December 11, 2017

Five Moves Investors Should Consider Before 2018

Paul Christopher, CFA
Head of Global Market Strategy

Key Takeaways

» *We have conviction that modest tax reform is coming, but other macroeconomic fundamentals may support markets less in 2018 than they did in 2017.*

» *Investors also are likely to see more market volatility in 2018, as liquidity provides less support.*

What it may mean for investors

» *Now may be the time to begin to be more proactive about assessing the balance between risk and reward. We provide some examples to consider below.*

Asset Group Overviews

What are our basic convictions about financial markets?

The S&P 500 Index has broken above 2600, but we do not believe that the limited upside in our equity targets underestimates the equity market or financial markets broadly. We see tax reform as only a mild positive for 2018, while other principal factors still point to more moderate gains and potentially more volatility in 2018 than in 2017. These include:

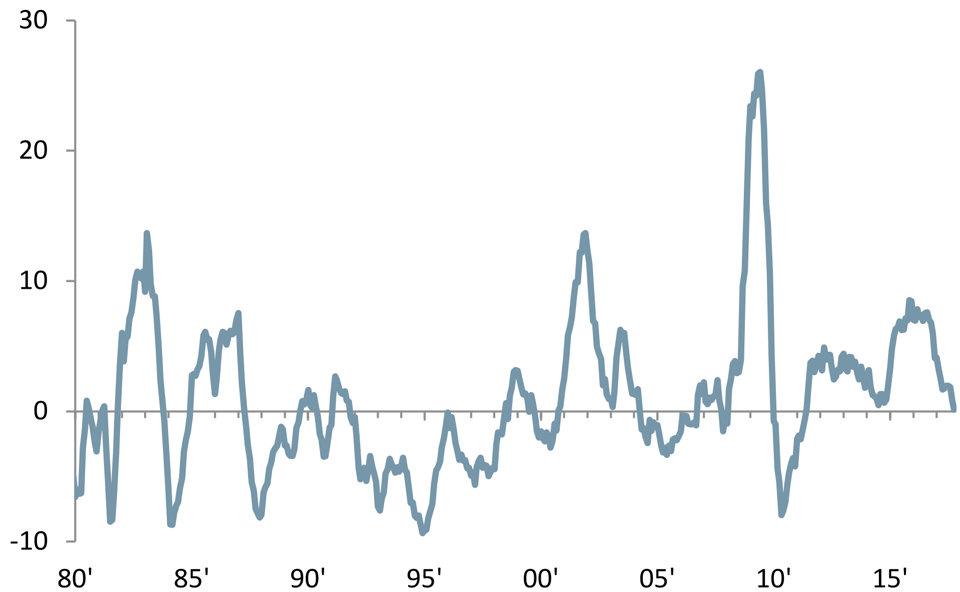
Tax reform offers limited stimulus: We expect only modest tax-reform economic stimulus and financial market impact. Ultimately, the final bill for the president's signature may require us to make additional economic and financial market target adjustments, but our November changes updated our outlook before the financial markets completely price in the potential impact.

The economy is a positive: The international economies are earlier than the U.S. in their economic expansions, and we anticipate stronger international earnings growth. The U.S. economy is probably in the final third of its expansion, and U.S. earnings growth is likely to slow (but remain positive) in the coming years.

Valuations look full: If international earnings continue to accelerate, valuations abroad should increase and help to keep these markets looking attractive. We also do not believe that full valuations signal the end in the U.S. cycle. We expect new S&P 500 Index highs in 2018 and beyond, but also see rich valuations as the main challenge that domestic investors face in the coming year.

Liquidity support should fade: Low interest rates reduce the costs of borrowing and holding cash. Chart 1 illustrates one liquidity measure, which is cash and bank deposit growth above inflation and above the cash needed to cover economic activity. Liquidity follows cycles and appears set to contract. Data back to 1960 (not shown) reveal that S&P 500 Index volatility has been below average when this liquidity is growing—but above average when liquidity is contracting. We underestimated liquidity's support for equity markets in 2017, but the liquidity cycle seems less beneficial for 2018. Investors may suspect that liquidity is no longer helping when, for example, day-to-day speculations about events or rumors in the news give markets more than just mild declines.

