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Investment Strategy

WEEKLY GUIDANCE FROM OUR INVESTMENT STRATEGY COMMITTEE

January 7, 2019

The Fed Should Watch the Yield Curve

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

Key takeaways

» *We believe that the U.S. economy will remain healthy in the near term, and we see the economic expansion continuing in 2019. Yet, we believe that the yield curve merits close monitoring.*

» *There has been concern that a yield curve inversion could signal impending U.S. economic weakness ahead. The Treasury yield curve has been a powerful predictor of recession in past economic cycles.*

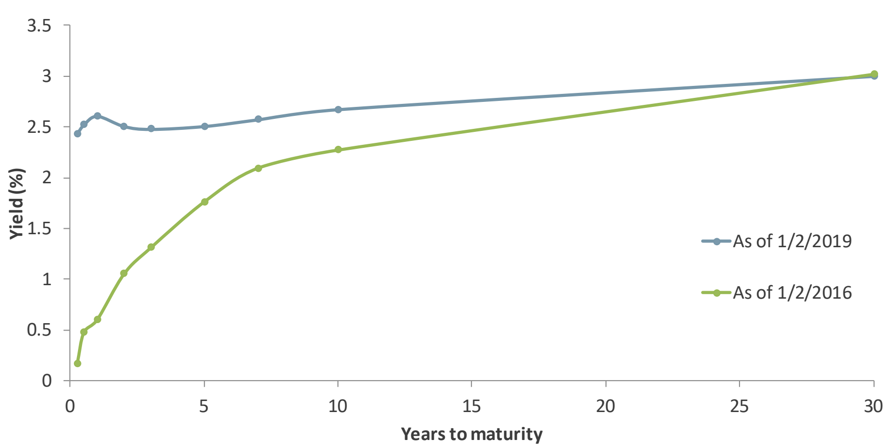
What it may mean for investors

» *Higher short-term rates can present investors with an attractive opportunity to own high quality, short-term securities at yield levels that have not been available for some time. We have a favorable view of short-term investment grade fixed income.*

The yield curve shows the difference between short- and longer-term interest rates. In recent years, as the Federal Reserve (Fed) has transitioned to tighter monetary policy, we have seen meaningful flattening of the yield curve. The yield curve follows fairly predictable long-term trends; steepening early in an economic recovery before flattening and finally inverting into an eventual economic downturn. When short-term rates move above longer-term rates, we have a yield curve inversion. This pattern has been repeated consistently over the past 30 years.

Asset Group Overviews

Chart 1. The U.S. Treasury yield curve has been flattening over the past three years



Sources: Bloomberg, Wells Fargo Investment Institute, January 2, 2019. *For illustrative purposes only.* Chart shows the average yield of a range of Treasury Securities, all adjusted to the equivalent of a 10-year maturity and the equivalent of a one-year maturity. 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.**

The Fed Should Watch the Yield Curve

While some Fed members have noted their concern about the yield curve, the majority of Fed voters do not appear to be overly concerned that the yield curve may invert. The Fed raised rates at its December meeting and did little to alleviate market fears that it was proceeding down a path of additional rate hikes that could eventually lead to a meaningful yield curve inversion.

Given the structure of rates across the entire yield curve, inversions can occur in many forms. Our favored measure of yield curve inversion is the gap between the one-year Treasury yield and the 10-year Treasury yield. We look for the curve to invert for four consecutive weeks or by 25 basis points to indicate a meaningful inversion.[1] The 1-year to 10-year Treasury yield indicator has fallen meaningfully during the recent market volatility. Yet, at 7 basis points (0.07%), this indicator shows that the yield curve remains positively sloped—suggesting that the current growth environment should remain in place.

It is important to note that while a flat yield curve is typically indicative of late-cycle bond market behavior, it does not necessarily indicate that a recession is imminent. Once the yield curve does invert, history suggests that it could still be as long as two years before a recession.

