WELLS FARGO
INVESTMENT INSTITUTE

Investment Strategy

WEEKLY GUIDANCE FROM OUR INVESTMENT STRATEGY COMMITTEE

October 23, 2017

Investing in Record-Breaking Markets

Tracie McMillion, CFA
Head of Global Asset Allocation

Key Takeaways

» *Most fixed income and equity indices are at, or very near, record highs.*

» *International equities and real assets are trading below their all-time highs and may offer better potential return for the amount of expected volatility risk.*

What It May Mean for Investors

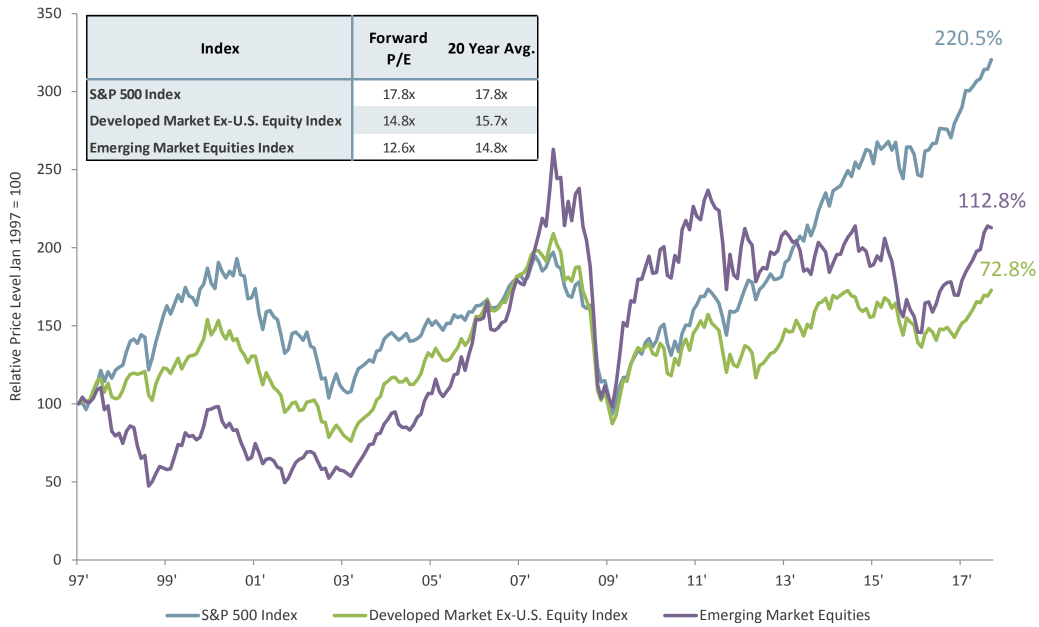
» *We believe that this is a good time for investors to rebalance portfolios after the YTD rally in many equity asset classes (and in financial markets, generally).*

Seventy—that's how many times the Dow Jones Industrial Average (DJIA) has hit a new record high since last November. Last week, the DJIA topped 23,000, having crossed the 20,000 mark just nine months earlier, in late January of this year. But the DJIA is not alone. The S&P 500 Index (comprised mainly of U.S. large-cap stocks), the NASDAQ (comprised mainly of U.S. technology stocks), and U.S. small- and mid-cap equity indices are at, or very near, their all-time highs. Bond market and hedge fund indices, too, are trading near record highs. While U.S. equity markets have surpassed their pre-crisis levels and moved significantly higher, international equity markets have yet to reach that milestone. Valuations appear more reasonable for international developed markets and for emerging markets than for the U.S. (see Chart 1). Real estate investment trusts (REITs) also appear relatively more attractive than U.S. stocks, having the benefit of higher current yields than most stocks and investment-grade bonds, along with the potential for the underlying real-estate properties to appreciate in value. Commodities are significantly below their all-time highs and remain in a bear market. As such, we suggest underweighting this asset class.

Asset Group Overviews

Investment and Insurance Products: ▶ NOT FDIC Insured ▶ NO Bank Guarantee ▶ MAY Lose Value

Chart 1. International Equity Valuations Appear More Attractive Than Those in U.S. Equity Markets



Sources: Wells Fargo Investment Institute, FactSet; 10/18/17 The forward price-to-earnings ratio (forward P/E) is a valuation method used to compare a company's current share price to its expected per-share earnings. Estimates are based on certain assumptions and on views of market and economic conditions which are subject to change.

