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Mixed Signals from the U.S. Economy

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Key takeaways

» *Increased U.S. market volatility and negative equity returns late in 2018 stood in sharp contrast to continued solid economic fundamentals.*

» *Concerns do exist surrounding trade policy, slowing global growth, and central-bank actions. Yet, we anticipate eventual resolution of trade conflicts, and we are seeing the possibility of greater central-bank patience.*

What it may mean for investors

» *We believe that U.S. economic growth remains solid, but we forecast slower 2019 economic growth than in 2018. As such, we remain favorable on U.S. Large Cap and Mid Cap Equities and U.S. Short Term Fixed Income.*

The fourth quarter was tough for U.S. equity markets. Volatility increased significantly, and stock-market returns were strongly negative. All of this was in the face of still solid economic fundamentals. While markets are forward looking, they also are vulnerable to investor sentiment and bouts of irrational behavior, brought on by external forces. Although U.S. growth had been strong, supported by solid household spending and business investment, investor concerns were rising about the trade conflict with China continuing to escalate; a further slowing in global growth; and potential over-tightening by the Federal Reserve (Fed). Some recent economic data has suggested a softening in economic expansion is indeed taking place. However, we believe that the conditions are set for continued solid, yet slowing, U.S. economic growth.

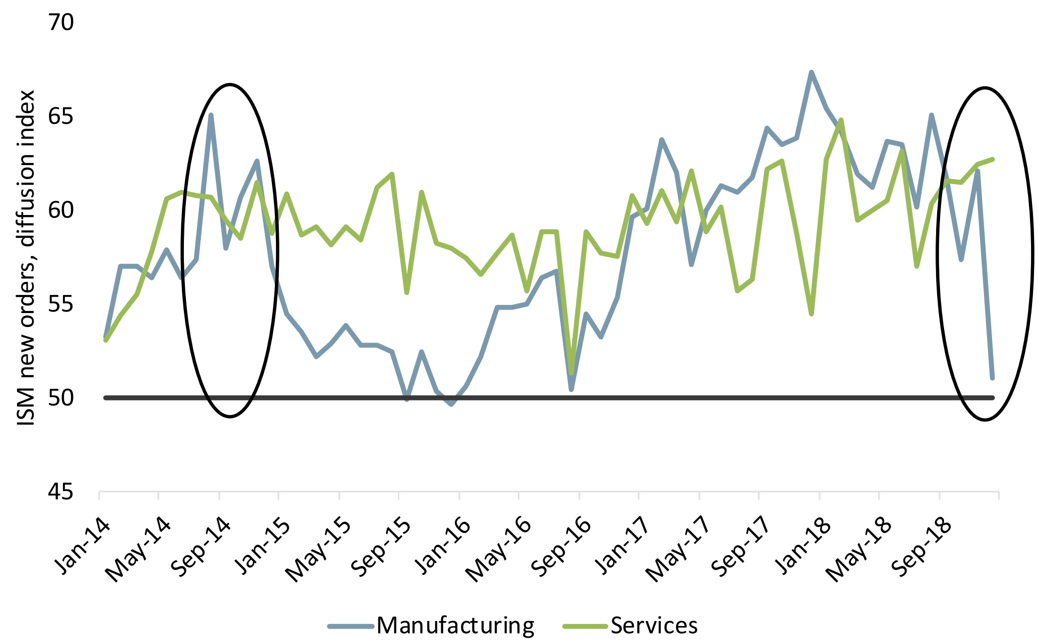
What are the underlying economic signals telling us?

As of the third quarter in 2018, the U.S. consumer accounted for about 70% of activity that contributed to economic growth. The primary support of continued consumer spending is the labor market. When the U.S. labor market is strong, as it is now with solid payroll growth and low unemployment claims, many consumers feel comfortable spending and driving continued economic growth. Business investment has slowed, but remained at a solid 6.6% year-over-year pace of growth in November.[1] Businesses likely have slowed the pace of investment in the face of concerns over trade, global growth, and Fed policy. Yet, this growth rate remains higher than over most of the recovery, and it could rise if positive resolutions are achieved in trade or Fed policy.

[1] Using capital goods new orders, nondefense, excluding aircraft, as a proxy for business investment.

The Institute for Supply Management's (ISM) measures of new order activity in the manufacturing and services sectors reflect the relative strength in consumer spending compared to business investment. While these are surveys and not hard measures of actual economic activity, they serve as a good proxy. Chart 1 shows this divergence in activity in the fourth quarter. The ISM index level for the services sector remains elevated and is actually improving. In contrast, manufacturing has posted a sharp contraction.

Chart 1. Service sector is still supported by higher consumer spending



Sources: Institute for Supply Management, Bloomberg, and Wells Fargo Investment Institute, January 10, 2019. Monthly data from January 2014 through December 2019. Series represent diffusion indices of new orders for the manufacturing and nonmanufacturing (services) sectors (see end of the report for definitions). A level greater than 50 represents expansionary conditions.

