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FIRST ANALYSIS

Institute Alert

NEWS OR EVENTS THAT MAY AFFECT YOUR INVESTMENTS

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Selloffs and Slowdowns

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

Paul Christopher, CFA
Head of Global Market Strategy

Key takeaways

- *2018 is ending with concern and confusion among investors as various worries create fluctuations across global investment markets.*
- *We believe recession risks for 2019 are overpriced within today's markets.*

What it may mean for investors

- *Our recommendations are that investors keep investment goals front of mind, manage risk, and make cash a tool—not as a goal.*

2018 is ending with concern and confusion among investors as the AAII Bull & Bear survey last week showed the highest bearish reading since 2009. The explanations last week were familiar to our readers. Investors focused keenly on the fluctuating probability of a no-deal Brexit, falling oil prices, and weak economic data from Europe and China. Looking ahead, this week's Federal Reserve policy meeting will be a particular focus. There is concern across global markets that policy makers may be raising rates too quickly. U.S. economic data were very strong, and U.S.-China trade headlines were marginally positive (including China potentially dropping retaliatory tariffs on U.S. autos), but risk-off sentiment continues to dominate.

Start by weighing all the information

During turbulent times, it's usually best to consider a wide range of market information, starting by looking through recent headlines to core fundamentals—including corporate positive profit margins and profit growth, ongoing U.S. deregulation, and oil prices as more a source of consumer stimulus than stress. Overseas, China's slowdown is in focus, but Beijing's various stimulus measures should gain traction early in 2019. In an added show of determination, China has rolled back (at least temporarily) some earlier reforms to support their economy.

That said, it also helps to account for other information. First, in our opinion, the concerns do have merit, to a point. Since the end of 2017, we have said that investors should anchor their portfolio strategies in a late-cycle framework that anticipates lower returns than those of the past nine years. Rising wages and other input costs eventually may thin profit margins. Rising interest rates make credit less affordable and create stress for lower-quality bonds. High-yield spreads over U.S. Treasuries have widened in the past two months. For now, we believe, these trends are likely to slow the U.S. economy's pace in line with its nine-year trend but are probably (at least) a year away from triggering a recession.

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Second, the persistent worries can entrench negative sentiment. The longer the selloff persists, the more persuasion the markets may demand to show a durable improvement in sentiment. That evidence probably includes sustained advances on rising trade volume as well as broader advances across equity issues. So far, we are seeing encouraging signs. For example, some of the largest tech companies have held above their November 20 lows, and emerging markets, which have lagged U.S. markets all year, are starting to outperform.

Taken together, the last two considerations do not overwhelm our positive growth outlook but may require more attention to risk and patience from investors. Our conviction remains that current commodity and equity market pricing is too pessimistic. Stated clearly, we believe recession risks for 2019 are overpriced within today's markets.

Historical perspective can help

Let us draw a parallel to a similar period three years ago. Global markets deteriorated quickly in late 2015. Cyclical equities, emerging markets, and Europe were all down 25%-30%, and U.S. high-yield credit spreads widened by more than 3.5 percentage points. The U.S. economy was slumping, apparently towards the next recession. In early 2016, however, the Federal Reserve paused on hiking rates; the U.S. dollar peaked; and Chinese stimulus took hold. Growth rebounded.

We are not implying that 2016-2017 should, therefore, repeat in 2019; but today's growth concerns again seem overdone as they were in 2015-2016. The lesson is that a slowing economy can trigger a selloff, but the fears have to materialize in order to produce a bear market (i.e., a loss of 20% or more). To be clear, we do not believe the fears will materialize into a bear market in 2019.

What investors can do now

Keep investment goals front of mind: From March 2009 – November 2018, the S&P 500 Index gained 361% on a total return basis—even with most of the latest correction. A portfolio with similar equity returns could leave a portfolio so concentrated in equities that total risk far exceeds its original goal[1]. Meanwhile, the investor is almost 10 years older and may have less risk appetite today. An investor, who can be patient as the current selloff resolves itself, could review the target risk for the portfolio. This applies also to relatively new investors: Even an equity exposure that dates only from January 2016 has seen the S&P 500 Index total return mark 43%, and risk may be higher than intended.

Manage risk: We expect higher global equity and commodity prices into year-end 2019. However, the aging cycle should create more volatility and opportunities to rebalance—i.e., to sell at high levels and to reallocate to our more favored sectors or markets. For example, should U.S. large-cap equities rebound and take the S&P 500 Index into our 2019 target range (2,860-2,960), investors should have a chance to lighten large-cap

[1] An index is unmanaged and not available for direct investment. *Index returns do not represent fund performance.*

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exposure and to reallocate. In sectors, we favor cyclical sectors (Industrials and Financials), as well as Information Technology, Health Care, and Consumer Discretionary. We would reallocate from Utilities (which have outperformed the S&P 500 Index during the correction), Real Estate, and Communication Services. Among other equity markets, we favor U.S. mid caps, and we particularly favor emerging markets.

Let cash be a tool, not a goal: Rebalancing should generate cash, but rising interest rates can tempt investors to leave the money in cash alternatives. We favor not treating cash buildup as an objective but as a means to deploy it. As the uncertainties fade, invested cash has a greater potential to outperform a cash position. While markets remain turbulent, we favor deploying cash incrementally. Patience and a disciplined plan can make this step most effective.

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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. **Mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Communication services** companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. Risks associated with the **Consumer Discretionary** sector include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players; reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. Investing in **Financial** services companies will subject a investment to adverse economic or regulatory occurrences affecting the sector. Some of the risks associated with investment in the **Health Care** sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio's performance. **Real estate** investments have special risks, including possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks smaller, less-seasoned companies, tend to be more volatile than the overall market. **Utilities** are sensitive to changes in interest rates, and the securities within the sector can be volatile and may underperform in a slow economy.

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