Table 1. The Treasury yield curve (1-year to 10-year yield gap) has been a powerful recession indicator

	Number of weeks before recession						
1-year to 10-year indicator	Dec. 1969	Nov. 1973	Jan. 1980	July 1981	July 1990	Mar. 2001	Dec. 2007
One week of inversion	207	31	61	32	75	126	99
Four weeks of inversion	204	19	58	29	72	46	93
Inversion of 25 basis points	170	18	61	31	67	47	68

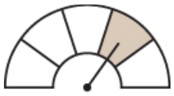
Sources: Bloomberg, Wells Fargo Investment Institute, Federal Reserve Bank of St. Louis (FRED) database, January 2, 2019. *For illustrative purposes only.*

Given the predictive power of the short end of the yield curve and the direct influence that the Fed has over it, we can reasonably assume that the Fed has a significant part to play in yield curve inversions. There are times when the Fed has no other choice but to continue to raise short-term rates, even if the curve does invert—as it believes the damage of high inflation must be quashed through slower growth, even if it inflicts a recession. This does not appear to be one of those times. We have only just recently reached the Fed's inflation target, and most indicators suggest that a meaningful move above the Fed inflation target is very unlikely. Still, the Fed appears intent on continuing its current gradual push to move short-term interest rates higher.

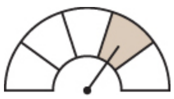
For now, the yield curve remains positively sloped in key areas, but the margin is shrinking. We do look for added yield curve volatility in the coming year. Yet, we urge investors to wait for a definitive signal before becoming overly concerned. We believe that Fed members would be wise to pay more attention to this key indicator of economic health. For a more in-depth discussion of the yield curve, please ask your investment professional for a copy of our July 26, 2018, Fixed Income Strategy report titled "Power in the Yield Curve."

[1] One hundred basis points equal 1%.

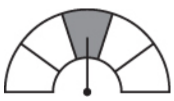
Audrey Kaplan, Head of Global Equity Strategy
Ken Johnson, CFA, Investment Strategy Analyst



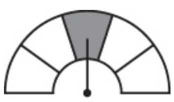
Favorable
U.S. Large Cap Equities



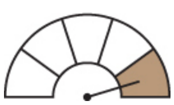
Favorable
U.S. Mid Cap Equities



Neutral
U.S. Small Cap Equities



Neutral
Developed Market
Ex-U.S. Equities



Most Favorable
Emerging Market Equities

Bad U.S. quarterly equity returns often are followed by a better future

U.S. large-cap equities had their worst annual return since the 2008 financial crisis, but the 4.4% S&P 500 Index decline last year was small relative to the gains of the past decade. All U.S. market-cap segments had negative fourth-quarter returns that were among the worst in history. For example, the fourth quarter decline for the Russell Midcap Index (-15.8%) and the Russell 2000 Index (-20.5%) were the fifth and seventh worst of these indices' history. The S&P 500 Index posted its 25th worst quarterly return. After historically large U.S. quarterly equity losses, our analysis shows that the following 6-, 12-, and 24-month periods have been positive 67-100% of the time. Even including the negative return years, these three indices historically achieved double-digit gains during the 12- and 24-month periods that followed the bad quarter (see table). In our opinion, we don't believe that investors should extrapolate short-term losses and assume that longer-term losses are definitely on the horizon.

While we expect slower U.S. earnings growth, we assign a low probability to a recession and a high probability of record-high earnings per share this year. Fear surrounding global growth, trade disputes, and a possible Fed misstep created what we believe is an irrational market valuation discount, which, in our opinion, provides an ideal entry point to put cash to work. With a strong consumer, modest inflation, and a healthy labor market supporting wage growth, we believe that the U.S. equity market will recover as these issues are resolved, and uncertainty is reduced, in 2019.

Key takeaways

» The average 12-month return following bad quarterly returns is 28.6%, 11.0%, and 25.0% for the S&P 500 Index, Russell Midcap Index, and Russell 2000 Index, respectively.

» Volatility has been driven by trade tensions and rising interest rates, but fundamental valuations remain solid.

