WELLS FARGO

INVESTMENT INSTITUTE

2018 Midyear Outlook

Late Cycle Doesn't Mean End of Cycle

2018 targets as of June 14, 2018

ECONOMY

Year-end forecasts

U.S. GDP growth Rolling four quarters	2.9%
U.S. unemployment rate End of period	3.9%
U.S. inflation 12-month average	2.4%
Global GDP growth	3.7%
Dollar/euro exchange rate	\$1.18–\$1.26

Overview

- We expect the rest of the year to deliver continued synchronized global growth and moderate inflation.
- Modestly higher inflation in developed markets and easing pressures in emerging markets suggest a balanced picture for global inflation.

Investor watch

- We believe that the U.S. economic expansion is entering the final third of its cycle. Various recession-related indicators that we track do not point to a recession this year.
- In our view, developed markets as a whole are likely in the mid-cycle of their recovery, while emerging markets are bordering early- to mid-cycle.
- Widening U.S. fiscal and trade deficits and rising hedging costs should combine to weaken the dollar further.

EQUITIES

Year-end forecasts

S&P 500 Index	2,800–2,900
S&P 500 operating earnings per share	\$152
Russell Midcap® Index	2,200–2,300
Russell Small Cap Index	1,650–1,750
MSCI EAFE Index	2,050–2,150
MSCI Emerging Markets Index	1,160–1,240

Overview

- We retain a favorable outlook for most U.S. equities based on a broadening economic recovery, driven by increasing household and business spending.
- We see more opportunities in U.S. equities in the second half than in either international developed market or emerging market equities.

Investor watch

- Our outlook for the U.S. economy and equity markets leads us to favor cyclical sectors, which tend to benefit the most from economic growth, over sectors that respond adversely to rising interest rates.
- We have a neutral view of developed market equities because it's possible that their earnings growth rates may have peaked. We are also neutral on emerging market equities, whose attractive valuations must be weighed against likely volatility from ongoing risks.

FIXED INCOME

Year-end forecasts

10-year U.S. Treasury yield	2.75%–3.25%
30-year U.S. Treasury yield	3.25%–3.75%
Federal funds rate	2.00%–2.25%

Overview

- Global central banks gradually are reducing the liquidity they provide to the markets, with the Federal Reserve (Fed) leading the way.
- A combination of increases in the Fed's key interest rate and significant new supply has resulted in significantly higher yields in short-term fixed-income securities.

Investor watch

- We look for interest rates to trend modestly higher, and as a result, we favor shorter maturities.
- As the credit cycle ages, we believe investors should look to move up in credit quality.

REAL ASSETS

Year-end forecasts

West Texas Intermediate Crude-oil price per barrel	\$50–\$60
Brent Crude-oil price per barrel	\$55–\$65
Gold Price per troy ounce	\$1,250–\$1,350

Overview

- Real estate investment trust (REIT) fundamentals remain relatively sound, and we're expecting them to stay that way for a few more years.
- Master limited partnerships (MLPs) are struggling to grow but currently offer relatively generous dividend yields. MLPs could become more attractively priced later in the year.

Investor watch

- Our expectation for higher yields leads us toward a neutral view on REITs for the second half of 2018.
- We currently have a neutral view of MLPs, but our view may become more positive if relative strength trends improve.
- Commodities remain in the midst of a bear market supercycle; we therefore have an unfavorable view toward the group.

ALTERNATIVES

Overview

- We believe that late-cycle dynamics such as rising interest rates, rising inflation, and rising volatility favor equity hedge and relative value hedge fund strategies.
- Lending conditions are beginning to tighten, setting up an environment in which long/short credit and private debt could thrive.

Investor watch

- The characteristics of a maturing economy—rising rates, inflation, and volatility—are all tailwinds for long/short equity and relative value strategies.
- We see emerging opportunities in corporate credit markets, where early indications of tighter lending standards and deteriorating fundamentals may lead to opportunities to benefit from short exposures and distressed situations. We believe this bodes well for long/short credit and private debt.

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

Three portfolio moves and risks for the balance of 2018

We prefer stocks over bonds and U.S. over international

The economy and U.S. equity markets still could register some of their best returns of this cycle.

Weigh risk and reward even more carefully than usual

High-yield bonds, U.S. long-term bonds, developed market bonds, and commodities look risky to us.

Take advantage of volatility

Volatility may offer attractive entry points or the chance to rebalance.

Risk considerations

All investing involves risks, including the possible loss of principal. 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. Their values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign markets** have additional risks, including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Mid- and small-cap stocks** are generally more volatile, are subject to greater risks, and are less liquid than large-company stocks. **Bonds** are subject to market, interest rate, price, credit/default, call, liquidity, inflation, and other risks. Prices tend to be inversely affected by changes in interest rates. **High-yield** (junk) bonds have lower credit ratings and are subject to greater risk of default and greater principal risk. **Real assets** are subject to the risks associated with real estate, commodities, MLPs, and other investments and may not be suitable for all investors. 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. **MLPs** may be sensitive to price changes in oil, natural gas, etc., and other risks, including the volatility associated with the use of leverage; volatility of the commodities markets; market risks; supply and demand; natural and man-made catastrophes; competition; liquidity; market price discount from net asset value; and other material risks. **Real estate** has special risks, including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions. **Alternative investments**, such as private debt strategies seek to actively improve the capital structure of a company often through debt restructuring and deleveraging measures. This strategy has speculative characteristics that include potential default, limited liquidity, and the infrequent availability of independent credit ratings for private companies. Long/short credit strategies seek to mitigate interest rate and credit risks regardless of market environment through investment in credit-related and structured debt vehicles. These strategies involve the use of market hedges and involve risks such as those associated with investments in derivatives, fixed income, foreign investment, currency, hedging, leverage, liquidity, short sales, loss of principal and other material risks. There is no guarantee such strategies will be successful.

Index Definitions

An index is unmanaged and not available for direct investment.

MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia, and the Far East, excluding the U.S. and Canada.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

Russell 2000® Index (Small Cap) 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 U.S. stock market.

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