Monthly Market Advisor

Market Reflections and Future State

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In this Monthly Market Advisor:
» Reviewing a full year of Wells Fargo Investment Institute’s 2017 Outlook through five key market shifts
» Exploring how investor behavior can influence expectations and misdirect investment decisions
» Evaluating fundamental developments and their implications for the future state of markets
» Identifying potential investment opportunities in an aging recovery and the value of strategic portfolio enhancement

2017 Reflections Outlined in Five Key Shifts
Investors faced endless headlines and uncertainties throughout 2016, which caused many to react to events versus planning for the long-term. In 2017, Wells Fargo Investment Institute strategists identified changes to the following five factors to help investors navigate through ongoing event-driven turbulence: consumer spending, inflation, interest rates, commodities, and geopolitical volatility. In this Monthly Market Advisor, we reflect on the progress of these factors, evaluate the current fundamental state of the economy and markets, and explore potential investor opportunities for 2018.

Consumer spending
As anticipated, consumer spending proved to be a bright spot throughout the year. While shifts in consumer behavior (i.e., online shopping, sharing, and mobile) are challenging some traditional consumer-focused companies, we believe the underlying health of the U.S. consumer is very solid. Because consumer spending contributes approximately two-thirds of our economy, this has been a welcome development. The Conference Board’s Consumer Confidence Index hit a 17-year high in October, supported by factors like rising home prices and record low unemployment. Today, household net worth is at all-time highs and the average household debt load, a pain point during the Great Recession, is now near all-time lows.

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Inflation
We expected the U.S. as well as global inflation rate to rise slowly toward a more historically average rate. However, wage inflation has remained stubbornly low as has pricing for core consumer goods and services, as seen in Figure 1. While higher economic growth certainly could trigger a rise in the rate of inflation, we have yet to see signs that would support a sharp rise in prices.

Figure 1: U.S. Inflation Losing Steam

![Graph showing U.S. inflation expectations falling](image)

Source: Bloomberg, Wells Fargo Investment Institute, 8/31/2017

Interest rates
Improving labor markets and the potential for increased inflation called for a continued and gradual shift in Federal Reserve monetary policy, moving toward one of less accommodation. As expected, we saw a measured path toward higher interest rates. We also saw the Federal Reserve (the Fed) start shrinking its $4.5 trillion balance sheet through a process of asset purchase “tapering.” The Fed initiated this process in October and is expected to continue it through and beyond 2018.

Commodities
With a sharp drop in prices, commodities as a whole were destabilizing to markets over the past few years. In early 2017, we believed that the worst was over but stressed that any rebound in prices would likely be limited. For certain commodities, idle capacity can quickly come online when prices rise to a level that makes it economically viable for producers to operate. Hence, we see oil and other commodities continuing to trade along a horizontal and range-bound path as the commodities bear market “super cycle” continues to play out.
**Geopolitical volatility**
On the heels of "Brexit" and the U.S. presidential election, we expected geopolitical uncertainty to continue, and it has done so in 2017. Examples include the far right AfD party securing a place in Germany’s parliament and Catalonia’s vote for independence from Spain. In 2018, we expect such instability to persist as global income inequality amid a continued and gradual economic recovery and continued hostile actions by rogue states contribute to more friction.

**The Risk of Investor Behavior and Bias**
Even though we anticipate that these are long-term shifts in the economy and market, it is critical that we not assume that they will continue uninterrupted in 2018. Such assumptions can lead to "recency" bias, where an investor draws conclusions largely dependent on outcomes of the recent past. Approaching its ninth year, the current bull market is fueling investor expectations that U.S. stocks will keep rising. The comparative age of the current bull market can be seen in Figure 2.

**Figure 2: U.S. Equity Bull Markets**

![Figure 2: U.S. Equity Bull Markets](source)

Source: Bloomberg, Wells Fargo Investment Institute. 9/30/2017. Market represented by the S&P 500 Price Index. Past Performance is no guarantee of future results. An index is unmanaged and not available for direct investment.