U.S. equity performance following the 10 largest quarterly losses

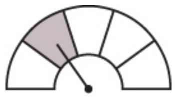
	S&P 500			
	10 Worst Quarters	+6 Months	+12 Months	+24 Months
6/30/1932	-39.40	56.2	146.3	121.4
9/30/1931	-34.52	-20.3	-16.8	0.1
12/31/1929	-28.88	-5.6	-28.5	-62.1
9/30/1974	-26.12	32.0	32.0	65.6
12/31/1937	-23.33	12.9	24.5	18.1
12/31/1987	-23.23	10.0	12.4	43.0
12/31/2008	-22.56	2.2	23.5	39.2
6/29/1962	-21.28	15.0	26.7	49.1
3/31/1938	-19.43	44.0	29.2	43.3
6/30/1970	-18.87	26.9	37.1	47.3
Average		17.3	28.6	36.5
% return is positive		**80%**	**80%**	**90%**

	Russell Midcap			
	10 Worst Quarters	+6 Months	+12 Months	+24 Months
12/31/2008	-27.79	9.5	37.7	70.0
9/30/2011	-19.24	25.7	25.8	58.3
9/28/2001	-18.18	21.3	-9.4	16.7
9/30/2002	-17.96	5.7	30.5	54.9
12/31/2018	**-15.79**	--	--	--
9/30/1998	-15.26	17.2	17.7	52.7
9/30/2008	-13.29	-35.6	-5.7	9.0
3/30/2001	-10.82	-10.7	8.3	-15.3
3/31/2008	-10.33	-12.3	-42.1	-4.6
6/30/2010	-10.23	27.4	36.4	31.8
		5.4	**11.0**	**30.4**
		67%	**67%**	**78%**

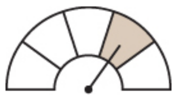
	Russell 2000			
	10 Worst Quarters	+6 Months	+12 Months	+24 Months
12/31/1987	-29.40	25.4	22.4	39.8
12/31/2008	-26.51	3.6	25.2	56.9
9/28/1990	-24.93	34.6	40.8	50.2
9/30/2011	-22.15	28.9	30.0	66.7
9/30/2002	-21.69	1.8	34.6	58.1
9/28/2001	-21.07	25.1	-10.6	19.8
12/31/2018	**-20.51**	--	--	--
9/30/1998	-20.42	9.5	17.4	43.0
9/30/1981	-18.19	-2.0	4.9	73.8
3/31/2009	-15.36	38.1	60.5	99.5
		18.3	**25.0**	**56.4**
		89%	**89%**	**100%**

Sources: Wells Fargo Investment Institute, Bloomberg, January 2, 2019. Analysis period begins in March 1928, March 1993, and March 1979 for the S&P 500 Index, Russell Midcap Index, and Russell 2000 Index (small caps), respectively. *For illustrative purposes only.* Index returns do not represent investment performance or the results of actual trading. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** There is no guarantee any asset class will perform in a similar manner in the future or in other similar market environments even if it has done so historically. Small and mid-cap stocks are generally more volatile that large company stocks. Please see the end of this report for the definitions of the indices.

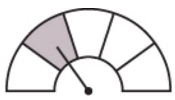
Peter Wilson
Global Fixed Income Strategist



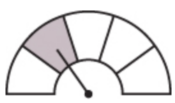
Unfavorable
U.S. Taxable Investment Grade Fixed Income



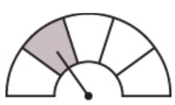
Favorable
U.S. Short-Term Taxable Fixed Income



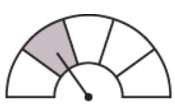
Unfavorable
U.S. Intermediate Term Taxable Fixed Income



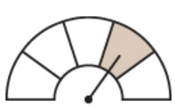
Unfavorable
U.S. Long-Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



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



Favorable
Emerging Market Fixed Income

Comparing 10-year government bond yields in developed markets

We hold an unfavorable view on Developed Market (ex-U.S.) Fixed Income, partly because sovereign bond yields outside the U.S. remain below Treasury security yields. As the federal funds rate has risen, the yield gap between the U.S. and other major sovereign bond markets has widened over the past year (see chart below). While we expect developed market (DM) yields outside the U.S. to rise somewhat this year, convergence with U.S. yields likely will be a slow process—that we do not believe will be completed in 2019.

