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January 10, 2019

Refining Our 2019 Outlook and Targets

No guidance or allocation changes

Investment Strategy Team

☐ Guidance change

☑ **Forecast change**

☐ Allocation change

Forecast changes

- *Global economy: We are decreasing our 2019 year-end targets for U.S. gross domestic product (GDP) growth, U.S. inflation, global GDP growth, developed-market inflation, and eurozone GDP growth.*
- *Global fixed income: We are decreasing our 2019 year-end targets for the 10-year U.S. Treasury yield, the 30-year Treasury yield, and the fed funds rate.*
- *Global equities: We are decreasing our 2019 year-end targets for the S&P 500 Index, S&P 500 earnings per share (EPS), the Russell Midcap Index, Russell Midcap EPS, the Russell 2000 Index of small-cap companies, and Russell 2000 EPS.*

Table 1. Revised 2019 economic forecast and market targets

	New 2019 year-end targets	Previous 2019 year-end targets
Global economy (%)		
U.S. GDP growth	2.5	2.7
U.S. inflation	2.2	2.5
Global GDP growth	3.6	3.7
Developed market GDP growth	2.0	2.2
Developed market inflation	1.9	2.0
Eurozone GDP growth	1.6	1.9
Global fixed income (%)		
10-year U.S. Treasury yield	3.00 - 3.50	3.25 - 3.75
30-year U.S. Treasury yield	3.00 - 3.50	3.25 - 3.75
Fed funds rate	2.75 - 3.00	3.00 - 3.25
Global equities		
S&P 500 Index	2750 - 2850	2860 - 2960
S&P 500 earnings per share	$173	$177
Russell Midcap Index	2045 - 2145	2090 - 2190
Russell Midcap earnings per share	$124	$126
Russell 2000 Index	1500 - 1600	1525-1625
Russell 2000 earnings per share	$81	$83

Source: Wells Fargo Investment Institute, January 9, 2019.

We believe that 2019 will prove to be a better year for markets than 2018 was. We also believe that sentiment has become too pessimistic relative to fundamentals. Still, there is a feedback loop from sentiment to decision making. In particular, the concerns about rising interest rates, along with slower U.S. and global economic growth and trade, dented consumer and business sentiment last quarter. These changes appear to be curtailing some 2019 business investments in plant and equipment. Consumer confidence also retrenched somewhat last month. If private spending marks a slower pace, earnings should decelerate by slightly more than we originally forecast. In a slower-growth environment, interest rates may rise more modestly as well.

To account for these economic growth concerns, we are fine-tuning our economic forecasts and equity and fixed-income targets modestly. It is important to note that these adjustments do not change our fundamental outlook: We still believe that the economy and earnings will grow in 2019, and that interest rates and longer-term yields will rise. But the trajectory of the economic and equity market recovery from current levels might be more gradual than we initially forecast in our 2019 Outlook report.

Economic forecasts

We continue to believe that a recession remains unlikely in the coming year. Yet, weaker consumer and business sentiment, along with softer projections for U.S. private spending—especially business investment in plant and equipment—should lower 2019 economic growth somewhat. In Europe, political uncertainty is weighing on business spending more than we had anticipated, and we are now tracking a sharper decline in economic indicators. Our U.S. inflation assumption also is lower, as slower spending growth reduces the economy's pace of expansion. We remain comfortable with our outlook for slight depreciation in the U.S. dollar in 2019.

Nevertheless, our economic forecast adjustments are more moderate than the December equity market plunge, because we believe that investors are underappreciating the current health of the U.S. economy. Job growth remains on a strong uptrend, and the rising number of people becoming job seekers should mean that labor cost pressure should rise only gradually. This also should help to prolong the U.S. economic expansion. Home sales have slowed but are still trending higher. Further, very strong holiday sales underscore that consumer sentiment remains at a high level, despite a lower December reading.

Equity

Our reduced economic growth expectations imply that EPS growth will remain positive but will be less robust than our initial expectations reflected. The continued (but gradual) increase in wages and corporate borrowing costs also should create headwinds for corporate margins to expand further from historically high levels. Additionally, investors are unlikely to pay multiples that are as high as those of a year ago, before markets began to reprice economic and earnings growth to lower levels. For these reasons, it makes sense to lower our expectations for U.S. earnings growth and U.S. equity index price targets in 2019.

However, we have conviction that markets will rebound from the worst annual returns since 2008. We believe that investors should maintain their portfolio allocations across asset classes. Even if valuations do not rebound to previous highs, current valuations seem excessively low. S&P 500 price/earnings multiples in 2018 experienced their third largest decline in the past 40 years. This decline has created some of the most attractive valuations of the current economic expansion (as long as earnings growth remains positive).

Fixed income

Our lower growth and inflation forecasts have knock-on effects for our fixed income outlook. We now believe that the Federal Reserve (Fed) will only raise interest rates two times this year (previously we expected three rate hikes). Also, we now expect less upside pressure on long-term interest rates, and we are making downward revisions to our 10-year and 30-year Treasury yield forecasts. These revisions maintain our view that the yield curve will remain flat but with a slightly positive slope. However, we continue to favor caution within the fixed income class. We would not take on too much duration (a measure of interest rate sensitivity) or credit risk. It is also worth reiterating that, in our opinion, investors should continue to view fixed income as a stabilizer in the overall asset allocation, rather than as a major source of returns.

Summary

Given the higher levels of volatility and uncertainty over the past three months, and the feedback loop from sentiment indicators to the economy, it makes sense to lower our expectations for economic growth, inflation, corporate earnings, and interest rates. We do not believe that these changes materially alter the opportunities and risks that we highlighted in our 2019 Outlook report.

- We continue to favor growth assets like equities over long-term fixed income, because we expect positive economic and earnings growth—and see signs of excesses in credit markets.
- Equity risk premiums at current levels are historically consistent with double-digit stock market returns in the following 12 months, when the economy does not enter a recession.
- We begin 2019 positioned for some retracement of losses in 2018, although the path higher is unlikely to be smooth.
- Our highest conviction U.S. equity sectors remain Industrials and Financials. We also favor the Health Care, Consumer Discretionary, and Information Technology sectors.
- In international markets, we remain most favorable on emerging markets, which outperformed the S&P 500 Index by eight percentage points since early September, when we assigned emerging markets our most favorable rating.

We see a solid year for investment returns, especially given the more attractive starting valuations post sell-off. We believe investors should continue to focus on having a plan, keeping it up to date, and making sure that they are resolute on implementation. We will remain vigilant to the possibility that the feedback loop between sentiment and actual spending may require further target adjustments.

Forecasts are based on certain assumptions and on our current view of market and economic conditions, which are subject to change.

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 has special risks. 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 **financial services companies** will subject a portfolio to adverse economic or regulatory occurrences affecting the sector. Some of the risks associated with investment in the **health care sector i**nclude competition on branded products, sales erosion due to cheaper alternatives, research & development risk, government regulations and government approval of products anticipated to enter the market. Risks associated with investing in **Industrials** include the possibility of a worsening in the global economy, acquisition integration risk, operational issues, failure to introduce to market new and innovative products, further weakening in the oil market, potential price wars due to any excesses industry capacity, and a sustained rise in the dollar relative to other currencies. 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

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000 Index.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

An index is unmanaged and not available for direct investment.

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