

## Market comment for the week ending December 7, 2018

### Spooked!

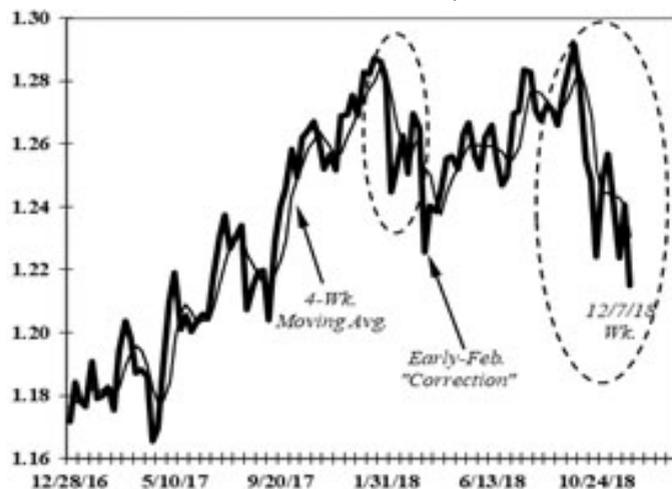
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**Requiem for a bull market?** A roller-coaster week for the stock market left the S&P 500 Index within a hair of its November 23 low. The worst December start in a decade risks upending what historically has been the market's second-best month of the year, a reminder of the limits to seasonal strengths. Monday's short-lived trade-truce rally gave way to a host of concerns over trade and Federal Reserve (Fed) policy and geopolitical concerns atop uncertainties over the outlook for economic growth, inflation, and interest rates. The broad, deep sell-off extended across 9 of the 11 S&P 500 sectors and 115 of the benchmark's 126 constituent industry groups in volatile trading lifting the VIX fear gauge above its long-term average most of the week. Yield-sensitive utilities and real estate bucked the sell-off, supported by a bond rally sending the yield on competing 10-year notes to a late-August low of less than 2.85%. Bottom-dwelling financial services were hurt by those same declines, threatening banks' net interest margins and profitability. Close behind were trade-sensitive industrials, materials producers, and technology, hurt by the worrisome aftermath of last week's trade truce with China.

Treasury gains outpaced those in non-Treasury sectors, as they often do in a flight-driven rally, lifting yield premiums on corporate and high-yield securities to August and December 2016 highs, respectively. Rising Treasury prices were part of a broad rally in haven assets, led by gold given a rare opportunity by dollar and interest rate declines to show its safe-haven credentials. Risk-off trading left prices on a narrow basket of haven assets at a September 2017 high against a similar portfolio of risk assets hurt most by the S&P 500 Index's deep dive.

#### "Risk" assets seesaw lower against "safe-haven" counterparts on trade, other worries

Ratio of total return indexes, risk/safe haven portfolios, 12/21/05=1.00



Sources: Data from BofA Merrill Lynch, Inc.; Bloomberg Financial News, Inc.

Heightened volatility and widening yield premiums have lifted financial stress to an eight-month high by one measure, signaling less ample credit supportive of risk assets. For stocks, the lights slowly are going out on a record, nine-year bull market. Most major benchmark indices are well into correction territory, with the U.S. Nasdaq and dollar-based emerging market indices already beyond the bear-market threshold of a 20% decline. The silver lining to steep market declines is that excesses are being wrung from many of them. For example, the S&P 500 Index's forward price-earnings (P/E) multiple, at a September 2015 low of 15.1 times projected earnings over the next 12 months at Friday's close, was the narrowest gap in over four years. However, seemingly attractive valuations—and a less worrisome outlook for interest rates—may be less an opening for renewed market gains than an increased risk premium for weaknesses and uncertainties confronting the market.

Among the most immediate of these is the trade outlook with China after a one-two punch suffered by last week's truce agreement, first from the Canadian arrest for U.S. extradition of Huawei's CFO and the follow-on threat by White House advisor Navarro of increased, broader-based tariffs on Chinese goods without progress during the 90-day negotiating period. The specter of growth-sapping tariffs raised to 25% from the current 10% has aggravated worries over the economic and earnings outlook already stirred by slowing global growth and recent oil-price declines. China's ability to separate trade from technology-oriented sanctions has been viewed by some as the key to keeping trade talks with the U.S. on track. Doing so has been complicated by U.S. national security concerns raised by China's trophy multinationals Huawei and ZTE before it—an issue striking at the heart of China's system of state capitalism. As for oil, Friday's price rebound, triggered by an announced 1.2 million barrel-per-day cut in OPEC and other major-producer output, will be tested by slowing global growth weighing on oil demand and by increased U.S. output in the second half of 2019 as new Permian pipeline capacity online. Success in shoring up prices will help shape the trajectory of inflation, interest rates, and market risk tolerance.