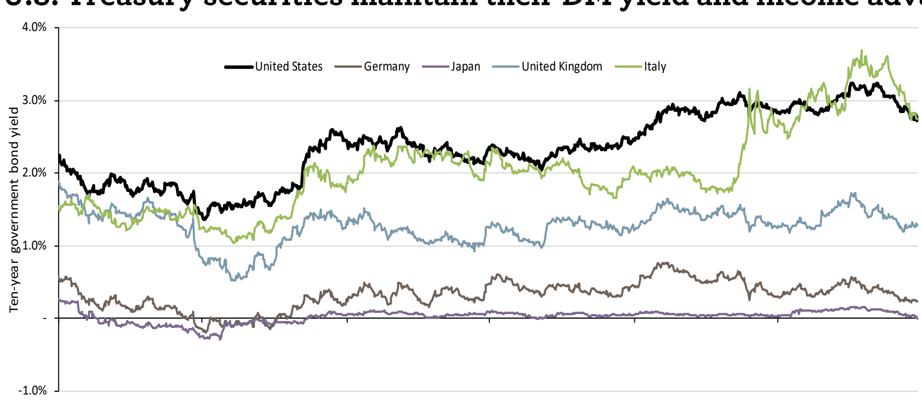
Each market will face unique risks. We expect yields on 10-year German bunds, which ended 2018 at just 0.24%, to rise by year-end. Yet, whether they will sustainably break above the 0.76% 2018 high would depend on a eurozone economic recovery that is firm enough to allow the European Central Bank (ECB) to begin normalizing interest rates in 2019. ECB President Draghi's term will expire in October, so his potential successor will be a topic of market concern. Italian yields have fallen recently, but volatility may return if populists are emboldened by gains in European Parliamentary elections in May. Ten-year U.K. Gilt yields, in our opinion, are trapped in a trading range due to Brexit negotiations—caught between an inflation outlook that would justify higher rates and risks of severe economic dislocation that could drive yields lower. Finally, Japanese Government Bond yields remain stuck at zero, in the center of the Bank-of-Japan-controlled 0.2% trading band. Hopes that more flexibility on the trading band would allow yields to rise have been frustrated by still-sluggish inflation.

Key takeaways

» With the exception of Italy, most major developed government bond markets have yields far below those available on U.S. Treasury securities. While we expect yields to rise in 2019, in our opinion, convergence with U.S. yields likely will be slow.

» Eurozone bonds face risks from a lackluster economy and likely populist gains in European Parliamentary elections; U.K. Gilts face a binary outlook that is dependent on Brexit developments; and 10-year Japanese sovereign yields remain stuck close to zero.

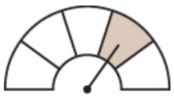
U.S. Treasury securities maintain their DM yield and income advantage



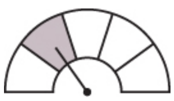
Sources: Bloomberg, Wells Fargo Investment Institute, December 31, 2018. *For illustrative purposes only.* Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. **Past performance is no guarantee of future results.** The stability of the issuing government is an important factor to consider when assessing the risk of investing in sovereign debt.

Austin Pickle, CFA
Investment Strategy Analyst

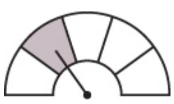
"If you don't like change, you're going to like irrelevance even less."
--Eric Shinseki



Favorable
Commodities



Unfavorable
Private Real Estate



Unfavorable
Public Real Estate

Energy commodities look to be heating up

When we upgraded commodities last September, we suggested avoiding the energy commodity sector. Today, we see energy as the most attractive commodity sector. Why the 180? An epic price collapse.

In September, the rationale for our unfavorable energy outlook was that we believed oil prices were unjustifiably high. At the time, West Texas Intermediate (WTI) crude oil[2] traded at around $70 per barrel. Less than one month after our unfavorable energy commodity call, oil prices peaked and then proceeded to crash. As of January 2, 2019, WTI oil prices were down roughly 40% from this recent peak.

Oil and its derivatives (e.g., gasoline and diesel) make up roughly two thirds of the Bloomberg Energy Commodity Index. The remaining one third, natural gas, initially surged to more than $4.60 but then fell back to earth at around $2.90 and near its starting price of $2.80 per million Btu (British Thermal Units). As a result of the epic oil price collapse and the round trip of natural gas prices since our September guidance, energy has been the worst-performing major commodity sector by far (as measured by the Bloomberg Commodity Index sectors: agriculture, energy, industrial metals, and precious metals).

