WELLS FARGO
INVESTMENT INSTITUTE

Investment Strategy

WEEKLY GUIDANCE FROM OUR INVESTMENT STRATEGY COMMITTEE

December 26, 2018

2018—A Year in Review

Paul Christopher, CFA
Head of Global Market Strategy

Key takeaways

» *Dramatic shifts in sentiment about economic growth drove a return to volatility in 2018, after two mostly quiet years in 2016 and 2017.*

» *Successive tremors from higher inflation, trade disputes and, finally, worries about future economic growth shook investor enthusiasm. By the middle of December, many asset classes were showing negative returns for the year.*

What it may mean for investors

» *For 2019, we see potential opportunities—but also would take three steps—looking for investments where potential reward exceeds potential risk; rebalancing regularly, especially after gains; and allocating cash, instead of accumulating it.*

Asset Group Overviews

2018—a year of strong crosscurrents

Investor enthusiasm in 2017 spilled over into January 2018, reinforced by high expectations that tax reform might drive the strongest, sustained economic growth improvement of the nearly 10-year-old economic expansion. The U.S. economy accelerated for much of the year, but successive tremors from higher inflation, trade disputes and, finally, worries about future economic growth shook the enthusiasm. By the middle of December, many asset classes were showing negative returns for the year.

It's a truism that markets look forward, but the difficulty in predicting the future leads to extrapolating with limited information. So, for example, markets recorded strong equity gains, modestly higher bond yields, and rising oil prices in January 2018. Investment markets were anticipating the positive benefits of U.S. tax reform. By February, however, less positive trends emerged, and investors projected these forward. Rising interest rates looked like a threat to equity markets, and fears of unending rounds of U.S. tariffs and Chinese retaliation trumped the future benefits of tax reform.

Entering midyear, pessimism was never far away, despite the U.S. economy's improvement. U.S. equity prices recovered only slowly from their March lows, and bond yields traded in ranges. Meanwhile, international equity markets continued to slide, driven by trade disputes, local political differences (in Europe and elsewhere), and new economic reforms (in China). International growth fears also boosted the U.S. dollar but weighed on commodity prices (aside from crude oil). Finally, alternative investment strategies tended to suffer (along with active management generally) as macroeconomic and political worries eliminated much of the dispersion that drives returns in these strategies.

The prospect of slower growth assumed greater significance after midyear. Strong U.S. earnings growth in the second and third quarters prompted questions about peak earnings and an impending slowdown. The prospect of additional U.S. interest-rate hikes through 2019 added to the concern that Federal Reserve (Fed) policy might derail the U.S. economic expansion. After reaching their September highs, equity prices suffered a correction by falling more than 10%. International equity markets continued to decline, but generally by less than U.S. markets fell. Bond yields peaked with equity prices in mid-September but retreated on the new growth concerns. Amid the caution, the U.S. dollar remained firm against many currencies, though emerging market currencies tended to hold up better.

In real asset markets, some notable reversals of fortune occurred during the year's second half. Oil prices moved lower, as excess supply finally caught up with the market. As world supply growth edged ahead of (still-solid) consumption growth, prices retreated from near $76 per barrel (on U.S. West Texas Intermediate crude oil) in early October to around $49 by mid-December. The U.S. surged to become the world's largest petroleum producer, and liquefied natural gas gained impetus. In these trends, investors recognized new opportunities in U.S. energy infrastructure, and master limited partnerships (MLPs) attracted positive attention. Real estate investment trusts, however, increased in sensitivity to interest rates throughout 2018 and look less attractive now.

Our outlook—positive but cautious

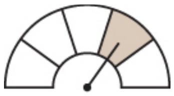
We hold a fundamentally solid 2019 equity outlook—i.e., slower (but still positive) economic and earnings growth—but the late-2018 market movements suggest that some of the weights on market sentiment could overflow into 2019. In our opinion, global equity prices should advance broadly, but mainly on earnings growth. Cautious investors are unlikely to overpay, and we expect modest valuations. Emerging markets remain our most favored asset class.

Gradually rising interest rates are likely, and we favor shorter-maturity securities over longer-maturity bonds, along with higher quality credits. Commodity prices and MLPs should rebound, and the U.S. dollar is likely to give back some of its 2018 gains (especially against emerging market currencies and the euro). International markets also should benefit if, as we expect, the U.S.-China trade dispute turns to negotiations; Europe resolves some political uncertainty; and China maintains stable economic growth.

