October 4, 2019

Seatbelt Light Is "On"—More Growth and Challenges Ahead

Paul Christopher, CFA
Head of Global Market Strategy

Darrell Cronk, CFA
President of Wells Fargo Investment Institute, Chief Investment Officer of Wealth and Investment Management

Key takeaways

» *The S&P 500 lost 1.8% on October 2 and is now down 1.3% year-over-year, as risk sentiment takes hold again in the fourth quarter.*

» *Weaker economic data and trade disputes combined to push markets lower. We do not expect a recession, but these concerns are building pressure that, over time, could crack consumer sentiment.*

What it may mean for investors

» *The economy is still growing, and a recession does not seem imminent. But at this point in the cycle, it is important to know where you are getting paid to take risk. In keeping with this advice, we have suggested reducing portfolio risk exposure systematically and thoughtfully over recent months.*

The S&P 500 Index lost 1.8% on Wednesday, October 2, 2019, its largest single-day loss since August 27. The index is now 1.3% lower for the 12 months ended October 2. Risk-off sentiment is taking hold in markets early in the fourth quarter. A sharp weakening in sentiment among purchasing managers caught market attention on October 2 and 3. An emerging concern is that the weakness could extend into services, which is still growing but less strongly.

The surveys of purchasing managers are important data that have predicted how future industrial activity will move. The current pessimism among survey respondents points to weaker industrial activity in the U.S. and around the world. Moreover, the latest readings probably do not fully reflect the recent escalation in U.S.-China (or U.S.-Europe) trade tensions. Consequently, we believe there could be further manufacturing weakness that, in turn, may trigger renewed concerns about an economic recession.

Trade disputes remain a secondary but still significant market worry. On October 2, the World Trade Organization (WTO) took a first step to settle two 15-year cases in which the U.S. and Europe each allege that the other side improperly subsidizes airplane manufacturing. In a first decision, the WTO ruled that the U.S. may impose tariffs on European industries. Investors had hoped that the two sides would negotiate a settlement, but Washington quickly proposed a long list of tariffs. We expect that the WTO will rule against the U.S. by early next year. In that event, Brussels is likely to retaliate with tariffs of its own. The new tariffs may raise the prices of a variety of goods, including airplanes.

More broadly, the importance of the WTO ruling is less about the new tariffs than it is about the new potential animus on both sides ahead of previously scheduled U.S.-European trade talks later this year. Many of the WTO-sanctioned U.S. tariffs are on agricultural products, and the U.S. wants to force EU agricultural markets open. Even though both sides are settling their airplane issues through a global institution (the WTO), the trade narrative that could surprise markets next is that the U.S. and the EU may be more willing to argue than negotiate over automobile tariffs and agricultural products.

However, there are positives and signs of stability in the economy and the financial markets. Even as equity volatility has spiked, credit spreads and rate volatility have remained in check, while expectations for Federal Reserve rate cuts grind higher. Historically, the economy and the equity market have continued to make gains during a manufacturing slump. We believe that this historical pattern is relevant today as job growth and consumer sentiment are still positive.

Signs of more near-term equity market weakness

The main focus on the trade front likely will be the U.S.-China trade talks in mid-October and new U.S. tariffs on Chinese consumer goods (December 15). Any interim deal could lift equity markets, but it could also be a sign that both sides fear more economic weakness at home. However, any breakdown in the talks could deliver a new and sustained downturn to equities and yields. U.S.-EU talks later this year could have the same effect.

The consumer remains a main economic actor to watch. Wage growth and household spending remain solid lines of defense that will be difficult to breach. An imminent recession still seems unlikely. Nevertheless, today's elevated sentiment could be vulnerable to cracking under continuous uncertainty. We may not be quite there yet, but further disappointing economic data may be testing the limits of what markets can bear. Fasten your seatbelts; there could be more choppiness ahead.

The choppiness is likely to reinforce some recent market trends. Supportive Federal Reserve policies and abundant liquidity have kept the stock market near record highs despite trade-war escalation. Yet, each successive high in the S&P 500 Index has come on dramatically lower momentum, amid increasing volatility, and narrower leadership. Defensives and high-quality sectors and issues have led the market in recent weeks, while other cyclical or low quality stocks have lagged. Lower rates and poor performance elsewhere in the market have lifted the overall equity risk premium, lessening risk at the index level but concentrating it in crowded outperformers.

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.

Definitions

An index is unmanaged and not available for direct investment.

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.

General Disclosures

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS' opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company. CAR 1019-00919