WELLS FARGO
INVESTMENT INSTITUTE

Market Commentary

WEEKLY PERSPECTIVE ON CURRENT MARKET SENTIMENT

The Stock Market Doesn't Believe the Fed

September 7, 2017

Scott Wren
Senior Global Equity Strategist

Last Week's S&P 500 Index:
+1.4%

Key Takeaways

» *The Federal Reserve (Fed) has been hinting all year that there would be a total of three interest rate hikes this year and three in 2018. Market confidence in that strategy has been waning as inflation eases and a number of economic reports have come in below expectations in recent months.*

» *Equity investors are looking for comments from our central bankers following this month's monetary policy meeting to show less commitment toward the implied pace of rate hikes in 2018.*

For virtually all of 2017, Fed Chairwoman Janet Yellen and other Fed officials have been hinting to the financial markets that there will likely be three interest rate hikes in 2018. They also hinted, coming into this year, that there would be the same number in 2017 as our central bankers continue down the long road to "normalizing" interest rates. But you can bet that there has been much debate inside the hallowed halls of the Fed over what to do now since much of the economic data reported over the last few months (outside of the recent second-quarter upside gross domestic product (GDP) revision) has come in below expectations. And probably most importantly, the Fed's favorite gauge of inflation, "core" PCE (Personal Consumption Expenditures), has fallen back to a feeble year-over-year increase of just 1.4 percent. The Fed has been telling market participants it expected inflation to reach the targeted 2 percent rate in the "intermediate" term for the last seven years. But it just hasn't happened.

Remember, the Fed has a dual mandate. Its two goals are price stability (modest inflation) and full employment (a moving target, in this strategist's opinion). Right now, inflation is a long way from our central banker's targeted goal. It could take quite some time (maybe even years) to reach the Fed's inflation target from the current level.

The readings on the labor market are also in question. Some would argue that with a 4.4 percent unemployment rate, the U.S. is already at "full employment" and the labor market is quite "tight." That is up for debate, at least in this strategist's opinion. The reason? It largely boils down to sluggish wage growth. If the job market was as tight as some market participants believe, wage growth should be picking up in a meaningful way. And that just isn't the case, as last Friday's employment report showed. In that report, average hourly earnings, an indicator Chair Yellen closely watches, rose just 2.5 percent over the last year. The average American is not seeing much in the way of increased buying power.

We continue to hold the view that the Fed will likely increase the fed funds target rate at the December meeting. However, the financial markets are not in agreement that three rate hikes next year are a high-probability event. Based on fed funds futures contracts being traded in the market, investors do not see a better than a 50 percent chance the Fed will raise rates at any meeting between now and June 2018. These futures contracts indicate that traders believe 2018 offers a much lower likelihood of three rate increases next year than our central bankers have been hinting. In fact, when looking at the futures contracts, traders give only a 65 percent probability that the fed funds rate will be higher than the current 1-1.25 percent target range by the end of next year.

So while our central bankers have been suggesting for many months that four rate hikes are likely between now and the end of next year, the financial markets are not pricing in a high likelihood of that actually happening. That has helped equities. Simply put, the stock market doesn't believe the Fed.

Risk Considerations

Forecasts are not guaranteed and are subject to change.

All investing involves risks including the possible loss of principal. 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.

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 0917-00576