This is similar to the divergence seen in late 2014 and in 2015. At that time, threats of a slowdown in Chinese growth and a sharp decline in the price of oil raised concerns that the end of the cycle could be approaching. These are similar to the events that have recently rattled markets and that may have contributed to slowing business investment in the fourth quarter. At the same time, solid levels of consumer spending supported healthy levels of economic growth. We believe that the labor market remains strong enough to continue supporting high levels of consumer spending and driving still durable U.S. economic growth, even with slower business investment activity.

In line with our expectation of slightly slower global growth and lower business investment growth, we recently reduced our 2019 U.S. gross domestic product (GDP) target from 2.7% to 2.5%. Although this means that growth is expected to slow, this level of growth remains above trend and far from recession. We continue to believe that the U.S. consumer will support solid growth. Business investment may yet reaccelerate, assuming positive resolutions to outstanding concerns.

Investment implications

Risks do exist for our outlook. Although trade negotiations with China, and now the European Union, appear to be moving in a positive direction, a surprise breakoff in negotiations or rise in tariffs would be negative for U.S. growth and markets. Global growth forecasts have been reduced for 2019, and a further material slowing would have a negative effect on U.S. growth through additional reduced investment and lower exports. The Fed has acknowledged the effect that rate hikes have had on market volatility, business investment, and market-sensitive industries (such as housing and autos). Further, Fed members appear to be open to exercising patience with further rate increases. While we still believe that the Fed will increase rates twice in 2019, the timing may be later in the year than was originally anticipated.

Yet, these risks do not factor into our most likely outcome for the U.S. economy in 2019. As such, we still believe that the U.S. economy will grow at a solid, but slower, pace than in 2018. In this environment, we still believe that the cyclical expansion will continue, and we favor the Consumer Discretionary, Industrials, and Information Technology sectors. We also have a positive view of the Health Care and Financials sectors. Although the Fed seems to be acknowledging increased market volatility and nonthreatening levels of inflation, we expect the Fed to continue raising interest rates in 2019. Thus, we still maintain our favorable view on short-term fixed income in the face of gradually rising rates.

Economic Calendar

Date	Country	Report	Estimate	Previous
1/15/2019	JAPAN	Machine Tool Orders YoY	--	-17.00%
1/15/2019	JAPAN	Tertiary Industry Index MoM	-0.50%	1.90%
1/15/2019	US	Empire Manufacturing	--	10.9
1/15/2019	US	PPI Final Demand MoM	--	0.001
1/15/2019	FRANCE	CPI YoY	1.60%	1.60%
1/16/2019	UK	CPI YoY	2.10%	2.30%
1/16/2019	US	MBA Mortgage Applications	--	--
1/16/2019	US	Retail Sales Advance MoM	--	0.002
1/16/2019	US	Import Price Index YoY	--	0.007
1/16/2019	US	Export Price Index YoY	--	0.018
1/16/2019	US	Business Inventories	--	0.006
1/16/2019	US	NAHB Housing Market Index	--	56
1/16/2019	US	Total Net TIC Flows	--	$42.0b
1/16/2019	US	Net Long-term TIC Flows	--	$31.3b
1/17/2019	EUROZONE	CPI YoY	1.60%	1.90%
1/17/2019	BRAZIL	Economic Activity MoM	--	0.02%
1/17/2019	JAPAN	Natl CPI Ex Fresh Food YoY	0.80%	0.90%
1/17/2019	US	Housing Starts MoM	--	0.032
1/17/2019	US	Building Permits	--	1328k
1/17/2019	US	Housing Starts	--	1256k
1/17/2019	US	Initial Jobless Claims	--	--
1/17/2019	US	Continuing Claims	--	--
1/17/2019	US	Philadelphia Fed Business Outlook	--	940.00%
1/18/2019	EUROZONE	ECB Current Account SA	--	23.0b
1/18/2019	US	Industrial Production MoM	--	0.60%
1/18/2019	US	Manufacturing (SIC) Production	--	0.00%
1/18/2019	US	Capacity Utilization	--	0.785
1/18/2019	US	U. of Mich. Sentiment	--	--
1/20/2019	CHINA	GDP YoY	--	6.50%
1/21/2019	GERMANY	PPI YoY	--	3.30%
1/21/2019	SOUTH KOREA	GDP YoY	--	2.00%
1/22/2019	GERMANY	ZEW Survey Expectations	--	-17.5
1/22/2019	US	Existing Home Sales MoM	--	1.90%
1/22/2019	US	Existing Home Sales	--	5.32m

Source: Bloomberg as of January 11, 2019.

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.

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. 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.

Definitions

Institute for Supply Management (ISM) Manufacturing Index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders and supplier deliveries.

Institute for Supply Management (ISM) Non-Manufacturing Index is based on surveys of more than 400 non-manufacturing firms by the Institute of Supply Management. The ISM Non-Manufacturing Index tracks economic data.

An index is unmanaged and not available for direct investment.

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