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INVESTMENT INSTITUTE

ASSET GROUP GUIDANCE
Equity Strategy

IN-DEPTH ANALYSIS OF THE EQUITY MARKETS

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Q&A: The "Why" Behind Our 2018 Equity Guidance

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Key Takeaways

» *Valuations for the S&P 500 Index remain near historic highs.*

» *In our opinion, double-digit year to-date (YTD) equity returns and low volatility have resulted in some investor complacency.*

What It May Mean for Investors

» *We believe that investors should consider rebalancing portfolios after the YTD rally in many equity classes (and in financial markets, generally).*

Are S&P 500 Index valuations full? Will that lead to limited upside in 2018?

We believe that the odds of a U.S. recession currently are low. Yet, risks can multiply in the latter third of a cycle, and can be catalysts for greater volatility and pullbacks. Overall, we are looking for flat-to-modest total returns next year for the S&P 500 Index, and we are evenweight U.S. large-cap equities. This means that we recommend investors remain fully allocated in this asset class. We are projecting 5.4 percent revenue growth and 7.0 percent earnings growth for the S&P 500 Index next year. Our target price range for the index at year-end 2018 is currently 2450-2550.

S&P 500 Index valuations are full, and price/earnings (P/E) ratios appear extended. The index's P/E ratio currently is roughly 20x (on a trailing basis), versus a 16.7x long-term median multiple. If we take out the bubble-market period of the late 1990s and 2000, the absolute P/E multiple of the S&P 500 Index has actually been cheaper 89 percent of the time and more expensive only 11 percent of the time (from the third quarter of 1986 to today). Table 1 shows that S&P 500 Index performance looks even more extended by other valuation measures. Recently, investors also have been willing to pay an all-time high price-to-sales ratio for the index at the same time that gross, operating, and net margins are sitting near historical highs. We would consider this to be a risk factor as well. Full U.S. large-cap valuation levels increase the likelihood that we may be heading into a period of more limited equity upside. While valuations tend to be higher when interest rates are low, we believe that the valuations shown in Table 1 are full, and that we now are on the verge of a period of slowly increasing interest rates.

It also is important to remember that most of the increase in the S&P 500 Index since 2011 (103 percent) has been from valuation increases, rather than from earnings growth (roughly 75 percent versus 28 percent).

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S&P 500 Index Valuation Metrics

	Today	Long-Term Average	Long-Term Median	Percent of Time Lower
Price/Earnings*	20.5x	16.8x	16.7x	89%
Price/Cash Flow	14.3x	10.3x	9.5x	92%
Price/Sales	2.2x	1.4x	1.4x	98%
Price/EBITDA	11.4x	7.4x	7.0x	99%
Price/Book Value	3.2x	2.7x	2.7x	89%
EV/Sales	2.5x	2.0x	2.1x	81%
EV/EBITDA	13.2x	10.5x	10.8x	91%
				Percent of Time Higher
Free Cash Flow Yield	4.2%	5.0%	4.7%	77%**

Sources: Bloomberg, S&P Capital IQ, Wells Fargo Investment Institute, 10/17/17. EBITDA= Earnings Before Interest, Taxes, Depreciation, and Amortization. EV (Enterprise Value) = market value of common stock + market value of preferred equity + market value of debt + minority interest - cash and investments. *P/E data: 1986-2017. All other data represents 1990-2017. ** Cash flow from operations peaked in 2013.

Wells Fargo Investment Institute's year-end 2018 targets are showing relatively flat returns for the S&P 500 Index. Is the cycle coming to an end? What is the economic outlook through 2018? Should investors reduce S&P 500 Index exposure?

We do not believe that the cycle is coming to an end. Our macroeconomic group is projecting 2.1 percent gross domestic product (GDP) growth for the third quarter, 2.5 percent for the fourth, and 2.4 percent for 2018. Yet, we do believe that we now are in the last third of the cycle, and some risks tend to increase during latter stages of a cycle. For instance, wage growth can be a benefit to consumers, but a risk to corporate margins, as the cycle ages. In this cycle, the market also appears to be registering a fair amount of hope that a material tax-reduction package and other growth policies will be passed by Congress.