In our opinion, there are three notable reasons why so many investment markets are hitting record highs this year. One primary reason is that the macroeconomic picture is conducive to higher asset prices. With global growth firming and inflation tame across most countries, global equities have gained in price, while global bond prices have been supported by very low interest rates. Second, U.S. stocks have experienced an earnings recovery this year—bolstered by a positive rebound in energy companies' earnings and higher growth rates in sectors such as Information Technology, Industrials, and Financials. A third reason for higher asset prices is that ample liquidity is available for investors to make purchases and for companies to borrow at very low cost. This may lead to companies and individuals borrowing to make financial-asset purchases—a behavior that eventually could contribute to a broad asset-price correction. However, our analysis of current debt levels for the U.S. government and private sectors leads us to conclude that this is unlikely to be a near-term problem.

We expect these three conditions to persist, allowing the U.S. economy to avoid a recession in the coming year. In our view, the current global macro environment supports broad asset prices at or near current levels through the end of next year. However, some consolidation is likely, particularly in financial-market segments that historically are more volatile. Countering the positive trends are geopolitical risks, Federal Reserve tightening, upcoming European Central Bank tapering, and the potential for fiscal-policy disappointments.

We believe that investors should consider rebalancing portfolios, shifting from the fully valued, higher-risk segments of the markets into assets that may offer more value for the amount of expected risk. For example, we suggest removing some volatility risk from the overall portfolio by underweighting small-cap stocks and high-yield bonds. Meanwhile, we suggest adding to REITs and hedged alternative investment strategies like equity hedge and relative value, areas of the markets which we believe offer a more compelling return-for-risk ratio today.

Markets may continue to set new records in the days and weeks ahead; however, we believe that investors should remain fully invested in a diversified portfolio, despite the risk of a pullback in asset prices. We expect pullbacks at this point in the business cycle to be short-lived; but some rationalization of the currently full valuations, particularly in U.S. stocks, is likely. We suggest rebalancing overall portfolio holdings back to target weights. If you have cash to invest, but are wary to do so at current prices, we recommend considering international stocks, an area of the market where more upside potential is possible. Broadly speaking, we believe that investors should bring their allocations up to neutral weight (evenweight) for international equity classes. For more information, please see our recently published Equity Strategy Report, *Q&A: The "Why" Behind Our 2018 Equity Guidance*.

Sean Lynch, CFA
Co-Head of Global Equity Strategy

Underweight
U.S. Small Cap Equities

Evenweight
U.S. Large Cap Equities

Evenweight
U.S. Mid Cap Equities

Evenweight
Developed Market Ex-U.S. Equities

Evenweight
Emerging Market Equities

A Market Not at an All-Time High—but Getting There

Which equity market has tripled over the past eight years and yet remains 45 percent below its all-time high?

The answer is **Japan's Nikkei 225.**

Japan's equity markets are hitting 20-year highs; yet they remain well below the lofty 1989 levels. Japan's recent equity-market resurgence can be attributed to improving economic growth, rising business and consumer confidence, and political stability.

Last weekend, Shinzo Abe won the snap election vote for prime minister of Japan, a position he has held since 2012. Prior to Mr. Abe's election in 2012, Japan had seven prime ministers in seven years. This leadership (and policy) continuity provides a level of comfort to equity investors. As a result, Japan likely will continue to see additional stimulus plans presented by Prime Minister Abe. Further, the Bank of Japan (BoJ) is expected to remain very accommodative in its monetary policy. We also anticipate that Japan will continue to focus on improving corporate governance and broadening its labor reforms. These two policies have been key parts of Shinzo Abe's leadership. We heard plenty of optimism about these developments on our recent visit to the country.

Even though Japanese equity prices have reached 20-year highs, valuation remains reasonable. Earnings for the Nikkei 225 Stock Average at year-end 2018 are projected to be 33 percent higher than their level just three years ago.[1] Valuation actually has fallen over the past few years with the trailing 12-month price/earnings ratio currently at 15.5x compared to the 10-year trailing average of 18.1x.[2]

Key Takeaways

» We have a favorable outlook on the Pacific region, and Japan's large weight in developed-market equities makes it a key country to watch next year.

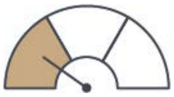
» While Japanese equities have reached 20-year highs, valuation remains reasonable.