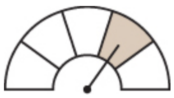
2018—A Year in Review

For 2019, we see potential opportunities but favor keeping risk and reward in clear view. For example, after many years of equity market gains, many portfolios are likely to have more equity concentration than investors originally may have planned. An investor who can be patient as the current sell-off resolves itself could review the target risk for their portfolios. Second, the aging cycle should create more volatility and opportunities to rebalance—i.e., to sell investments at high levels and reallocate to more favored sectors or markets. For instance, should U.S. large-cap equities rebound and take the S&P 500 Index into our year-end 2019 target range (2860-2960), investors should have a chance to lighten large-cap exposure and reallocate. Finally, we favor not treating cash accumulation as an objective but as a means to reallocate from lower-return, higher-risk assets to those with a more favorable risk/reward balance.

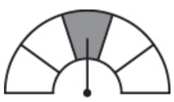
Audrey Kaplan, Head of Global Equity Strategy
Ken Johnson, CFA, Investment Strategy Analyst



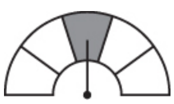
Favorable
U.S. Large Cap Equities



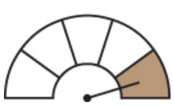
Favorable
U.S. Mid Cap Equities



Neutral
U.S. Small Cap Equities



Neutral
Developed Market
Ex-U.S. Equities



Most Favorable
Emerging Market Equities

Equity markets—2018 year in review

U.S. equity market performance was "bookended" with high volatility in 2018. In February and March, volatility spiked. This was followed by the midyear period (April to September) when U.S. equities saw modest volatility and climbed higher. Yet, after reaching a record high on September 20, the S&P 500 Index had tumbled 14% by mid-December and fallen by 6.2% year to date.

Traditionally lower-risk equity classes outperformed higher-risk equities. The chart below shows that U.S large caps outperformed small caps and U.S. equities outperformed higher-risk equity classes such as frontier markets.

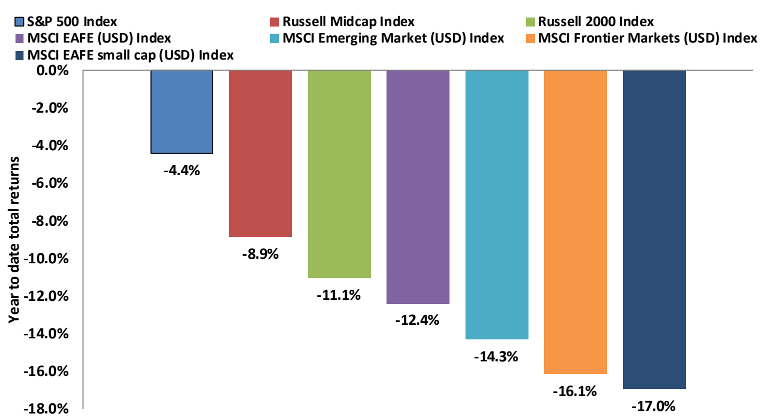
Are these equity declines predicting the next recession? We analyzed the performance of the S&P 500 Index using the returns prior to the start of every recession since the late 1920s. We determined that S&P 500 declines only predicted 2 recessions consistently, for a batting average of 14%. In other words, for 86% of U.S. recessions, a down market did not predict a recession. The S&P 500 has experienced double-digit declines with no forthcoming recession many times in history. Therefore, the negative returns, in our view, may simply be a pause before higher highs in 2019. We believe that earnings per share and equity prices have room to rise in 2019. We also expect to see more attractive international opportunities in 2019, especially in emerging markets.

Key takeaways

» There is no consistent historical evidence that an S&P 500 decline predicts the next U.S. recession.

» 2018 volatility has been driven by trade tensions and rising rates, but we believe that fundamental valuations remain solid, supported by a favorable economy, investing firms, and a robust labor market.

Year to date 2018 equity performance; S&P 500 Index returns and U.S. recessions

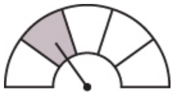


Recession start date	Prior 6 months	Prior 12 months	Prior 18 months
August-29	17.9	49.5	67.0
May-37	-4.0	21.1	32.6
February-45	7.9	17.2	17.9
November-48	-4.5	-2.0	2.6
July-53	-8.6	-2.8	1.8
August-57	7.8	-4.3	5.4
April-60	-1.0	-0.2	11.5
December-69	-10.5	-15.9	-10.6
November-73	-4.7	-7.2	0.5
January-80	5.1	10.3	14.8
July-81	-6.8	9.5	20.8
July-90	1.0	10.9	27.0
March-01	-16.0	-9.9	-7.6
December-07	-0.2	6.7	20.2
	-1.2	5.9	14.6
% of the time positive	**36%**	**50%**	**86%**

