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From the desk of Darrell L. Cronk

State of the Markets

All Rise

Late May on the calendar brings rising levels of mercury on the thermometer along with rising anticipation of summer as we march into Memorial Day weekend. For the capital markets, the month of May has also brought its own ascension for many asset groups. We have witnessed rising equity prices, rising interest rates, rising oil prices, a rising U.S. dollar and rising trade and geopolitical tensions—all forcing markets to reassess their near term outlook.

Most concerning of late for investors have been the effects of rising rates and oil prices. The bond market convulsions are becoming increasingly frequent now as U.S. Treasury 10-year and 30-year yields recently hit levels unseen since 2014. Oil prices, after posting their longest run of weekly gains in seven years, continue their steady march higher on growing concerns over supply disruptions from the Middle East.

So far, any contagion has spared equities and rotated instead to currencies, emerging markets, and precious metals. Equity outperformance has remained reasonably pronounced as the U.S. economy continues to rebound from its first-quarter weak patch. The Atlanta Federal Reserve's GDPNow model, a running estimate of real GDP growth, estimates second-quarter real GDP growth is now running at more than 4% and private fixed investment growth is tracking close to 6% growth, up from 2% last quarter.

The S&P 500 Index has outperformed the Bloomberg Barclays US Aggregate Bond Index by 5% so far during the second quarter. We've stayed favorable on U.S. equities and cyclicals versus defensives through both major bond market sell-offs this year because we thought stocks could handle higher rates as long as Federal Reserve policy remained accommodative and earnings growth strong. Also, since their market low in early February, U.S. small caps quietly have risen by double digits and have taken out their all-time high. Even more impressive is that, this quarter, the Russell 2000 Index (small caps) is beating the S&P 500 Index (large caps) by 7.5% as small caps tend to buffer investors against rising trade tensions and benefit from a larger drop in effective tax rates than their large cap peers.

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What else is on the rise? We believe the dual fiscal stimulus packages from December's tax reform and the sizable spending budget passed in January by Congress are both having much-anticipated positive effects. Signs of corporate purse strings being unleashed are evident in the most recent data. The first quarter of this year saw the fastest start on record for merger and acquisition activity, which has surged \$473 billion, up 68% year over year. S&P 500 dividend growth also spiked to a three-year high; last quarter was the first quarter since 2003 with literally zero dividend cuts within the index. U.S. share buyback authorizations for S&P 500 companies also jumped \$205 billion, or 48%, year over year last quarter. And finally, we're seeing early signs that capital expenditure (Capex) spending by companies is tracking well above expectations and is likely to further accelerate in the second half of this year. All we believe are positive signs that sturdier economic growth lies before us through the remainder of 2018 and into 2019.

Memorial Day weekend is the unofficial start to summer. We stroll into this summer in a good place with rising profits, rising employment and rising consumer and business spending and confidence. However, the title of this update is not just about market and economic variables. Memorial Day is a call of remembrance to pay tribute to those who died in service to their country. There can be no greater sacrifice. We owe a great gratitude to all who served for their dedication and bravery. May we have the courage to do our duty as well as they have done theirs. All Rise.

- 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.

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Definitions

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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.

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.

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