Chart 1. Liquidity available after inflation and economic activity (12-month growth rates, percent)



Sources: Bloomberg and Wells Fargo Investment Institute, December 4, 2017. Monthly data: January 1980 through November 2017. Chart shows year-over-year percentage change. Liquidity growth is calculated as cash-plus-deposits, less inflation and less industrial production (as a proxy for contemporaneous economic activity).

What should investors consider now?

It is difficult to find a global market today that has low valuations and that trades below its intrinsic value. We believe that investors should remain fully invested. However, we encourage vigilance, so that market optimism does not become complacency. We also recommend diligence, to detect favorable comparisons between risk and reward. For example:

Take international equity exposure toward target levels: Portfolios that are below long-term target allocations to international equities should raise exposures to target levels. This can be done incrementally over the coming quarters, as valuations are unlikely to be stretched over the length of the cycle.

Maintain U.S. small-capitalization equities at levels below target: We currently view the potential reward as inadequate to the risk involved. Small-cap stocks seem especially vulnerable to market pullbacks on softer economic data. Also, we expect small caps to enjoy a larger percentage benefit from tax reform, but any legislative setbacks could hit small caps hardest. However, a more favorable risk-reward balance is possible if valuations become less rich (possibly on a pullback).

Reduce lower-quality credit exposure: Historically narrow yield spreads pose risks for lower-credit-quality bond sectors. Also, the policy transition (i.e., tax cut stimulus replacing low interest rates) and heightened geopolitical uncertainty could create price swings in credit markets. We prefer higher-quality bonds, including U.S. investment-grade and U.S. intermediate-term taxable bonds.

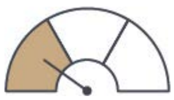
Reconsider real estate: The fundamental and valuation outlook is attractive for global real estate investment trusts (REITs). Strong demand, little evidence of oversupply, and compelling valuations are positives. We do not see interest-rate increases as a threat at this time.

Improving market for stock pickers and credit pickers: We favor equity hedge and relative value strategies in the alternative investment space. Equity prices are increasingly diverging, favoring active management. We also expect widening credit spreads as credit prices diverge, which could favor both hedge funds and private capital strategies next year.

Conclusion—Be proactive

There comes a time in a race when the last turn is taken, and the final straightaway lies ahead. Everyone anticipates the finish line, but the race still has a long stretch to go. The runners can no longer passively follow others but must redouble their push and make their moves. So, too, for investors—the final third of the U.S. economic expansion does not mean that the end is imminent—but we believe now is the time to be more proactive as risk shifts relative to reward.

Stuart Freeman, 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

Conference Board's LEI supports cyclical versus defensive sector stance

The Conference Board's Leading Economic Index (LEI) continues to point toward favorable economic growth and a lean toward cyclical versus defensive sectors. While S&P 500 Index revenues and earnings reached levels beyond the last cycle's highs in 2011, the forward-looking LEI moved beyond the last cycle's high in March 2017 and hit a new all-time high in October. Currently, the index is 5.2% higher than it was one year ago.

The LEI is a composite of 10 leading economic indicators. Historically (looking back to 1983), when the LEI increased between 4.7% and 5.7% during a year, the average S&P 500 Index increase over the next 12 months was 12% (the median was 10%). Within the 43 instances, the S&P 500 Index had declined in only seven of them (16% of the time). For those seven occurrences, the average decline over the next 12 months was only 2.9% (2.3% at the median), and there were no instances when the U.S. economy was in recession during those forward 12-month periods. This LEI increase is not the sole basis for our 2018 performance estimate, but it does support our thesis for new S&P 500 Index highs next year.

