. An even more far-reaching longer-term threat is to the dollar's single-handed role as the key currency in international trade and finance from our unilateral trade restrictions and economic sanctions.

House bound. Mixed economic releases on the week may have left investors not engrossed in the latest trade developments wondering if an expected second-half shift to more sustainable growth already was under way. Soft spots in housing-dominated data most of the period raised questions about this early cycle, interest-sensitive sector's support for second half growth. May's cycle-high rate of housing starts plus increases in mid-June mortgage applications strong enough to reverse four-week moving average declines much of the spring were countered by hints of lost momentum in coming months, including a decline in May housing permits (often foreshadowing starts), slippage in the early-June home builders survey, an unexpected decline in May home re-sales, and a modest rise in April home prices leaving the 12-month increase at its smallest since last July.

Manufacturing also came up short, with steeper-than-expected declines in the Philadelphia Fed's regional index and in a preliminary U.S. purchasing managers' survey for early June. Rounding out the week's eyebrow lifters was an unexpectedly modest increase in the May index of leading indicators. The good news on the week came from the more mundane, weekly data, raising hopes for a limited slowing of second-half growth from a seemingly unsustainable, 3½-4½% rate in the spring quarter. Joining mortgage applications with increases in the latest period strong enough to lift rolling four-week averages were a Bloomberg consumer confidence index, an index of leading indicators and a company sales survey by Evercore ISI. Equally encouraging was an unexpected decline in mid-June jobless claims from an already historically low reading, signaling ongoing tightness in the labor market.

Slow, but steady wins the race?

Cumulative real GDP growth, from recovery start, in percent



Source: U.S. Commerce Department.

Upcoming data will be scrutinized closely in coming months for signs of slower, sustainable growth. A sustained slowdown would expose the economy to policy and political surprises, muted this year by optimism over the earnings and economic outlook tied, in part, to growth's fifth mini-burst in this decade-long expansion. Gauging this unusually long cycle's staying power is complicated by dwindling excess capacity and by gathering financial strains matched against unusually modest growth averaging nearly 1.5 percentage points less than the average for two long growth cycles, allowing the economy to navigate bottlenecks common in an aging expansion. The good news is that lower fuel costs are boosting household purchasing power. Less encouraging is the threat of a Brexit-like hit to business confidence and investment from unsettling policy surprises and administration statements challenging long-held world views.

This week's data calendar fills out by volume and breadth of coverage, extending beyond housing and manufacturing to the all-important consumer sector plus a top-down, final look at first-quarter GDP and the Chicago Fed's broad National Activity Index for May. Also on tap will be a \$100 billion, three-part sale Tuesday through Thursday of 2-, 5- and 7-year conventional Treasury notes plus a \$16 billion mid-week offering of 2-year floating-rate Treasury notes. Upcoming data with the greatest market-moving potential include Tuesday's June report on consumer confidence, May's advance foreign trade and durable-goods orders, Wednesday, and Friday's reports on May personal income and consumer spending, plus June's Chicago purchasing-managers' index. Investors also may be casting a wary eye on a late-week summit of European leaders to discuss hot-button migration, economic and financial issues having market-moving potential heading into next weekend.

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