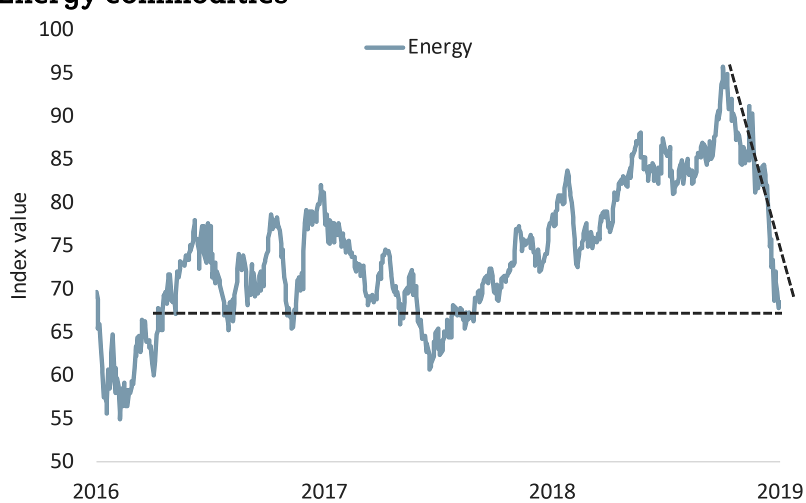
We believe that the oil price collapse has gone too far, and we expect higher oil prices by year-end 2019. Additionally, given the 35% price collapse for natural gas over the past four weeks, the risk/reward profile for energy commodities as a whole looks quite attractive to us. Oh, how quickly things can change.

Key takeaways

» The recent oil and natural gas price collapse has changed our view on energy commodities.

» The energy commodity sector now looks attractive to us.

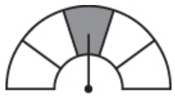
Energy commodities



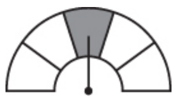
Sources: Bloomberg, Wells Fargo Investment Institute. Energy represented by the total return of the Bloomberg Commodity Energy Subindex. Daily data: 1/4/2016 – 1/2/2019. Index returns do not represent investment performance or the results of actual trading. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** Investing in commodities is not suitable for all investors. Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Please see the end of the report for the definition of the index and a description of other risks associated with investing in commodities.

[2] WTI is a grade of crude oil used as a benchmark in oil pricing.

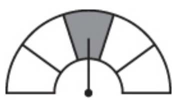
Justin Lenarcic
Global Alternative Investment Strategist



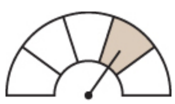
Neutral
Private Equity



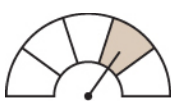
Neutral
Hedge Funds-Macro



Neutral
Hedge Funds-Event Driven



Favorable
Hedge Funds-Relative Value



Favorable
Hedge Funds-Equity Hedge

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.

