

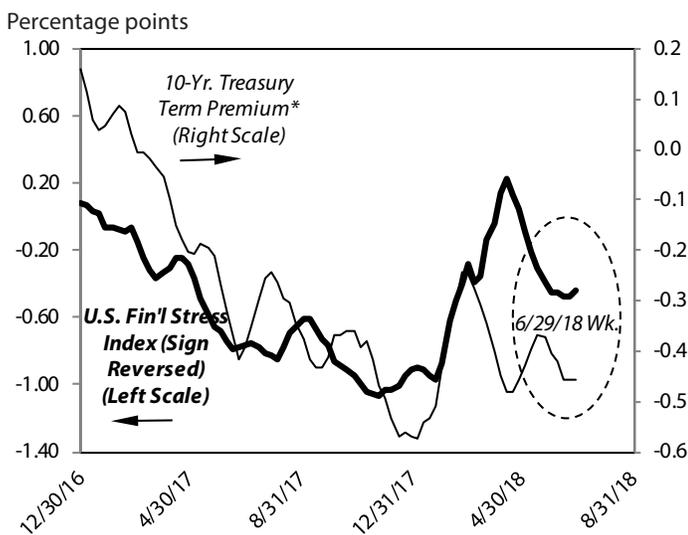
Market comment for the week of June 29, 2018

Halftime transitions

Gary Schlossberg

Better than it felt. Stocks overcame policy and geo-political anxieties, keying, instead on still solid economic and earnings fundamentals in chalking up a respectable, front-loaded return of 3.4% on the quarter. Punctuating the second quarter's narrow rally was the near-45% share of the second quarter's rise by the benchmark's top five performers—all so-called FANG tech / Amazon.com companies—compared to about a 25% share of the gain in last year's fourth quarter and for the entire year. The spring period went out like a lamb, suffering back-to-back weekly declines on trade protectionism and its fallout that left June's total return at just 0.6%. Oil prices, trade policy, and the Fed all had a hand in shaping performance during the period, propelling energy stocks to the top spot during the opening months on rising oil prices, whipsawing interest-sensitive sectors on rising, then falling rates and weighing on trade-sensitive industrials and, ultimately, tech with a trade-policy soap opera. Tech's growing share of the cap-weighted S&P 500 is changing the face of an increasingly NASDAQ-like benchmark, in the process adding to its sensitivity to protectionism both through tech's high dependence on foreign-based revenue and through gathering restrictions on China's access to cutting-edge technology.

Still ample market "liquidity" despite a slightly elevated financial stress index



*The extra yield required by investors to hold a 10-yr. note vs. a series of s.t. securities.
Source: Bloomberg Financial News, Inc.

Clear from the stock market's resilience throughout the period was its continued support from an upbeat earnings outlook—featuring projected growth exceeding 20% during the balance of the year on recent corporate tax cuts and on solid economic growth, plus still-ample liquidity apparent from historically low (i.e., still-negative) financial

stress indexes and the negative term premium on bond yields (i.e., discounting expected shorter-term rates due, in part, to still-subdued inflation expectations). However, flight capital in recent weeks has been powerful enough to overcome those twin supports in sending risk assets to a mid-April low against safe-haven investments during the latter part of June.

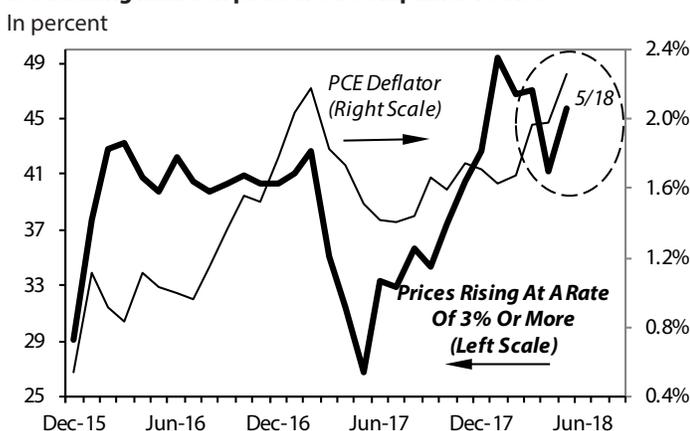
A supportive financial backdrop for risk nonetheless has been reinforced by a reversal of cyclical interest-rate increases, driven most visibly by safe-haven demand. The benchmark ten-year Treasury rate touched a low for the month of less than 2.83% last Wednesday, leaving the gap between two- and ten-year yields at a new decade low in an unusual, late-cycle bull-market flattening of the Treasury yield curve. However, more fundamental support has come from subdued investor inflation expectations, despite increased price pressures, and from a decline in the real (inflation-adjusted) yield often tied to the economy's strength or weakness. Those looking for emerging signs of financial stress could find it in widening quality spreads this past week between high-yield and non-investment grade securities, reversing a trend of recent months. More generally, ample liquidity's double-edge sword is its support to financial-market distortions and leveraging for takeover activity, stock buy backs, and other financial engineering underpinning risk-asset values.

