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FIRST ANALYSIS

News or events that may affect your investments **April 25, 2024**

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Disappointing economic data underscores potential opportunities

Key takeaways

- Investor disappointment after Thursday’s first-quarter (Q1) 2024 gross domestic product (GDP) report on economic growth and inflation triggered selling in equity and fixed income markets.
- This was another in a series of recent reports that reinforce a key part of our 2024 outlook, namely, that inflation is unlikely to unstick and cool further until the economy also slows further.

What it may mean for investors

- Our guidance has been and remains to focus on quality and to rebalance. Additional volatility may create potential opportunities, however.

Why did markets sell off after Thursday’s release of Q1 2024 U.S. GDP growth?

In a word, disappointment. Thursday’s GDP report contained information about the first quarter’s pace of activity and prices. Both categories disappointed investors. Economic growth was positive, but the details of the report uncovered some of the weaknesses in economic activity that we have been expecting. Spending on durable goods (those that can be stored or kept in inventory for at least three years) fell by 1.2% annualized for the quarter. And trade data continued to show that the U.S. bought more from abroad than it sold, a sign that signals a concern about economic weakness overseas.

Paradoxically, the central problem for markets seems to be strength — especially in household spending on services. In recent quarters, consumers have been prioritizing their spending away from goods and toward services, and today’s reading was a particularly strong 4.0% annualized pace for the quarter. Services strength typically supports equity earnings and ultimately equity prices but also is pushing employers to hire more help. As wage rates typically rise, the upward pressure remains on inflation. In fact, today’s report included a still-elevated 3.1% annualized quarterly increase in the GDP deflator, a measure of prices across the economy, including producer and consumer goods, and a worrisome 3.7% increase for prices measured by quarterly personal consumption expenditures. The pace suggests that the March personal consumption expenditures report — set to release Friday, April 26 — may print another annual inflation increase.

What do we believe the bond markets are telling investors with the spike in long-term yields?

Bond investors appeared to watch the deflator number carefully. A hotter reading than expected sent the yield on the 10-year Treasury up sharply, touching a new yield high (4.70%) for the year on an intraday basis today. This rise has tracked closely with other markets that follow inflation expectations, notably the inflation swaps market, where the 1-year swap intraday (on Thursday, April 25) implies expected inflation a year ahead of 2.68%, up from its year-to-date low of 1.91% on January 8, 2024.

In turn, the rise in inflation expectations can weigh on the technology-related equities in the S&P 500 Index. These equities are especially sensitive to long-term bond rates because so much of their price today rests on expectations of future earnings. If over that time horizon a 10-year Treasury starts to fall in price (and rise in yield), some investors typically find the bond more attractive than the equity. And so, we have seen weakness in the technology-related stocks since inflation expectations started moving higher in late February.

What are the key data readings you will be watching in the next few weeks?

To reiterate, the next significant economic reading available to markets will be the monthly (March) personal consumption expenditures measure, available at 8:30 a.m. ET on Friday (April 26). Investors will be watching closely to see if that measure confirms the inflation concern registered in today's quarterly GDP report. Looking ahead, any further signs of strength in services spending and related inflation — whether from the April jobs report on May 3, or the April consumer price index reading on May 15 — should be important next data on the story of services spending and inflation.

In an environment like this, what are key principles investors should keep in mind when making portfolio decisions?

At the beginning of the year, inflation-swaps markets and interest rate futures markets were pricing falling inflation and interest rates. Meanwhile, equity markets began the year with a flourish, as the U.S. economy finished 2023 with a strong fourth quarter. That combination struck us as overly optimistic and unrealistic, as we detailed in our 2024 Outlook report in December and other observations we published in January.[1] Our outlook remains for the economy (yes, including services) to slow as the year progresses.

We believe there is enough strength for the slowdown to be gradual and then, if inflation cools alongside the economy as we expect, falling interest rates should spark a modest new acceleration in growth through 2025. We are constructive on equities, but foresee additional volatility in the coming weeks, as we anticipate markets to adjust their expectations to what we believe is a more realistic outlook for growth, inflation, and interest rates. One might also throw in the volatility risk of election uncertainties, which historically do not register with markets until after midyear. In any such case, we expect disappointments to register as downside risks to financial markets. Thus, for long-term investors, we are keeping our quality-oriented preferences around portfolio allocation.

How can investors be opportunistic as markets work through this volatility?

Periods of volatility (like the one that seems to have begun) have tended to occur historically when markets are adjusting expectations. For now, we reiterate our preference for a quality focus in portfolio allocation, but volatility often can produce the potential for new opportunities for investors of all time horizons. We favor considering the following steps:

1. See "Updating guidance and shifting fixed-income allocations", Jan. 9, 2024, Wells Fargo Investment Institute.

1. **Rebalance:** After consecutive monthly gains in the S&P 500 Index since November 2023, a portfolio's balance between stocks and bonds may have increased equity exposure by more than originally desired. Now is a good time for a conversation with an investment professional about rebalancing risk to target levels. A good place to start trimming may be in the Information Technology and Communications Services sectors, which look expensive from a price-to-earnings perspective, even with the modest recent pullback. Long-term investors may prefer to reallocate to short-term fixed income. Investors with more of an interest in tactical allocation could consider rebalancing from technology-related funds or positions into our favored sectors: Industrials, Materials, Energy, and Health Care.

2. **Prepare for likely volatility in fixed-income markets:** An unexpected event may have a larger market impact, which may temporarily delay the resumption of disinflation. We prefer short-term fixed income instead of holding cash and prefer investment-grade intermediate-term and long-term bond positions close to long-term target allocations. We favor making sure that the portfolio is not underweight to strategic targets in intermediate-term fixed income.

3. **Consider commodities to help diversify:** If economic strength persists, we expect commodity prices to rise with inflation. We favor a commodity allocation as a partial inflation hedge for long-term (or strategically oriented) investors, including a small allocation for income-oriented portfolios. For shorter-term, tactically oriented investors, an overweight to commodities could be a good way to hedge further geopolitical risk.

4. **Volatility may create new buying opportunities:** If market volatility continues, as we expect, there may be other opportunities for investors with both strategic and tactical investment horizons. Please continue to check with your investment professional for any new guidance changes from us.

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