WELLS FARGO

INVESTMENT INSTITUTE

August 15, 2019

From the desk of Darrell L. Cronk

State of the Markets

The Cold Winds of August—Signals To Watch

Even by August standards, when market liquidity declines and volatility often rises, this month is delivering a larger than normal amount of unusual events. The escalation of the U.S.-China trade conflict on August 1 and subsequent delay of newly proposed tariffs on August 13; the U.S. Treasury's labeling of China as a currency manipulator, the first use of that designation in 25 years; and unrest and protests in Hong Kong shutting down major transportation arteries—coupled with already slow global growth—all have markets concerned about the path forward.

Asset prices are reacting with a burst of chilly August wind for investors. Gold prices are at six-year highs, oil prices are setting new 2019 lows, interest rates continue to fall globally, and Germany's entire yield curve is now negative for the first time in history. Closer to home, the 2-year/10-year U.S. Treasury yield curve has inverted for the first time since 2007. Equity prices have remained somewhat resilient, at the time of this writing, only down approximately 6-7% from early August all-time highs. Many questions we are receiving center around what signals investors should be watching these days. We have our eyes on five Cs.

China: China has been at the epicenter of most of the disruptive news. What began in January 2018 as a relatively straightforward tariff on imported washing machines from China soon could expand to some form of tariff on almost every Chinese import. Tariff escalation risks continue to aggravate the current weakness in global manufacturing, with risk now threatening to infiltrate the resilient service sector and labor market. Retaliation against U.S. technology companies by China as a response to additional U.S. tariffs could bring great supply-chain disruption. Most recently, markets and global leaders are closely watching for any military escalation of Hong Kong protests, given its status as a major global financial hub.

Currencies: Concern is growing that currencies have become the next front in the escalating U.S.-China trade conflict. The Chinese yuan "cracked 7" recently, and the U.S. Treasury officially labeled China a currency manipulator. The Chinese government increasingly believes that the benefits of using this depreciation as a more prominent policy tool outweighs the costs, and we see China's move through 7 as a major policy shift. We do not believe this latest skirmish will end in a currency war, but in our view, this is a very important signal that cannot intensify any further without an abrupt capital market reaction.

Curves and credit: Bond yield-curve inversions have historically pre-dated the end of expansion cycles by 10-22 months. The U.S. and UK yield curves have recently inverted, reflecting a view that monetary policy remains too tight versus growth expectations. Credit spreads thus far have remained relatively well behaved. Any material widening would suggest risk of rising delinquencies or defaults within the investment grade or high-yield bond market. More ominous credit-spread signals are not flashing currently, but conditions can change quickly, so we remain particularly watchful. So far, strain has shown up in equity sectors and industries with more challenged growth and leveraged financial statements—Energy, Retail, and select areas of Health Care. Risks around earnings, credit-rating downgrades, and defaults often rise in challenged growth environments—this is true even if borrowing costs drop, as they have been.

Consumer: The consumer has been and remains the bright spot for this recovery. Last quarter showed strong consumer spending trends helping to offset weakness in manufacturing. Recent drops in borrowing costs and oil and gas prices; a strong labor market; and rising wages are all positive tailwinds for the consumer. Key consumer indicators we watch closely include auto sales, mortgage applications, retail sales, and unemployment claims. All have remained steady thus far but will likely see further pressure during the third quarter as growth continues to slow. A strong and healthy consumer is paramount to extending this business cycle.

Confidence: Both business and consumer confidence have remained at elevated levels during most of the first half of 2019, notwithstanding the impacts of trade and geopolitical events. By comparison, however, consumer confidence has remained more resilient than business confidence as earnings and capital spending trends have slowed. If a confidence shock were to occur during the second half of 2019, it could pose a threat to the current cycle. Historically the best indicator—and what we watch most closely for signs of strain—is a material change in confidence on a relative basis. While we would expect some decline this quarter in confidence overall, given recent news events, any rapid decline would be more consistent with end-of-cycle conditions. So far this has not occurred, but it is an important leading indicator that we need eyes fixated upon.

Financial markets continue to press to the downside on all of these indicators with some, like yield curve inversion, triggering more ominous signals. With strong year-to-date gains, we believe investors should use this strength to position more defensively and for more challenging times ahead.

- Stay up in quality across equities and fixed income.
- Reduce exposure to more risky asset classes where fundamentals are deteriorating.
- Be patient putting new cash to work.

Darrell L. Cronk, CFA

President of Wells Fargo Investment Institute

Chief Investment Officer for Wealth and Investment Management, Wells Fargo & Company

Darrell L. Cronk is the president of Wells Fargo Investment Institute, which is focused on delivering the highest quality investment expertise and advice to help investors manage risk and succeed financially. Mr. Cronk leads global investment strategy and research including equity, fixed income, real assets, and alternative investments. He also serves as chief investment officer for Wealth and Investment Management, a division of Wells Fargo & Company that includes Wells Fargo Private Bank, Wells Fargo Advisors and Abbot Downing.

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. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk.

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 Wealth and Investment Management, a division within the Wells Fargo & Company enterprise, provides financial products and services through bank and brokerage affiliates of Wells Fargo & Company. Brokerage products and services offered through Wells Fargo Clearing Services, LLC, a registered broker-dealer and non-bank affiliate of Wells Fargo & Company. Bank products are offered through Wells Fargo Bank, N.A.

Abbot Downing, a Wells Fargo business, offers products and services through Wells Fargo Bank, N.A. and its various affiliates and subsidiaries.

Wells Fargo Private Bank offers products and services through Wells Fargo Bank, N.A. and its various affiliates and subsidiaries.

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 0819-02495