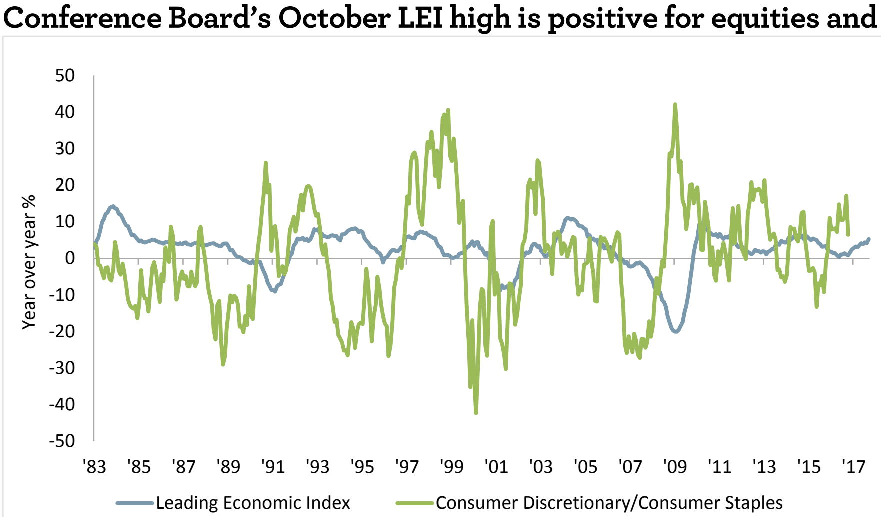
Additionally, the average outperformance of the (cyclical) Consumer Discretionary sector versus the (defensive) Consumer Staples sector was 3.4 percentage points during those forward 12-month periods. This makes intuitive sense, as the breadth of actual hard-data economic indicators and soft data (polling statistics) are at the high end of their ranges for this cycle. We are currently targeting S&P 500 Index earnings-per-share growth of 12.4% for 2018.

Key takeaways

» The Conference Board's LEI is at an all-time high. The LEI's increase helps to support our expectation for U.S. economic growth and new S&P 500 Index highs in 2018.

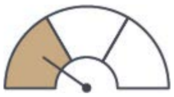
» The LEI's strength also backs our expectation for low odds of a 2018 recession and our view that investors should continue to lean toward cyclical versus defensive U.S. equity sectors.

Conference Board's October LEI high is positive for equities and cyclical sectors



Sources: FactSet, Bloomberg, Wells Fargo Investment Institute; December 6, 2017.

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



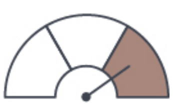
Underweight
High Yield Taxable Fixed Income

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

The Fed cannot escape the business cycle

Later this week, the Federal Reserve (Fed) likely will increase the short-term federal funds rate for the third time this year. While short-term rates have been steadily rising, longer-term rates remain little changed from their levels at the beginning of this year. As a result, the yield curve has continued its flattening trend.

The yield curve follows fairly predictable long-term trends; steepening early in an economic recovery before flattening into an eventual economic downturn. This pattern has been repeated consistently over the past 30 years. Theories abound to explain why this time is different; from the impact of quantitative easing to global relative value. Often, the best explanation is the most obvious—the business cycle is inescapable.

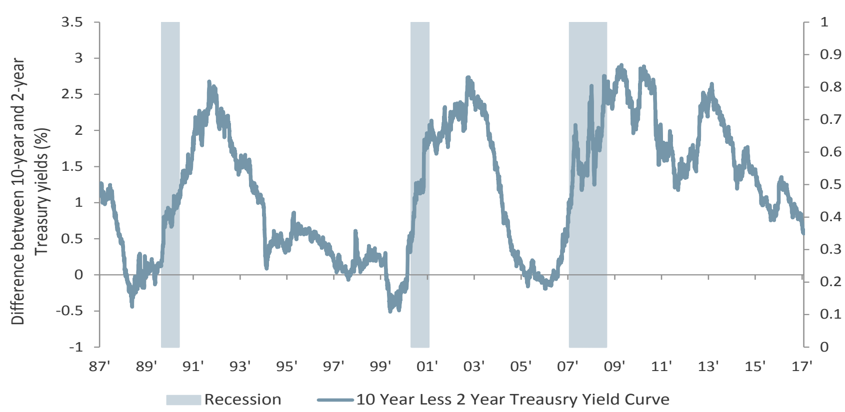
The Fed does not seem overly concerned; content that higher inflation will materialize and a pickup in growth will justify higher rates. Yet, even the Fed cannot escape the business cycle in our opinion, it would be wise for the Fed to consider slowing its already measured pace of rate increases going forward—or it could risk an even flatter yield curve in the months ahead.