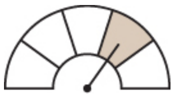
Sources: Wells Fargo Investment Institute, National Bureau of Economic Research, Bloomberg, December 18, 2018. Table shows price returns only. *For illustrative purposes only.* Index returns do not represent investment performance. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** *Investing in stocks involves risk. A stock's returns and risk levels can vary depending on prevailing market and economic conditions. Small- and mid-cap stocks are generally more volatile, subject to greater risks and are less liquid than large company stocks. Foreign investing entails special risks such as currency fluctuation, political, economic, and different accounting standards. These risks are heightened in emerging and frontier markets. Please see the end of this report for the definitions of the indices.*

FIXED INCOME

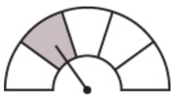
Peter Wilson
Global Fixed Income Strategist



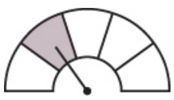
Unfavorable
U.S. Taxable Investment Grade Fixed Income



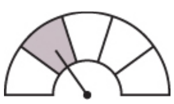
Favorable
U.S. Short-Term Taxable Fixed Income



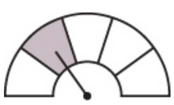
Unfavorable
U.S. Intermediate Term Taxable Fixed Income



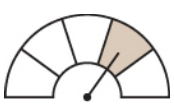
Unfavorable
U.S. Long-Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



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



Favorable
Emerging Market Fixed Income

Fixed income markets—2018 year in review

2018 was a challenging year for fixed income, with only cash alternatives and shorter-maturity securities showing positive year-to-date returns.[1] Ten-year Treasury notes started weaker, with yields rising partly on concerns over the budget deficit and increased issuance. For much of 2018, 10-year Treasury yields range-traded near 3.0%, moving higher late in the third quarter, only to regain the former 2.70%-3.10% range in the fourth quarter on perceived "flight-to-quality" buying as equities declined.

Two-year Treasury yields climbed, from below 1.5% in 2017 to nearly 3.0% in November, driven by four 25-basis-point fed funds rate increases. (One hundred basis points equal 1%). As a result, the yield curve (2-year to 10-year spread) flattened from a high near 80 basis points to almost 10 basis points by December. The curve is flat but not yet inverted. As such, it is not signaling an imminent recession, in our view.

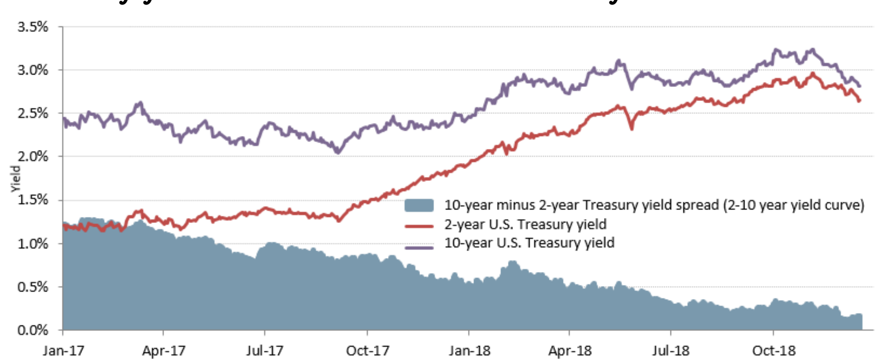
U.S. credit markets performed well for much of 2018, with investment-grade (IG) and high-yield (HY) corporate spreads remaining at relatively narrow levels, until the fourth quarter's equity selling widened HY spreads to above 450 basis points and IG spreads to near 150 basis points over 10-year Treasury yields. International markets also were negative as the dollar remained strong. Developed market (DM) bonds saw low yields decline further as eurozone growth disappointed and political risk emerged in the U.K. (Brexit) and Italy. Localized emerging market (EM) crises in Turkey and Argentina raised yields for dollar-denominated sovereigns above 7%, and better valuations in bonds and currencies saw EM debt stabilize and recover somewhat by late December.

Key takeaways

» 2018 has been a challenging year for fixed-income returns across markets and maturities. Only cash alternatives and shorter-maturity bonds were positive through late December as the Fed raised rates four times.

» Credit markets saw spreads widen in the fourth quarter. DM sovereign bond yields declined, but currency losses outweighed bond price increases. Turkey's and Argentina's volatility cheapened EM bonds, and higher yields brought some EM stability late in 2018.

