

# Economic and financial outlook highlights

## June 2017

Gary Schlossberg

- Moderate, 2%-2.5% growth likely will be sustained, on average, through the end of the year, sandwiched between support from housing, business investment and, to a lesser extent, consumer spending versus restraint from structural and atypical late-cycle weakness in commercial construction, state, and local spending.
  - Unusual late-cycle fiscal stimulus, even if successful in navigating a polarized Congress, risks boosting inflation more than economic growth, or simply failing to lift consumer spending, hiring, and investment.
- Inflation's slow turn toward the Federal Reserve's official, 2% target rate risks delay from subdued oil prices and, perhaps, from the dampening effect of the Fed's interest-rate "normalization" and associated dollar strength on trade-sensitive "goods" prices in the CPI. Leading-edge increases in domestic-driven, labor-intensive services costs also are at risk from the more general growth-dampening threat of higher rates to an economy made more interest-sensitive by housing and other asset-price inflation's boost to associated debt-financing costs.
  - Oil prices ultimately could settle in the \$45-\$55 per barrel range, viewed as stabilizing industry credit quality, by the OPEC cartel's replacement with more market-driven, U.S. "fracking" as the oil sector's "swing" producer.
  - Interest rates unencumbered by inflation pressures could repeat the "bull-market flattening" pattern early in 2004-06 interest-rate cycle, in which longer-term rates were steady to lower after a year.
- Stubborn "disinflation"—the hallmark of this economic cycle—is a pervasive force in the outlook, affecting "pricing power" and profit margins, the pace of interest-rate "normalization" by the Fed, the trajectory and pattern of interest-rate increases along the yield curve (i.e., the path traced by interest rates at various maturities) and, ultimately, the threat posed by asset-price inflation to economic and financial-market stability.
- The main justification for raising interest rates in an environment of moderate growth and subdued inflation is to contain an emerging asset "bubble" caused by the same historically low rates and ample "liquidity" that sank the financial market and the economy nearly a decade ago. Stronger finances and more heavily regulated banks help make similarities to a decade ago more by nature than by degree, however.
- Central to the outlook for stocks is their continued ability to toggle between "reflation"-driven earnings growth and support to valuations from interest rates subdued by low inflation. Earnings gains could face head winds, as easy year-earlier comparisons fade, due to weak pricing power, labor-cost pressures and late-cycle growth restraints, leaving the market more dependent on historically low interest rates to buoy market valuations.
- Chances for a disinflationary interest-rate "up cycle"—featuring rising shorter-term and steady-to-lower longer-term rates—would open up opportunities for returns enhancement through an unusual combination of late-cycle rotation into longer-dated securities and a more typical extension at this stage of the rate cycle out along the credit-risk curve.
  - Either way, converging shorter and longer-term rates (dubbed a "flattening yield curve") has and should continue to favor a "barbell" strategy of splitting investments between the two to achieve a desired "duration"—akin to maturity and measuring a security's price sensitivity to a given interest-rate change—over a "bulleted" strategy of focusing on a single maturity. In the four weeks to mid-June, the barbell return averaged a half percentage point more than that on a bullet strategy centered on the duration of a two-year Treasury note.

Wells Fargo Asset Management (WFAM) is a trade name used by the asset management businesses of Wells Fargo & Company. WFAM includes but is not limited to Analytic Investors, LLC; ECM Asset Management Ltd.; First International Advisors, LLC; Galliard Capital Management, Inc.; Golden Capital Management, LLC; The Rock Creek Group, LP; Wells Capital Management Inc.; Wells Fargo Asset Management Luxembourg S.A.; Wells Fargo Funds Distributor, LLC; and Wells Fargo Funds Management, LLC.

Wells Capital Management (WellsCap) is a registered investment adviser and a wholly owned subsidiary of Wells Fargo Bank, N.A. WellsCap provides investment management services for a variety of institutions. The views expressed are those of the author at the time of writing and are subject to change. This material has been distributed for educational/informational purposes only, and should not be considered as investment advice or a recommendation for any particular security, strategy or investment product. The material is based upon information we consider reliable, but its accuracy and completeness cannot be guaranteed. Past performance is not a guarantee of future returns. As with any investment vehicle, there is a potential for profit as well as the possibility of loss. For additional information on Wells Capital Management and its advisory services, please view our web site at [www.wellscap.com](http://www.wellscap.com), or refer to our Form ADV Part II, which is available upon request by calling 415.396.8000.