Unwinding financial distortions are among several market threats monitored by investors, overshadowed, at the moment, by protectionism's more visible challenge to growth and to financial stability. Trade restrictions risk cost-push inflation from supply-line disruptions plus slower economic growth directly and indirectly, as business confidence and investment is undercut and less efficient supply lines are established. This mix of uncertainties, cutting across so-called economic sectors making up most benchmark indexes, is creating difficult choices for investors, between, for example, defensive (i.e., economically insensitive) but typically yield-oriented stocks and between trade-sensitive large caps, and economically sensitive smaller cap stocks. Dilemmas could be resolved by favoring style-group indexes more precisely targeting strengths and weaknesses cutting across economic sectors. Elevated oil prices are another threat, perversely responding to announced production increases last month by rising to a December 2014 high on worries over dwindling spare capacity pressured by unexpected output declines in Iran, Libya, and Venezuela. And then there's the dollar's rise—up 7.5% from its mid-February low on safe-haven demand and an attractive yield premium from a more advanced interest-rate up cycle—creating a head wind for non-oil commodity prices by raising the local-currency cost of these dollar-priced goods. It also has strained emerging-market and other country finances by raising the local-currency cost of dollar-debt repayments and by draining funds from local markets enough to force central-bank rate increases in weaker markets.

China's yuan is at the nexus of dollar-related and protectionist pressures. The currency's steady decline since mid-April, to a November 2017 late last week, has been propelled by a credit-induced growth slowdown aggravated by economic fallout from mounting trade tensions with the U.S. and by more recent credit easing to shore up a sagging economy. Heightening the currency slide's visibility has been China's economic size and its importance as an export market and as a source of investment. Further yuan weakness risks aggravating trade tensions, through accusations of currency manipulation to counter tariff costs. It also complicates China's rotation toward less capital- and credit-intensive consumer-led growth by lifting import costs, and by risking a recurrence of capital flight roiling the financial markets in 2015-2016. China's predicament is a classic unholy trinity of policy contradictions facing countries trying simultaneously to maintain a stable exchange rate, independent monetary policy, and free movement of international capital—the last a pre-requisite for the yuan's ascension to key-currency status rivaling the dollar in world trade and finance. The betting is that the central bank will move to stabilize the currency through intervention and capital controls, complicating efforts to expand the yuan's international role.

Back to Earth? Slowing growth and firming inflation were themes running through the latest batch of economic data, more in line with a typical late-cycle pattern than the mini-burst of growth through early spring. Evidence of a shift to a more sustainable pace even before the ink was dry on healthy second-quarter growth came from the late-June Citigroup Economic Surprise Index matching actual versus expected data results, in the red on the week for the first time since last September. Disappointing numbers signaled by the index were due partly to expectations elevated by early-quarter strength and partly to late-period softening sufficient to lower most real-time growth estimates for the second quarter to a range of 3½%-4½% from 4½%, or more, just a week or two ago.

Broadening inflation pressure accompanies its rise



Sources: U.S. Commerce Department, Federal Reserve Bank of Dallas.

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Disappointing numbers for May on the week included a decline in equipment orders, lowering three-month growth to a moderate pace, and a modest rise in consumer spending overshadowing an accelerated three-month rise. A second straight decline left May pending home sales at a January low. Slowing home-price increases into the early spring suggested weak demand responding to affordability pressures, rather than tight supply, as the main culprit. More supportive, ironically, was foreign trade, buoyed by solid growth of exports through May on fairly broad-based strength beyond oil. How exports are affected in coming months will depend on the ultimate breadth, mix, and collateral damage from the trade restrictions. As important as the activity data were fresh signs of firming inflation, hitting a year-on-year rise in the core PCE deflator of 2%—the Fed's official target for this favored price gauge—for the first time in six years, accompanied by a fuel-bolstered, six-year high of 2.3% in the overall index.

An action-packed week ahead, interrupted by Wednesday's July 4 holiday, will feature top-tier purchasing-manager reports for June manufacturing and non-manufacturing Monday and Thursday, respectively, minutes of the June 12-13 FOMC meeting and ending with the June employment report Friday. Overshadowed by trade policy and related international issues is the extent of any shift to more sustainable U.S. economic growth from the second quarter's respectable pace. Investors will be scrutinizing upcoming data for added signs of lost momentum suggested by recent economic reports and their implications for the earnings outlook and for Fed policy.