Treasury yield curve has flattened but not yet inverted

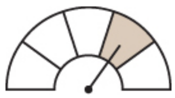


Sources: Bloomberg, Wells Fargo Investment Institute, December 19, 2018. A flattening yield curve means that the difference between short-term and long-term bonds is decreasing. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. **Past performance is no guarantee of future results.** Please see the end of this report for definitions of the Ten-Year and the Two-Year Constant Maturity Indexes.

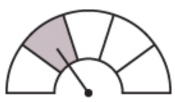
[1] References to year-to-date returns are as of December 18, 2018.

Austin Pickle, CFA
Investment Strategy Analyst

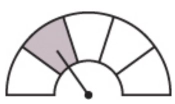
"All genuine knowledge originates in direct experience."
--Mao Tse-tung



Favorable
Commodities



Unfavorable
Private Real Estate



Unfavorable
Public Real Estate

Real assets—2018 year in review

2018 was quite a ride for most asset groups, including real assets. Below, we review some of the more notable 2018 events and performance drivers within the real assets space.

Global growth optimism and a weak U.S. dollar sparked a commodity rally before trade tensions, growth concerns, and a surging dollar pressured prices lower. Oil—which had resisted the negative pull of commodities for most of the year—peaked in October, with a 26% gain on the year. For the first 10 months of 2018, it was lonely being one of Wall Street's rare oil bears. That was until the fourth quarter (Q4), when our oil-bear thesis played out (which was that robust supply growth would outstrip demand growth to push prices lower)—and oil crashed nearly 40% from the October highs. The other headline-inducing commodity, gold, largely traded inversely to the dollar throughout 2018. Yet, the Q4 equity market collapse prompted some perceived "safe haven" buying, which supported gold prices despite a strong dollar.

Real estate investment trusts (REITs) collapsed in the first quarter as long-term interest rates surged to new highs. Then, through the third quarter (Q3), as long-term rates failed to break out of their new trading range, REITs performed admirably. Q4 saw rates again break out to new highs, which hurt REITs. Then, the stock-market meltdown increased the demand for defensive assets. This defensive posture pressured rates downward (the 10-year Treasury yield dropped by more than 40 basis points in just over one month), which contributed to REITs' outperformance later in Q4.

MLPs were hurt by a negative tax ruling in March, before higher oil prices and improving fundamentals spurred a Q3 rebound. MLPs then were hit doubly hard in Q4 by both the oil and stock-market collapse. As a result, MLPs have been one of the worst-performing major asset classes in Q4.

Key takeaways

» Global growth optimism and a weak dollar sparked a commodity rally before trade tensions, growth concerns, and a surging dollar pressured prices downward.

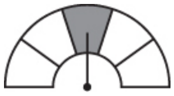
» Oil prices, after defying gravity for much of 2018, finally succumbed to surging supply and moderating demand growth and collapsed in Q4.

» Gold largely traded with the dollar throughout 2018, until Q4, when perceived "safe haven" demand supported prices.

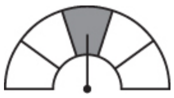
» REITs were hurt by interest rates breaking out to new highs, but demand for defensive assets in Q4 helped them to outperform equities through late December.

» MLPs were whipsawed by negative tax rulings, equity market volatility, and surging—then collapsing—oil prices in 2018.

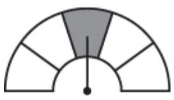
Justin Lenarcic
Global Alternative Investment Strategist



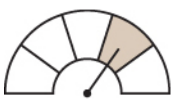
Neutral
Private Equity



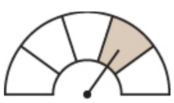
Neutral
Hedge Funds-Macro



Neutral
Hedge Funds-Event Driven



Favorable
Hedge Funds-Relative Value



Favorable
Hedge Funds-Equity Hedge

Hedge funds—2018 year in review

Describing hedge fund performance as a "tale of two cities" may seem cliché, but it also seems quite appropriate as this year draws to a close. 2018 started with positive returns for a hypothetical 60/40 global equity and fixed income portfolio ("blended portfolio")—only to see weakness in February and March—followed by flat to slightly negative markets in April, May, and June. Hedge funds, as defined by the HFRI Fund Weighted Composite Index, outperformed the blended portfolio through the first half of 2018, limiting losses in negative months and outperforming in April and May.

Yet, hedge funds, especially Equity Hedge strategies, were unable to keep pace with the blended portfolio in June and July. Short equity positions detracted significantly in June, while long positions hurt in July and August. October was an extremely challenging month, with some managers down the most since the 2008 financial crisis. Although hedge funds, on average, captured only 65% of the loss experienced by the blended portfolio, we would have liked to see a much better return. Defensive positioning after October also precluded managers from capturing much of the November market rebound.