When an investment decision is based primarily on recent outcomes, which may have little fundamental support, it can be subject to outsized risks. This is especially important to acknowledge in the increasingly mature bull market and economic recovery we find ourselves in today. Investors might consider reflecting further back and recall how U.S. stocks fell about 40 percent in 2008 after a bull market that was half the age of the current run. After such a long period of positive returns, it is easy to forget that equities are a risky asset class.
The Future State

Due to the aging recovery and extended bull market, some market observers think that we are close to an economic downturn. Weakening fundamentals such as shocks to aggregate supply and demand, central bank policy missteps, or exogenous events are common trigger points for such an event. Our view is less pessimistic; recoveries and bull markets do not typically die from old age alone.

We see several tailwinds in 2018. In our view, employment should remain healthy, consumer and business confidence should stay strong, and financing likely will remain cheap and increasingly accessible as central bank policies remain relatively accommodative. These trends should continue to fuel a long-awaited business spending cycle, as seen in Figure 3. Such developments could stimulate capital velocity and further economic growth. The anticipation of pro-growth tax and regulatory reforms have stimulated investor expectations for further valuation support for equities and have driven the stock market to new record highs throughout the back half of 2017.

Despite these positives, we also see headwinds. These include a continued rise in global populism fueling support for anti-trade and anti-immigration policies, rising geopolitical risks, and mounting currency volatility. Furthermore, the change at the helm of the Fed warrants keeping an eye on Fed policy. There should also be rising uncertainty around the 2018 U.S. midterm elections.

Figure 3: A Changing Tide for U.S. Manufacturing

Source: Bloomberg, Institute for Supply Management, FactSet, Wells Fargo Investment Institute, 9/30/2017
With respect to the market, lofty equity valuations are pointing to a potential market correction, defined as a decline of at least 10 percent. Many fear that such a market correction could lead to a recession. There are two things to note:

- First, while all 12 recessions since World War II were preceded by a market correction, there were a total of 38 corrections over this period.
- Second, most corrections have been fairly short, and most were followed by a subsequent rise in the market.

While we are expecting a correction, we believe that it will be of the short-lived variety and may represent an opportunity for investors.

**Conclusion: Investor Application**

As we enter the New Year and move further along on our extended recovery, it is important to recognize the importance of risk management. The prolonged bull market has yielded attractive returns, but against a backdrop of historically low volatility and high asset price correlation. Investors should ensure that their U.S. equity exposure has not become over extended during this run, and consider aligning holdings to strategic target allocations. Furthermore, we believe that asset price dispersion will rise and correlations will fall, leading to an environment favorable for active asset management. Thus, investors who are overly exposed to passive strategies might consider diversifying into actively managed strategies.

With rich equity valuations and rising interest rates, it is understandable why many investors might hesitate to put money to work in the market. However, we still see a range of attractive opportunities as we move later into this cycle. For instance, investors may want to consider international and emerging market stocks, which have just recently started to benefit from improving fundamental trends and remain attractively valued. Qualified investors might consider appropriate alternative investments. Specifically, in these types of market conditions, relative value, equity long/short, and private debt strategies may help enhance risk-adjusted returns.

Another opportunity to consider is social impact investing. In many respects, this type of investing is timeless in nature as the underlying investments are selected to align to an investor’s unique set of values. Beliefs and values are unlikely to be materially influenced by the economy or capital markets. At the core of this approach is a thorough assessment of environmental, social, and governance factors accompanied by traditional fundamental and quantitative research, analysis, and portfolio construction.

Ultimately, it comes down to staying true to one’s investment plan and maintaining alignment. This discipline can help shield investors from the biggest risk to their investments – themselves. In our opinion, investors should engage a trusted investment professional to review their investments and to help maintain alignment to a plan. In a constantly shifting market, an investor’s plan can be a beacon of stability.
**Risk Considerations**

All investing involves risk, including the possible loss of principal. Each asset class has its own risk and return characteristic. 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.

*Alternative investments are not suitable for all investors and are available only to persons who are "accredited investors" or "qualified purchasers" within the meaning of U.S. securities laws.* They are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. Alternative strategies, such as Relative Value and long/short equity, may expose investors to risks such as short selling, leverage, counterparty, liquidity, volatility, the use of derivative instruments, and other substantial risks. Private debt strategies seek to actively improve the capital structure of a company, often through debt restructuring and deleveraging measures. This strategy has speculative characteristics that include potential default, limited liquidity, and the infrequent availability of independent credit ratings for private companies.

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