Japanese Equity Market Hits 20-Year High

Source: Bloomberg; 10/18/17

1 Sources: Bloomberg, Nikkei 225 Stock Average, 10/18/17
2 MSCI Japan Index, Bloomberg, 10/18/17

Brian Rehling, CFA
Co-Head of Global Fixed Income Strategy



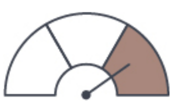
Underweight
High Yield Taxable Fixed Income

Underweight
Developed Market Ex.-U.S. Fixed Income

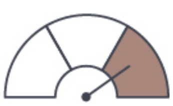
Evenweight
U.S. Short Term Taxable Fixed Income

Evenweight
U.S. Long Term Taxable Fixed Income

Evenweight
Emerging Market Fixed Income



Overweight
U.S. Taxable Investment Grade Fixed Income



Overweight
U.S. Intermediate Term Taxable Fixed Income

Yielding Insights: High-Grade Fixed Income

Fixed-income investors have long been attracted to yield, which is precisely what investors are looking for in order to generate sustainable cash flow for living expenses. But beyond simple cash flow needs, the prevailing yield in high-quality fixed income also has another use for investors; historically, it has been quite good at predicting total-return performance over longer periods of time. This is especially true of high-quality fixed income classes.

Using Bloomberg Barclays U.S. Aggregate Bond Index data from its 1976 inception to today, we modeled the annualized total return that was experienced over a period of years—and how much of that return could be predicted by the current yield level. (The Bloomberg Barclays U.S. Aggregate Bond Index is composed of U.S. investment-grade taxable securities.) Over the past 38 years, the current yield has been a very strong predictor of future returns for the Bloomberg Barclays U.S. Aggregate Bond Index. We found the strongest correlation to the initial yield level was near the index's five-year average total return. Of course, past performance is no guarantee of future results.

The average variation between initial yield and ensuing annualized five-year total return has been just 0.38 percent since the index's 1976 inception. The current yield of the Bloomberg Barclays U.S. Aggregate Bond Index is 2.55 percent; our expectation is that investors in a well-diversified investment grade taxable bond portfolio should expect a yearly total return in the low single digits (on average) over the next five years.

Key Takeaways

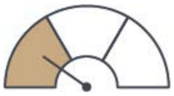
- » Historically, high-quality fixed income has provided a high predictability of expected returns over longer periods of time. We expect this to continue.
- » In the current low-yield environment, fixed-income investors are likely to experience lower returns in the future than they have seen over the past decade.
- » A well-diversified high-quality fixed income portfolio is unlikely to experience significant losses over time.

Bloomberg Barclays U.S. Aggregate Bond Index: Initial Yield versus Annualized Five-Year Total Return

Sources: FactSet, Wells Fargo Investment Institute; 10/18/17 Yields and returns represent past performance. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment.

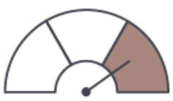
John LaForge
Head of Real Asset Strategy

"The degree of one's emotion varies inversely with one's knowledge of the facts—the less you know, the hotter you get."
--Bertrand Russell



Underweight
Commodities

Evenweight
Private Real Estate



Overweight
Public Real Estate

Is $52 Oil Bad for Stocks?

Some investors believe that $52 oil is high enough that it may possibly cut into stock returns. We doubt it. As we'll discuss below, $65 oil likely is needed before we see an impact on stock returns. Equity investors should concern themselves with oil matters under two specific scenarios:

1. Excessively high oil prices, adjusted for inflation. Today's $52-per-barrel oil price equates to an average gasoline price of $2.70 per gallon. For stock returns to slow (based on oil's influence), history says that gasoline prices need to be $3.50 per gallon or higher (see chart below). In oil-price terms, this means that $65 oil likely would be needed to harm stock returns. Recall that roughly 75 percent of oil is used to produce gasoline, jet fuel, and heating oil—with gasoline being the biggest oil user of the three.

The chart below connects S&P 500 Index returns to gasoline prices, back to 1976. The top clip shows the S&P 500 Index; the bottom clip is the price of gasoline adjusted for inflation; and the statistics box shows annualized S&P 500 Index returns at different levels of gasoline prices. Notice that S&P 500 returns annualize at a -1.7 percent rate when gasoline prices exceed $3.50 per gallon (yellow box highlight).