Additionally, we believe that a level of complacency has resulted from persistently declining levels of volatility since 2015. October has the potential to represent the seventh straight monthly increase in the S&P 500 Index. Straight monthly increases lasting for periods of between 7 and 12 months only have occurred 18 times over the course of the past 90 years:

- Market history suggests that month-to-month increases could continue, but these low-volatility periods of S&P 500 Index returns are not the norm.
- Investors should appreciate their rarity, and be aware that there often is a significant time gap before the next steady 7-12 month period begins.

We continue to recommend maintaining a full weighting within the U.S. large-cap equity class. Therefore, if investors have not rebalanced their portfolio recently, now would be an appropriate time to do so. The YTD 16.1 percent total return of the S&P 500 Index suggests that many investors, if they were allocated properly at the start of the year, are now excessively overweight this asset class. With the S&P 500 Index up 75 percent over the past five years, the risk to a meaningful overweight position could be exacerbated.

Does Wells Fargo Investment Institute believe that large-cap valuation multiples will contract as the Federal Reserve (Fed) continues to hike rates?

Fed tightening increases the likelihood of valuation pressure. With the four rate increases in this cycle, thus far, we have not seen multiples contract. Yet, the fed funds rate is moving up from historically low levels. However, continuing growth, inflation creep, more Fed rate increases, and slowly rising 10-year Treasury yields increase the

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likelihood that U.S.-equity multiples will come under some pressure as rates continue to rise. Good examples include the tightening periods of the early 1990s, the late 1990s, and the early 2000s.

	Fed Funds Rate Increase	Change in Fed Funds Rate	Period P/E Decline	Change in P/E
Early 1990s	3.0%-6.0%	100%	21.9x to 14.7x	-32.9%
Late 1990s	4.75%-6.5%	37%	29.9x to 22.4x (18.0x by Q4-2002)	-25.1%
Mid-2000s	1.0%-5.25%	425%	19.5x to 15.2x	-22.1%

Sources: Board of Governors of the Federal Reserve System (U.S.), Thomson Reuters, Bloomberg, Wells Fargo Investment Institute, 10/17/17.

Thus far, the Fed has increased the fed funds rate to the 1.00-1.25 percent range. Expectations are for an increase of 25 basis points (100 basis points equal 1 percent) to the 1.25-1.50 percent range in December. We currently are looking for the level to be 1.75-2.00 percent at the end of next year (which would represent a 1.75-2.00 percent total fed funds rate increase from the low of this cycle).

With the S&P 500 Index currently carrying a 20x P/E valuation, we are suggesting a contraction to 18.5x by year-end 2018 (-7.5 percent). Even this atypically small decrease in valuation (versus others in history) could be just enough to offset next year's earnings growth.

Of course, should the outlook change (which could include the passage by Congress of a significant tax-reduction package or other material growth policies), our earnings expectations likely would be higher, and our targets for 2018 could be adjusted upward.

Can cyclical sectors outperform in a flat market?

U.S. cyclical sectors have outperformed defensives 52 percent of the time in markets that are roughly flat (between -2 percent and +2 percent over the course of a year), looking back to 1984. When this occurs, it always has taken place during periods of 1.4- 4.3 percent GDP growth. Over the past 30 years, we experienced cyclical outperformance in "flat" markets during the 1990s recovery in a monetary tightening period, in the early 2000s, and over 12-month periods ending in the last half of 2015. With 2.4 percent GDP growth expected next year, and earlier-cycle growth internationally, we continue to favor cyclically-sensitive sectors over defensive ones. If we were preparing for the next recession (which we are not), we would have a greater interest in defensive sectors whose earnings are less impacted by recession.

Why are emerging and developed-market stocks outperforming the S&P 500 Index this year? Is outperformance typically tied to earnings gains? Does Wells Fargo Investment Institute believe that this trend will continue?

Emerging and developed equity markets are outperforming those in the U.S., because economic and earnings growth rates appear to be improving at a faster rate than in the U.S. Additionally, currency translation has helped, more for developed-market equities than for emerging-market stocks. Dollar weakness, especially versus the euro, has benefited U.S.-based investors. Yet, we believe that strengthening fundamentals are the main trend that is fueling this outperformance.

International economies and earnings are at a different point in the business cycle than they are for the United States. We believe that this signals further upside potential for international equity markets in 2018. Typically, emerging markets will have sustained periods of outperformance and underperformance. The emerging markets trailed U.S. markets from 2011-2015 before the recent improvement in fundamentals.