Vying for top billing with trade and oil as a market concern have been the outlook for interest rates and its implications for economic growth. The market signaled its more dovish spin on Fed policy by lowering rate-increase probabilities this year and next, to 67% for a Fed rate hike on December 19 from 78% at the end of November and to 33% from 42% for even one more rate increase next year. Convergence of short- and longer-term interest rates, historically preceding economic recessions, has aggravated concern over signs of slowing growth. Adding to recession worries have been last week's partial inversion of an already flattening yield curve, as the rate on the 2-year Treasury note moved above that on the 5-year maturity.

Two considerations may help alleviate inversion jitters as short-term rates continue their assault on longer-dated yields. First, a seemingly reliable link between curve inversions and economic recessions masks a highly variable lag between the two, ranging from a few months to more than two years. Moreover, stocks gained in five of the past seven intervals between curve flattening and a recession. Second is the unusual, bull-market flattening driving this interest rate cycle, as the usual broad-based, late-cycle rise, paced by shorter-dated maturities, is replaced by bond yields propelled toward lower short-term rates by a combination of increased safe-haven demand and inflation expectations driven to a one-year low. Lingering disinflation—a hallmark of this decade-long growth cycle—has been at least as important as recent signs of slowing growth in suppressing inflation expectations, raising questions about the recession risks posed by a threatened yield-curve inversion.

**Late-cycle blues.** Strengths in a generally mixed batch of economic data on the week weren't enough to counter an increasingly guarded view of the outlook. Market caution was consistent with a third-straight weekly decline in the Citigroup Economic Surprise Index, measuring actual versus expected results in the data releases, and with further slippage in the Atlanta Fed's real-time fourth-quarter growth forecast to 2.4%. Soft purchasing-manager survey reports on November manufacturing and nonmanufacturing activity each posted unexpected increases from already strong levels. Manufacturing's Achilles' heel is support from aggressive inventory building, set to slow amid signs of moderating growth in underlying demand here and abroad. Strength in dominant consumer spending remains intact, underscored by a solid auto-sales pace last month raising its rolling three-month average to a December 2017 high. Housing also got a rare bit of good news from a third-straight rise in home-purchase applications during the November 30 week, to a five-month high, supported by recent mortgage-rate declines and improved affordability. However, a widening October foreign trade deficit added to the pressure on growth. Elsewhere, the Fed's Beige Book survey of regional economic conditions signaled modest-to-moderate growth in most regions and greater outlook caution amid trade and interest rate uncertainties.

The week's big news centered on emerging signs of weakness in a still-vibrant labor market, which, if sustained, poses a threat to consumer confidence and spending. Initial jobless claims turned the corner with a fourth-straight increase in its four-week moving average during the December 1 period to an eight-month high, accompanied that same day by news of a mildly disappointing November ADP survey of private-sector employment. Both served as a prelude to a glass-half-full/half-empty jobs report strong enough to provide cover for the Fed's December 19 rate hike. The report featured a steady unemployment rate at a historically low 3.7%, a disappointing payroll increase still leaving the rolling three-month average well above the 100,000–125,000 rate needed to make further inroads against unemployment, and wage increases holding steady at just over 3%. Countering strengths in the jobs report were slippage in the average workweek and an increase in the number of part-time workers preferring to work full time.

November inflation reports move to center stage at midweek, giving way to the month's top-tier retail sales and industrial output data on Friday. Also on tap will be a \$78 billion, three-part sale of 3-, 10-, and 30-year Treasury securities Tuesday through Thursday. Recent oil-price declines likely will suppress the CPI, joining the core component (that is, excluding food and energy) in moving below the Fed's 2% target rate. Renewed signs of disinflation, atop slower, more narrowly based growth, have given investors—and, more recently, the Fed—pause in their outlook for multiple rate increases between now and the end of next year. Overseas, a critical Brexit vote by the British parliament on Tuesday along with Thursday's equally important policy meeting of the European Central Bank (ECB) will draw much attention from investors seeking clarity on both issues. A likely defeat of Prime Minister May's withdrawal agreement could set the stage for an unexpectedly soft Brexit, maintaining close ties to the European Union after any future split. The ECB policy announcement will be scrutinized for wavering in the central bank's determination to end its program of quantitative easing (or QE) at the turn of the year despite signs of slowing growth within the region.

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