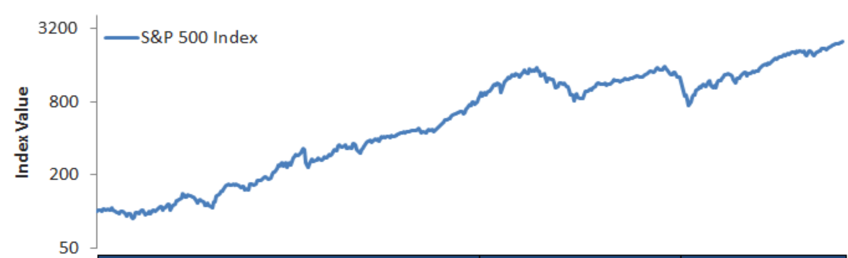
2. Oil spikes of 30 percent in less than a year. Additional research shows that short-term oil spikes can influence stock returns too. Typically, though, oil prices need to rise by 30 percent or more in less than a year, for annualized stock returns to turn negative.

Key Takeaways

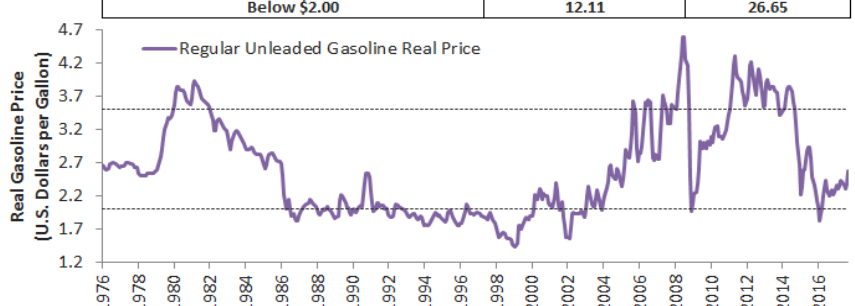
» An oil price of $52 per barrel likely is not high enough to derail stock-market returns.

» Unless oil prices quickly head into the $60s, equity investors should not be overly concerned.

S&P 500 Index versus Real Gasoline Prices



S&P 500 Index Performance When Real Gas Prices Are:	Annualized Return (%)	% of Time
Above $3.50	-1.76	17.23
Between $2.00 and $3.50	9.37	56.11
Below $2.00	12.11	26.65



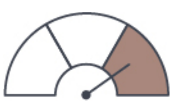
Sources: Bloomberg, Energy Information Administration (EIA), Wells Fargo Investment Institute.
Monthly data: 1/31/1976-9/30/2017. Top panel shown in log scale. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Jim Sweetman
Senior Global Alternative Investment Strategist

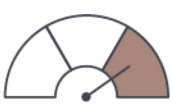
Evenweight
Private Equity

Evenweight
Hedge Funds-Macro

Evenweight
Hedge Funds-Event Driven



Overweight
Hedge Funds-Relative Value



Overweight
Hedge Funds-Equity Hedge

Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not suitable for all investors and are only open to "accredited" or "qualified" investors within the meaning of U.S. securities laws.

Hedge Fund Opportunities Late in the Cycle

As we approach year-end, equity valuations are near all-time highs, and volatility is at an all-time low. We believe that the global business cycle is in its latter stages, typically characterized by growth deceleration that precedes contraction. It also is usually associated with interest rates and inflation rising, and higher equity valuations, leading to modest-to-flat annualized returns. We believe that there is opportunity for hedge-fund strategies to thrive late in the cycle. The chart below shows the rolling 12-month hedge-fund return (across various HFRI indices) and the MSCI World Index from January 1990 through September 2017. In "flat" global equity markets (with returns of +/- 3 percent), hedge funds have outperformed global equities by approximately 8.7 percent. In down markets (defined as returns less than 3 percent), hedge funds had an average annual return of -0.9 percent, while the MSCI World Index had an average annual return of -16.8 percent.

While monetary easing has supported the credit cycle, there are potential headwinds ahead as central banks tighten policy. The Relative Value strategy, particularly the long/short credit sub-strategy, seeks to benefit from increasing dispersion as rates and volatility rise—and credit spreads widen. We believe that if markets dislocate, there could be compelling buying opportunities that also can help to lower portfolio sensitivity to long positions in fixed-income investments.