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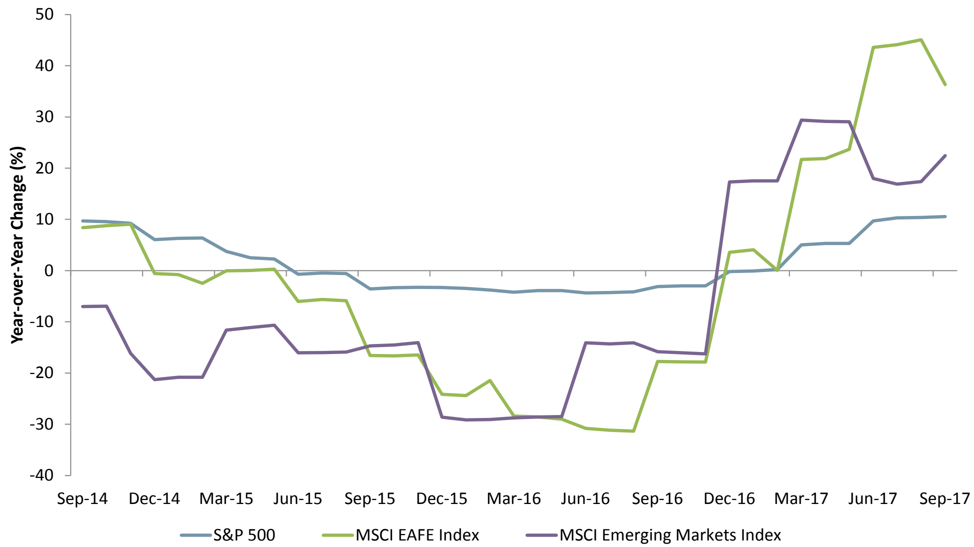
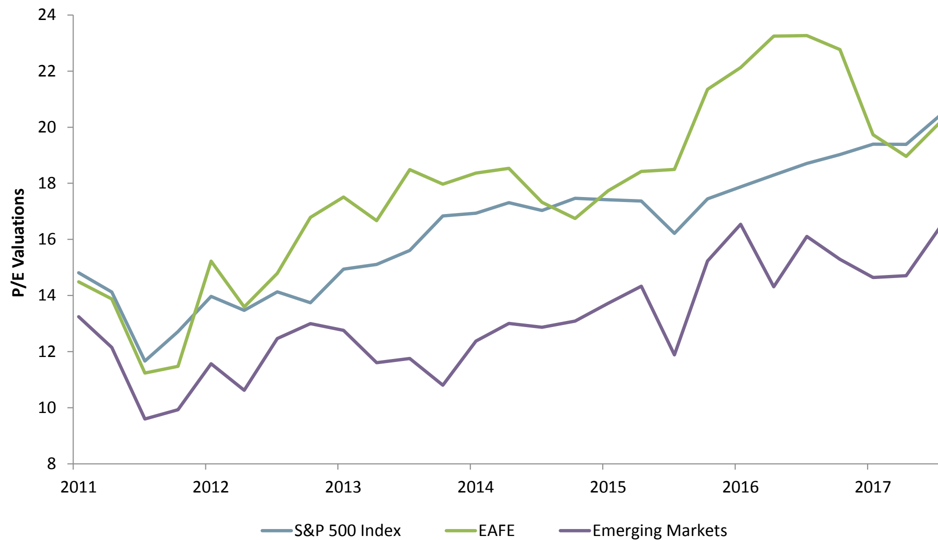
In both international developed and emerging markets, the earnings rebound since the 2008-2009 global financial crisis happened much later than it did in the United States. Consequently, central banks in these markets are likely to remain more accommodative than the Fed in the near term. Further, we expect business and consumer confidence levels to continue strengthening. We believe that these developments will be conducive to steady earnings improvement in international developed and emerging markets.

Chart 1. Earnings Growth in International Markets Has Outpaced U.S. Growth



Sources: Bloomberg, Wells Fargo Investment Institute, 10/17/17

Chart 2. Trailing 12-Month P/E Ratio



Sources: Bloomberg, Wells Fargo Investment Institute, 10/17/17

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MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market. The Index is unmanaged and not available for direct investment.

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