WELLS FARGO
Investment Institute

Weekly perspective on current market sentiment July 8, 2021

Scott Wren
Senior Global Market Strategist

Last Week's S&P 500 Index: +1.7%

Economic deceleration and the financial markets

Key takeaways

- Equity investors should expect deceleration in economic and earnings growth as well as inflation over the next 18 months.
- This slowdown should not disrupt the financial markets.

There is a lot of talk in the financial media about "peak growth" these days. And indeed, if analyst expectations are correct, the nearly 60% year-over-year earnings growth likely in the second quarter will be the high water mark for the cycle. But market participants are keenly aware that level of growth can occur only for a very short period of time, in this case one quarter. The same could be said about economic growth as the Atlanta Federal Reserve's "GDPNow" forecasting model is calling for nearly 8% growth in the second quarter as of July 2. We do not think the markets are worried about economic and earnings growth slowing from these very robust levels, at least at this point.

We also do not believe the markets are sweating increasing inflation. The major stock indexes have made all-time record highs over the last handful of trading days, and the yield on the 10-year Treasury note sits well below 1.4%. Investors appear to have a convicted opinion that the year-over-year 5% reading in the May Consumer Price Index (CPI) will be at or near the peak in this recovery and will be easing over the balance of the year and next. Indicators of future inflation expectations show that market participants are not expecting a sustained inflationary rise in coming years. In addition, a number of raw commodities (i.e., lumber, crude oil) are trading for future delivery at prices lower than the current or "spot" price. These are all important pieces of assembling the inflation puzzle.

We have not changed our basic view on inflation since late last year. We continue to believe that CPI inflation is in the process of peaking and will decelerate in 2022 from this year's pace. Saying that, we believe inflation, while slowing down, will remain somewhat above the 1.8% average of the 10-year prepandemic period at least through the end of next year – even if a return to 1970s inflation rates seems very unlikely. Remember, there are still dis-inflationary forces that frustrated the Federal Reserve's attempt to engineer sustained inflation at or around its target during the last decade.

Our recommended portfolio positioning reflects the belief that the recovery and rally in risk assets will continue. We favor economically sensitive sectors like Energy, Industrials, Materials, and Financials. In terms of fixed income exposure, we recommend a more defensive stance as we expect interest rates to rise from current levels. Diversified portfolios still need to hold exposure to fixed income in our view. We are focused on intermediate-term fixed income securities and favor municipal bonds and credit sectors.

We see deceleration in many aspects of the financial markets looking ahead including economic and earnings growth and, importantly, inflation from the higher levels that are currently being reported but do not see this deterring equity market upside.

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. **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. Investments that are concentrated in a specific sector or industry may be subject to a higher degree of market risk than investments that are more diversified. **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. **Municipal** bonds offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

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 or best interest 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. The material contained herein has been prepared from sources and data we believe to be reliable but we make no guarantee to its accuracy or completeness.

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 0721-00688