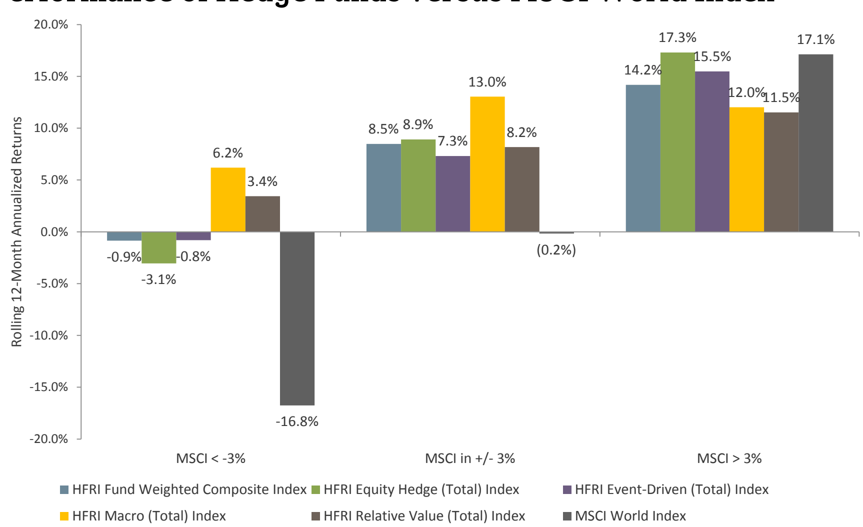
While we do not envision a near-term recession or a global downturn next year, the challenge facing investors is how to pursue late-cycle opportunities, while also preparing portfolios for tougher times ahead. We believe that allocating to hedge-fund strategies may help investors to diversify (and potentially dampen volatility), while offering investment opportunities that are independent of equity- and credit-market directionality.

Key Takeaways

» Hedge funds historically have outperformed equities in flat and declining markets, while helping to mitigate downside risk.

» Relative Value strategies, such as long/short credit, may help investors to diversify fixed-income holdings if volatility increases and credit spreads widen.

Performance of Hedge Funds versus MSCI World Index



Sources: Hedge Fund Research, Bloomberg; 10/18/17. Chart shows rolling 12-month returns for HFRI hedge-fund indices and for the MSCI World Index, for the period from January 1990 through September 2017. *For illustrative purposes only.* See page 8 for important disclosure on index performance and for the risks associated with the representative asset classes and for definitions of the indices. **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. **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. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **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. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. 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. **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 hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

An index is unmanaged and not available for direct investment.

MSCI EAFE (DM) and MSCI Emerging Markets (EM) Indices are equity indices which capture large- and mid-cap representation across 21 DM countries and 23 EM countries around the world.

MSCI Japan Index measures the performance of the large and mid-cap segments of the Japanese market. With 321 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan. It was developed with a base value of 100 as of December 31 1969.

MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of 23 developed markets including the United States.

Nikkei 225 Index is the leading and most-respected index of Japanese stocks. It is a price-weighted index comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. The Nikkei is equivalent to the Dow Jones Industrial Average Index in the U.S.

S&P 500 Index is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation and financial companies.

TOPIX, also known as the Tokyo Stock Price Index, is a capitalization-weighted index of all companies listed on the First Section of the Tokyo Stock Exchange. The index is supplemented by the subindices of the 33 industry sectors. The index calculation excludes temporary issues and preferred stocks, and has a base value of 100 as of January 4, 1968.

Hedge Fund Performance Chart: Index returns shown in the chart reflect general market results, do not reflect actual portfolio returns or the experience of any investor, nor do they reflect the impact of any fees, expenses or taxes applicable to an actual investment. The indices reflect the historical performance of the represented assets and assume the reinvestment of dividends and other distributions. Unlike most asset class indices, HFR Index returns reflect deduction for fees and expenses. Because the HFR indices are calculated based on information that is voluntarily provided actual returns may be higher or lower than those reported.

The HFRI Indices are based on information self-reported by hedge fund managers that decide, on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways.

HFRI Equity Hedge (Total) Index consists of Investment Managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. EH managers would typically maintain at least 50%, and may in some cases be substantially entirely invested in equities, both long and short.

HFRI Event Driven Index maintains positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Event Driven exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

HFRI Fund Weighted Composite Index is a fund-weighted (equal-weighted) index designed to measure the total returns (net of fees) of the approximately 2,000 hedge funds that comprise the Index. Constituent funds must have either $50 million under management or a track record of greater than 12 months. Sub-strategies include: HFRI Event-Driven, Distressed/Restructuring Index, and HFRI Event-Driven (Total) Index.

HFRI Macro Index: Investment Managers which trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom up theses, quantitative and fundamental approaches and long and short term holding periods. Although some strategies employ RV techniques, Macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments, rather than realization of a valuation discrepancy between securities. In a similar way, while both Macro and equity hedge managers may hold equity securities, the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposes to EH, in which the fundamental characteristics on the company are the most significant are integral to investment thesis.

HFRI Relative Value Index maintains positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative, or other security types.

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