While a flattening yield curve is indicative of late-cycle bond market behavior, it does not indicate that a recession is imminent. In fact, the relatively slow pace of yield-curve flattening suggests that the economic expansion will continue throughout 2018. If the yield curve were to quicken its pace of flattening, investors would probably be justified in increasing their level of concern.

Key takeaways

- We recommend that investors consider allocating a small portion of their portfolios to Treasury Inflation-Protected Securities (TIPS) to help mitigate an unexpected increase in inflation.
- We continue to favor intermediate-term fixed income. Should short-term rates continue to rise, value may move down the interest-rate curve.

Difference between 2-year and 10-year Treasury yields



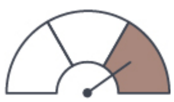
Source: Bloomberg; December 4, 2017. Yields represent past performance and fluctuate as market conditions change.
Past performance is no guarantee of future results.

Austin Pickle, CFA
Investment Strategy Analyst

"Nothing deflates so fast as a punctured reputation."
--Thomas R. Dewar

Underweight
Commodities

Evenweight
Private Real Estate



Overweight
Public Real Estate

Copper at $3 may be "ahead of itself"

"Dr. Copper" has long been considered a bellwether for global economic growth. After a lackluster start to 2017, copper went on a tear—at one time, gaining by more than 30% from the May low to nearly $3.25 per pound. Optimism surrounding future economic growth both in the U.S. and abroad helped to fuel copper's rise. Yet, it seems that copper may have gotten a bit ahead of itself, as prices tumbled 10% from its peak to $2.90 per pound.

Surging inventories and a tempering of global-growth expectations, especially for China, are the main drivers of copper's recent correction. And I cannot emphasize "especially for China" enough—as China is an absolute behemoth in the copper market—consuming 50% of the world's copper. So if Chinese demand is not firing the copper train, one can expect it to run out of steam.

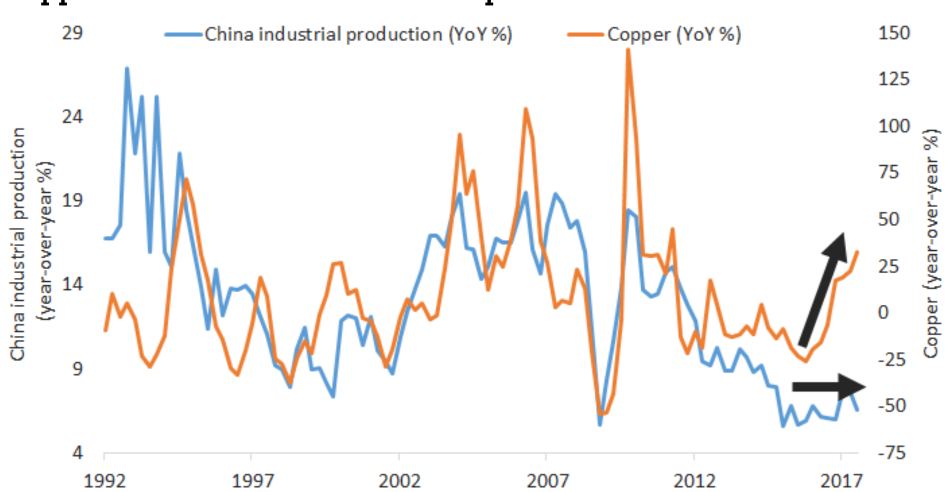
The chart below illustrates the connection between Chinese demand growth and copper performance. The orange line is the year-over-year copper price return and the blue line is the year-over-year change in Chinese industrial production. Notice how the two lines track each other closely—until recently. The black arrows show how China's flat demand growth has not supported copper's surge.

