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October 23, 2018

Disappointing Earnings Add to Market's List of Worries

Investment Strategy Team

Key takeaways

» *Equity markets are down over the past month and the economy's transition from a low-growth, low-rate environment to a higher-growth, higher-rate environment has led to an uptick in uncertainty and volatility.*

» *While sentiment may worsen in the short-term, we remain confident in our view that global economic growth remains solid and should drive continued corporate earnings growth at a slower, but more sustainable pace.*

What it may mean for investors

» *In our opinion, investors can take advantage of the pullback in equities by adding to exposure in our favored areas, large-cap, mid-cap, and emerging markets, in line with recommended allocations.*

Large-cap U.S. stocks (the S&P 500 Index) are down more than 8% from their all-time high on September 21, with the Materials, Financials, and Industrials sectors all leading the Index lower. We believe, much of the weakness can be attributed to factors that are caused by the markets and economy transitioning from a low-growth, low-rate environment to a higher-growth, higher-rate environment.

The decline has been driven by a myriad of domestic concerns, including tightening monetary policy, a drop-off in the pace of corporate earnings growth, upcoming midterm elections in the U.S., and a rise in long-term interest rates.

There are international worries as well: the potential for trade protectionism, a possible slowdown in global growth, a stand-off between the Italian government and the European Commission over a budget deficit, and concerns about stability in China and the emerging markets more broadly.

The main bright spot for U.S. equity investors thus far in 2018 has been the jump in corporate earnings growth (augmented by a cut in the U.S. corporate tax rate) as part of the most significant tax reform since 1962.

While many market participants expected the rate of earnings growth to slow, recent guidance (including this morning) from large corporations about future earnings has been more cautious than anticipated.

Specifically, large companies, especially those in the Industrials and Materials sectors, have reported that they are beginning to feel their profit margins come under pressure as the impacts of rising materials costs (the cost of benchmark steel is up 30% this year, part of which can be attributed to tariffs); rising labor costs (the unemployment rate continues to drop and wages tick up); rising freight and logistics costs (due to bottlenecks in the supply chain); and a strengthening U.S. dollar (which reduces sales and earnings from abroad) feed through at the same time that their end-demand seems to be slowing.

For some time, we have anticipated that corporate earnings would slow as the impact of tax cuts began to wane, while we continue to see constructive levels of corporate earnings growth, driven by a solid economy and wage growth that should remain contained.

We also believe that the Federal Reserve (Fed) will be measured in its interest rate hikes; trade and tariff issues will have a favorable resolution; midterms could actually be a positive catalyst (once the uncertainty lifts); and long-term interest rates at current levels do not pose a major threat to equity markets.

We also have a positive outlook on growth outside the U.S., which we believe should rebound in 2019, and believe that emerging market economies remain in solid shape. As a reminder, we recently upgraded both emerging market equities and U.S. dollar-denominated emerging market debt to favorable ratings.

In our opinion, investors can take advantage by slowly adding exposure to equities, especially in our favored areas of emerging market equities, large-cap equities, and mid-cap equities, in line with recommended allocations. We also continue to view Financials and Industrials as most favorable and Health Care and Consumer Discretionary as favorable.

From a technical standpoint (see chart below), we would expect support at the summer lows (2690-2710), and the spring lows (2580-2600).

S&P 500 Index with Technical Support Levels

Sources: Bloomberg, Wells Fargo Investment Institute, October 23, 2018. The moving average looks at the average price of a particular stock (or sector, market or asset class) over a rolling time period which creates a smoothed price trend line, an indicator used in technical analysis. Technical analysis is only one approach used to analyze stocks. The S&P 500 is a market capitalization-weighted index generally considered representative of the US stock market. An index is unmanaged and not available for direct investment.

Risk Considerations

All investing involve risks, including the possible loss of principal. There can be no assurance that any investment strategy will be successful. Investments fluctuate with changes in market and economic conditions and in different environments due to numerous factors some of which may be unpredictable. Each asset class has its own risk and return characteristics which should be evaluated carefully before making any investment decision. 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.

Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities. Mid-cap stocks are generally more volatile, subject to greater risks and are less liquid than large company stocks.
Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. 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 the **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. **Materials** industries can be significantly affected by the volatility of commodity prices, the exchange rate between foreign currency and the dollar, export/import concerns, worldwide competition, procurement and manufacturing and cost containment issues.

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