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FROM THE DESK OF DARRELL L. CRONK

State of the Markets

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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.
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August & Everything

As we turn the corner into late summer, two themes continue to evolve. First, a mid-summer downshift in U.S. growth emerged through July as seen by recent declines in labor market data and consumer confidence. Second, the Federal Reserve (Fed) continues to commit to using all of its tools to support the economy, even as a larger burden falls on Congress to deliver sustained fiscal support. As we exit the shortest but deepest recession since World War II, a number of questions continue to surface from investors in almost every discussion I have these days. Let's hit them head-on.

With so many challenges for today's economy, risk assets appear to defy logic and continue to march higher. What do you see and what remains most crucial for markets?

Markets enter August, seasonally one of the toughest months for risk assets, with as many signs of calm as concern—at least on the surface. Equity prices are close to multi-month highs and credit spreads are approaching four-month lows. However, a deeper look reveals that the most cyclically geared areas of the markets, such as U.S. Small Cap Equities, Energy, Industrials, and Financials all stopped advancing two months ago, in line with a resurgence of COVID-19 case counts. Apprehension below the surface is present in current risk asset positioning, hedging, and abnormally high current cash levels. The most critical elements to prevent a meaningful stall remain a continuation of global stimulus and important progress toward a coronavirus vaccine.

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Is asset volatility abnormally high?

The reality of a potential bumpy road to recovery has caused volatility levels to remain high across equities, currencies, and commodities, even as interest-rate volatility plumbs new all-time lows. Specific to equity volatility, first, implied volatility typically rises during a presidential election year; second, the unknown and unpredictable coronavirus path keeps volatility unusually high; and third, the high concentration of a few stocks naturally raises the cost of hedging for portfolios, keeping implied volatility elevated. In relation to interest-rate volatility, the markets' belief that the Fed will keep rates at the zero-bound until at least 2022, coupled with limited growth and inflation, has removed a large amount of near-term interest-rate volatility.

Dramatic increases in the federal debt and central bank balance sheets have investors wondering: Is inflation on the horizon?

The short answer is no. Although inflation could be a medium-term risk if growth stabilizes, in the near term, inflation has historically peaked during a recession, followed by disinflationary pressures early in the economic recovery. Current evidence supports this. Core Consumer Price Index (CPI) likely peaked in February of this year at 2.4% and has fallen over the past several months to 1.19%. According to the recent Consumer Expenditure Survey, the top 10% of households spend 69% of their after-tax income, while the bottom 90% spend 101% on average. Consistent with most downturns or recessions, spending by high-income earners falls more than that of low-income earners, who continue to spend on everyday necessities. Recent stimulus checks sent directly to consumers and extended unemployment insurance have kept the disinflationary impulses in check in the near term, but downward pressure may accelerate if stimulus fades. While higher inflation could be a possibility in the future, we see greater risk today for lack of inflation than for too much inflation.

Should investors be concerned about the recent decline in the U.S. dollar?

The U.S. Dollar Index is down approximately 8% to 9% from its 2020 highs and near its lowest level since 2018. Several factors have accounted for its recent weakness, including the rise in COVID-19 cases in many parts of the U.S. compared to countries in Europe and Asia that have done a better job with recent coronavirus containment. Europe's recent coordinated fiscal stimulus breakthrough has also been a source of attribution as the euro has recently appreciated rather strongly against the U.S. dollar. There are also medium-term risks creating downward pressure, including sizable U.S. government deficits, the possibility of higher corporate taxes, and elevated levels of national debt that negatively impact the dollar. That said, the U.S. dollar remains the world's reserve currency and has a relative advantage of higher interest rates and growth rates than most other countries around the globe, creating continued global demand for U.S. dollars. We believe the U.S. dollar will likely settle into a trading range closer to where it is today—without material appreciation or depreciation in the near term.

Given all the unprecedented monetary and fiscal stimulus, is there a future fiscal cliff looming?

In our opinion, Congress will muster the fortitude to deliver near-term stimulus support. However, a greater challenge comes in 2021 when this year's extraordinary fiscal stimulus programs fade. Almost all of the stimulus measures and credit support programs, both globally and in the U.S., have been designed with expiry dates on various components. This raises a risk that the largest and most coordinated fiscal thrust in modern history could become a significant drag if not somehow bridged or sustained. While the Fed remains unwavering in its commitment for longer-term support, openly discussing the need for an inflation overshoot of its 2% target and pledging to keep interest rates low for an extended period of time, the key question for economic growth will be how to supplement or replace expiring fiscal support next year. Election outcomes this November should prove to be a key inflection point determining future fiscal policy spending paths. The logic of coordinated monetary and fiscal actions to enhance the expansion has long been appealing conceptually, even if its implementation has proven elusive. The country's decades of low infrastructure spending, even by developed economies standards, could be a key area to finally make forward progress into next year.

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Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Currency risk** is the risk that foreign currencies will decline in value relative to that of the U.S. dollar. Exchange rate movement between the U.S. dollar and foreign currencies may cause the value of a portfolio's investments to decline. **Small-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

The **Energy** sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. Investing in the **Financial** services companies will subject an investment to adverse economic or regulatory occurrences affecting the sector. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio's performance.

Definitions

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

U.S. Dollar Index measures the value of the U.S. dollar relative to majority of its most significant trading partners. This index is similar to other trade-weighted indexes, which also use the exchange rates from the same major currencies.

An index is unmanaged and not available for direct investment.

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