

WELLS FARGO
INVESTMENT INSTITUTE



July 24, 2018

From the desk of Darrell L. Cronk

State of the Markets

The Old Normal

“May you live long, but never grow old...” –Unknown.

June marked the nine-year anniversary of this economic recovery, making it the second longest recovery on record. While old in years, this cycle doesn’t feel all that old in its behavior. In fact, in some ways, we are finally returning to what I like to call the “old normal.”

The old normal to me is an environment in which we once again witness rising interest rates, rising inflation, and the cycle’s most robust GDP growth—with conversations about annual GDP approaching 3% and in some quarters once again above 4%. We’re seeing global central banks finally discussing or acting upon tighter monetary policy instead of endlessly easing; a labor market in which, for the first time this century, the number of job openings exceeds the number of available workers; and active management regularly outperforming passive/index-only investing once again. Hooray for the old normal!

That doesn’t mean we are without challenges. In many ways, we have a market that, if not for trade concerns, could find a path of least resistance higher. The war-on-trade discussions continue to heat up around the three core areas of China, European Union auto tariffs, and NAFTA renegotiations. The good news in the tariff narrative is that processes are relatively well-telegraphed and follow a fairly rigid time frame, with public hearings and ample advance notice to implementation. The bad news is that all of the deadlines are actually being met—the administration is not using the maximum amount of time permitted under the trade statutes of 232 and 301, but rather the minimum amount of time.

That said, there are positive signs that these disputes could be resolved—creating upside potential for U.S. equity markets. A few of these positive signs:

- Germany has proposed a deal that would eliminate all auto tariffs between the U.S. and Germany in an attempt to de-escalate the auto tariff issue. The European Union has not fully agreed to this yet.

Investment and Insurance Products: ▶ NOT FDIC Insured ▶ NO Bank Guarantee ▶ MAY Lose Value

- China has not immediately responded to the latest \$200 billion tariff escalation proposal by the U.S.
- Notwithstanding some recent yuan weakness, Chinese government officials have said they won't use outright currency devaluation as a weapon of trade and pledged to keep the exchange rate "basically stable."
- The latest Treasury data shows that China increased its U.S. Treasury holdings last month, countering the fear that the Chinese may reduce or cease purchasing U.S. Treasury securities.
- The current NAFTA agreement has no fixed expiration date, which is important to know. It still remains unlikely that the administration will exercise unilateral withdrawal provisions from the current agreement without a more cohesive plan to replace the largest existing free trade agreement in the world today.
- Trade will continue to be a concern for markets and should be watched closely; however, there are good reasons to not be fearful of a pending trade war.

The fundamentals provide reason for optimism. This should be the third consecutive quarter with double-digit S&P 500 earnings growth, with year-over-year earnings growth of more than 20% on revenue growth of 8-9%. Small company stocks, as measured by the Russell 2000 Index, could report earnings growth that exceeds 40% year over year. Share buybacks announced for the second quarter were over \$440 billion, nearly double the previous record of \$242 billion set in the first quarter. Companies also paid a record \$111 billion last quarter in dividends, a 7.8% increase year over year, according to S&P Dow Jones. Mergers and acquisition (M&A) dollar volume hit \$726 billion, more than double the level for the same period in 2017. We saw 120 initial public offerings (IPOs) during the first half of 2018 worth more than \$35 billion—the best six months of the cycle so far. The tailwind of excess cash and earnings from tax reform remains alive and well.

While the fundamentals of the old normal are real, the tug of war between strong fundamentals and concerns over an evolving war on trade look to dominate the second half global outlook for 2018. However, the likelihood of an all-out trade war thus far has had muted economic and capital-market impacts and to us remains a tail risk rather than a baseline scenario today. We will be watching closely for any changes within this current path. It is important to remember, when it comes to risks, that all are possible, though not all risks are equally probable.

Happy investing, and let us know how we can be of help.

-Darrell

Darrell L. Cronk, CFA

President of Wells Fargo Investment Institute

Chief Investment Officer for Wealth and Investment Management, Wells Fargo & Company

Darrell L. Cronk is the president of Wells Fargo Investment Institute, which is focused on delivering the highest quality investment expertise and advice to help investors manage risk and succeed financially. Mr. Cronk leads global investment strategy and research including equity, fixed income, real assets, and alternative investments. He also serves as chief investment officer for Wealth and Investment Management, a division of Wells Fargo & Company that includes Wells Fargo Private Bank, Wells Fargo Advisors, Wells Fargo Institutional Retirement, and Abbot Downing.

Risks Considerations

Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities.

Definitions

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

An index is unmanaged and not available for direct investment.

General Disclosures

WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

Wells Fargo Wealth and Investment Management (WIM) is a division within Wells Fargo & Company. WIM provides financial products and services through various bank and brokerage affiliates of Wells Fargo & Company.

Opinions represent WFII's opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. WFII does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon.

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS' opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company. CAR 0718-03426