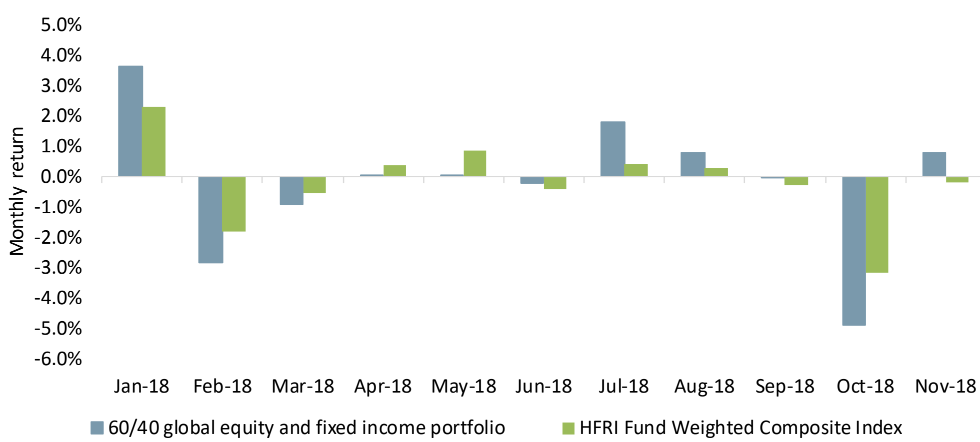
Despite the ups and downs experienced during the year, the year-to-date (YTD) total return for the HFRI Fund Weighed Composite Index through November 30 was only marginally lower than the YTD total return for the blended portfolio. Perhaps most importantly, certain strategies, such as Relative Value and Event Driven, which have gained 1.6% and 0.3%, respectively YTD, have outperformed our expectations. We believe that these strategies are well-positioned for 2019.

Key takeaways

- » Broadly speaking, hedge funds performed in line with a blended portfolio of global equity and fixed income assets in 2018, but performance in the first half was much better than in the second half.
- » We are pleased with the performance of certain strategies, such as Relative Value and Event Driven, which have held up well as credit market volatility increased into year-end.

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.

The first six months were strong for hedge funds—but the last five, not as much



Sources: Hedge Fund Research, Inc., Wells Fargo Investment Institute, December 2018. The 60/40 global equity and fixed income portfolio was constructed using a ratio of 60% MSCI World Total Return Index and 40% Bloomberg Barclays Global Aggregate Total Return Index. For illustrative purposes only. *Index returns do not represent investment returns or the results of actual trading of investable assets or securities. An index is unmanaged and not available for direct investment.* ***Hypothetical and past performance is no guarantee of future results.*** *Please see the end of this report for important risks considerations involving relative value and other hedge fund strategies, asset class risks and for the definitions of the indices.*

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. **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, including gold-related investments, 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.

An investment in Master Limited Partnership (MLP) units involves certain risks which differ from an investment in the securities of a corporation. Holders of MLP units have limited control and voting rights on matters affecting the partnership. In addition, there is certain tax risks associated with an investment in MLP units and conflicts of interest exist between common unitholders and the general partner, including those arising from incentive distribution payments.

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

Bloomberg Barclays Global Aggregate Bond Index provides a broad-based measure of the global investment grade fixed-rate debt markets. It is comprised of the U.S. Aggregate, Pan-European Aggregate, and the Asian-Pacific Aggregate Indexes. It also includes a wide range of standard and customized sub-indices by liquidity constraint, sector, quality and maturity.

HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2000 single-manager funds that report to HFR Database. Constituent funds report monthly net-of-all-fees performance in U.S. dollars and have a minimum of $50 Million under management or a 12-month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

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 EAFE Small Cap Index is an equity index which captures small cap representation across Developed Markets countries around the world, excluding the US 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.

MSCI Frontier Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of frontier markets. The MSCI Frontier Markets Index consists of 24 frontier market country indexes.

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

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.

Ten-Year Treasury Constant Maturity and the Two-Year Constant Maturity Indexes are published by the Federal Reserve Board and are based on the average yield of a range of Treasury securities, all adjusted to the equivalent of a 10-year maturity and the equivalent of a two-year maturity. Yields on Treasury securities at constant maturity are determined by the U.S. Treasury from the daily yield curve. The difference between the 10-year Treasury note yield and the 2-year Treasury note yield measures the spread between short and long-term interest rates.

An index is unmanaged and not available for direct investment.

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