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Lingering Concerns Finally Catch Up to Markets

Investment Strategy Team

Key takeaways

» *The recent volatility is the result of well-known concerns finally catching up to affect the markets' psyche—and may not be over.*

» *The fundamental outlook for equity markets remains constructive based on a solid economy, continued earnings growth, and reasonable valuations.*

What it may mean for investors

» *We believe that investors can take advantage by 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.*

After the market sell-off in February, it took time for markets to regain their footing. But since June, markets have had an uninterrupted run higher, and it's been hard to find anything that has worried investors. This complacency has occurred amidst the backdrop of rising trade tensions, interest rates and oil prices, concerns about the future trajectory of earnings growth and monetary policy, and greater uncertainty caused by politics in both the U.S. (midterm elections) and internationally (Italian budget negotiations). We are not surprised by the uptick in volatility toward more normal levels. Given the current downside momentum markets are exhibiting, along with the technical and psychological damage that has been done, it is too soon to say that the pullback is over.

That being said, we believe markets and investors will eventually come to the following realizations:

- The economy remains on solid footing (supported by higher fiscal spending).
- Monetary policy, when viewed through the lens of history, remains accommodative.
- Equity valuations remain reasonable.
- Longer-term interest rates are going up for the right reasons (better growth and a more normal inflationary environment).
- Corporate earnings growth should decelerate to a slower, but more sustainable pace.
- Credit markets/spreads remain well behaved.
- We are entering a seasonally strong period from October through May.
- Our work also shows that markets tend to do well following the conclusion of midterm elections—all of which should provide support for equity markets and help us find a bottom.

For the reasons listed above, we would view the recent weakness as part of the equity market's transition from reflecting a low-growth/low-rate environment to a higher-growth/higher-rate environment and a correction within a bull market, rather than the end to this bull market. Investors can take advantage by adding exposure to equities, especially in our favored areas: emerging market equities, large-cap equities, and mid-cap equities, which are in line with recommended allocations. As a reminder, our favored sectors within U.S. large-cap equities remain more cyclical areas such as Financials, Industrials, Consumer Discretionary, and Health Care.

From a technical standpoint (see chart below), the S&P 500 Index remains in an uptrend, and we would look to the 200-day moving average (2765) and the summer lows (2690-2713) as potential areas of support where buyers may find value and step in, in a more meaningful way. If these levels fail to hold, a retest of the spring lows becomes more likely (2538-2620). However, we would view that as a low probability event. It is also important to note that although we expect markets to rebound, a more normal volatility environment is here to stay, and we would advise investors to ensure their investment plans and portfolios are up to date.

S&P 500 Index with technical levels

Sources: Bloomberg, Wells Fargo Investment Institute, October 11, 2018. For illustrative purposes only. The moving average looks at the average price of a particular stock (or sector, market or asset class) over a rolling time period. This creates a smoothed price trend line, which is an indicator used in technical analysis. There is no assurance that these movements or trends can or will be duplicated in the future. 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. Past performance is no guarantee of future results.

Risks 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. Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. 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.

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 an 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.

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