For copper's rise to continue meaningfully, and potentially turn into another bull super-cycle, we believe that China would need to push the throttle on demand. Yet, this is unlikely—as China is in the well-telegraphed process of switching to more consumer-led growth over capital-expenditure-fueled growth. Without a major rise in Chinese demand, we expect copper prices to stall near $3 per pound.

Key takeaways

» Chinese demand growth has been a major driver of copper prices.
» With flat Chinese demand growth today, we expect that copper prices will stall near $3 per pound.

Copper versus Chinese industrial production



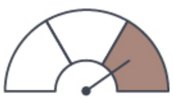
Sources: National Bureau of Statistics of China, Bloomberg, Wells Fargo Investment Institute. Quarterly data: 3/31/1992-9/30/2017.

Ryan McWalter
Investment Research Analyst

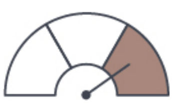
Evenweight
Private Equity

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.

Do large deals signal a changing M&A environment?

Large, high-profile mergers among major household names recently have made headlines. Internet and technology giants have branched into new sectors with innovative services and distribution plans, transforming grocery store, retail and other industries. We also are seeing an attempt in the health-care industry to combine pharmacy and insurance services to increase diversification and fend off new competition. Chart 1 shows that merger and acquisition (M&A) activity has risen this year as corporations have responded to competitive and revenue-growth challenges by merging and acquiring other firms.

Higher M&A deal activity and volume can enhance the opportunity set for the Merger Arbitrage strategy, with more deals from which to select and extract value. This also can lead to wider merger price spreads with a larger deal supply, while providing investors with returns that are uncorrelated with broader stock and bond markets.[1]

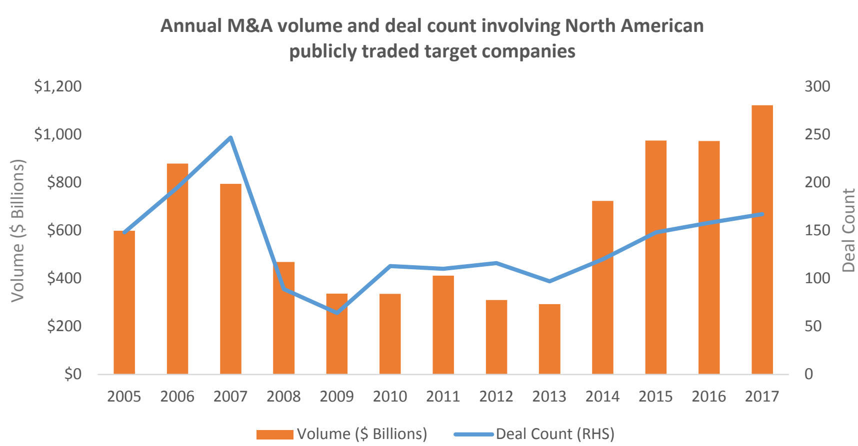
Average merger spreads among deals involving North American target companies have increased from 2.02% on October 13, to 4.51% on December 1.[2] Along with rising deal supply, spreads can widen due to deal-specific volatility, driven by regulatory or antitrust issues (as seen with a major media and telecommunication deal to be litigated). Shorter-term deal and spread volatility can provide tactical managers with the ability to extract value through idiosyncratic deal selection, deal complexity, position sizing and proactive management of positions.

Key takeaways

» Corporations continue to seek alternative means for expansion in a slower growth, yet competitive, corporate environment, which can support higher M&A levels.

» We believe that Merger Arbitrage can offer consistent, lower volatility returns that are not correlated with broader stock and bond markets.

Potential opportunity set for merger arbitrage



Source: Bloomberg, December 5, 2017. Data covers annual M&A volume and deal count for deals involving North American publicly traded target companies (deals in excess $500 million). 2017 data is through December 4, 2017. The data does not include deals that were terminated or withdrawn. Instead, it includes deals that have completed or are proposed or pending.

[1] In a merger arbitrage strategy, an investor may simultaneously buy and sell the stocks of two merging companies. The profit is made from the spread, or difference, between the share price of a target company after the announcement and the closing price when the deal is completed.
[2] UBS Special Situations Team (weekly data), December 6, 2017.

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.

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