High-yield credit volatility rose by more than five times in the fourth quarter

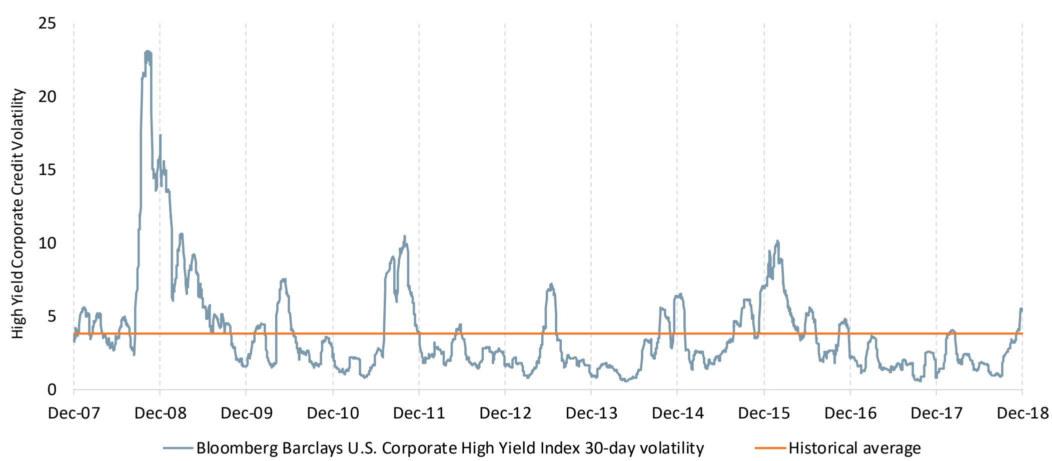
The rolling 30-day volatility of the Bloomberg Barclays U.S. Corporate High Yield Index spiked during the fourth quarter—ending well above its historical average since December 2007. While the magnitude of the volatility increase was surprising, the overall direction (higher) is something that we have been expecting for some time. In this case, weakness in both equity and oil markets pressured high-yield corporate credit. The entire CCC-rated portion of the high-yield debt sector is now averaging distressed spread levels (currently at approximately 1,100 basis points). Moreover, nearly 12% of high-yield issuers and 9.5% of the index face value are now trading at distressed spread levels.[3]

A more volatile high-yield credit market bodes well for our favorable view on Long/Short Credit and Distressed Debt strategies, though abrupt volatility spikes are almost always difficult to navigate. As mentioned in our 2019 Outlook report, we believe that credit selection is becoming increasingly important, which favors—in our opinion—active management. We anticipate that credit dispersion will increase in 2019, especially if capital markets tighten and bond issuance continues to decline. This could spur a wave of downgrades and further pressure high-yield credit spreads, leading to more selling from passive investors. Long/Short Credit managers typically thrive in this environment, as do more directional credit Distressed Debt managers that parse through the stressed and distressed debt rubble to find turnaround opportunities. We remain constructive on these strategies, and we are considering the possibility that the long-awaited opportunity set is finally on our doorstep.

Key takeaway

» Credit volatility increased significantly during the fourth quarter—reaching levels not seen since the 2016 market collapse driven by energy credits. We see this increase in volatility as supporting evidence that the environment is becoming more conducive to Long/Short Credit and Distressed Debt strategies.

High yield corporate credit volatility has returned to 2016 levels



Sources: Bloomberg, Wells Fargo Investment Institute, January 2019.Index returns do not represent investment performance or the results of actual trading. An index is unmanaged and not available for direct investment. Volatility is measured by the annualized standard deviation of the daily price change of the Index for the 30 most recent trading days. Standard deviation is often used to represent the volatility of an investment. The higher the standard deviation the higher volatility has been. **Past performance is no guarantee of future results.**

[3] Bank of America Merrill Lynch, "High Yield Strategy: Is This the Big One?" January 2, 2019. Ratings assess default and credit risk. Standard & Poor's designates CCC-rated obligations to be of poor standing and subject to very high credit risk. A security is often considered distressed if it is rated CCC or below by one or more of the major debt-rating agencies, which include Standard & Poors, Moody's and Fitch.

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 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.

Distressed securities are primarily debt securities which originate from companies that are in the process of reorganization or liquidation under local bankruptcy law, or companies engaged in other extraordinary transactions such as balance sheet restructurings. Investing in distressed companies is speculative and subject to greater levels of credit, issuer and liquidity risk. In addition, the repayment of default obligations contains significant uncertainties.

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 derivatives, fixed income, foreign investment, currency, hedging, leverage, liquidity, short sales, loss of principal and other material risks.

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

The **Ten-Year Treasury Constant Maturity and the One-Year Treasury 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 one-year maturity. Yields on Treasury securities at constant maturity are determined by the U.S. Treasury from the daily yield curve.

The **Bloomberg Barclays US Corporate High Yield Bond Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

Bloomberg Commodity Energy Subindex is a commodity group subindex of the Bloomberg Commodity Index. It is composed of futures contracts on crude oil, ultra-low sulfur diesel, unleaded gasoline and natural gas. It reflects the return of the underlying commodity futures and is quoted in USD.

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 U.S. stock market.

An index is unmanaged and not available for direct investment.

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