Overheating or Warming up

Key takeaways

» We believe most asset classes will move higher in 2020 but doubt the returns will rival last year’s gains.

» The Private Equity represented enterprise value is near the high-end of its range but remains in-line with the S&P 500 Index’s trailing EBITDA multiples.

» We recommend systematically allocating to private equity over time, allowing for vintage year diversification to capture opportunities over the longer run.

What it may mean for investors

› We remind investors to stay diversified in asset allocations and believe private markets have a place in portfolios, where appropriate.

As we enter a new decade, investors may be wondering if the spectacular returns of the past decade can continue. We believe that most asset classes will move higher in 2020; however, we doubt the returns will rival last year’s double-digit gains across all nine of our portfolio allocations.

Of the major public markets, the S&P 500 (which represents U.S.-based large company stocks) was not only the top performer last year, but it was also the top performer of the last decade. Over that period of time, the S&P 500 Index generated average annual returns of 13.6%. But there was another asset class that posted even better gains—private equity. Using the ILPA Index as a proxy for broad-based private equity investing, the annualized 5-year, 10-year, and 15-year returns were 13.8%, 16.8%, and 13.9%, respectively, exceeding S&P 500 Index returns by 150-500 basis points\(^1\) over the same periods.\(^2\)

Public and private—Two components of equity investing

Private equity has continued to deliver strong performance in recent quarters, and we continue to believe that it has a place in portfolios for qualifying investors. Even so, increasing interest in this asset class has resulted in rising valuations for private equity. As Chart 1 shows, the Private Equity represented enterprise value (EV) to its earnings before most expenses, including interest, taxes, depreciation, and amortization

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\(^1\) 100 basis points equal 1%.

Overheating or Warming Up

(EBITDA) or the EV/EBITDA multiples, is near the high-end of its range in this cycle but remains in-line with the S&P 500 Index’s trailing EBITDA multiples.

Chart 1. S&P 500 trailing EV/EBITDA Multiple versus Private Equity EBITDA Multiples

![Chart showing EV/EBITDA multiples for S&P 500 and Private Equity]

Although valuations appear high relative to historical valuations, we believe that attempting to time a private equity allocation can significantly reduce potential returns. Instead, we recommend systematically allocating to this asset class over time. For example, our long-term allocation recommendation may suggest a 10% weighting to private equity. However, for a new investor in private equity, only 2% may be invested in each of the next 5 years.³ This method of investing allows for vintage year diversification—a way to purchase different companies at different points in the market cycle.⁴ (Analysis on investing in private capital and vintage year diversification can be found in our Alternative Investments In Depth report, “Speedboats and Battleships,” published on January 2, 2020.)

Until the full 10% is allocated, holding the difference in public equity may be a good way to capture economic gains through the course of the private equity investment process.

Conclusion

There likely is still room for economic growth and asset price appreciation in the current market cycle. As such, we believe investors should stay diversified in asset allocations that include private markets, where appropriate. While valuations are rising in the private equity market, especially in large buyout funds, there may be better values in international markets and areas such as secondaries, niche, and venture capital. New investors in private equity may use vintage year diversification to capture opportunities over the longer run.

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³ Private asset classes, including private equity, private debt, and private real estate, tend to have significantly longer capital commitment (lock up) periods than public markets.
⁴ Vintage year refers to the initial inflow of capital distributed to an investment or venture within a private equity arm.
U.S. markets have displayed resilience despite uncertain events

The recent U.S. airstrike in Iraq on Iranian military personnel has brought geopolitical risk to the forefront again. This type of risk is always looming, but investors never know when it will surface and what the impact will be on financial markets.

History can be a guide when these events take place, and the chart below illustrates that some of the best years for stock market performance were fraught with concern. In addition, it shows that historically, geopolitical crises have led to temporary setbacks for the markets, usually presenting investors with attractive buying opportunities.

Some reminders of how stocks have outperformed during periods of crisis include 1991, amidst the Iraq War and a U.S. economic recession, and the years following the September 11, 2001 terrorist attacks.

With the potential for rising geopolitical risk in 2020, we remain neutral across all equity asset classes, with the exception of U.S. small-cap equities where risk may exceed reward. We continue to forecast modest upside in corporate earnings and stock prices this year, but favor higher quality asset classes, such as U.S. large cap, in the near term.

Key takeaways

- Historically, geopolitical crises have led to temporary setbacks for the markets, usually presenting investors with attractive buying opportunities.
- With the potential for rising geopolitical risk in 2020, we remain neutral across all equity asset classes, with the exception of U.S. small-cap equities where risk may exceed reward.

U.S. markets have displayed resilience despite uncertain events

Sources: Wells Fargo Investment Institute, Bloomberg, January 6, 2020. An index is not available for direct investment. Past performance is no guarantee of future results.
Leveraged loans—Caution warranted

Last month, the Financial Stability Board (FSB) published a report on leveraged loans (also known as bank loans), which has attracted attention from market participants due to findings of incremental vulnerabilities in the space. Leveraged loans are senior secured loans made to companies that have a below-investment-grade rating (think high yield), often outside the banking sector. According to the report, several FSB members have expressed concerns about the rapid growth in the leveraged loan market and the lower credit quality of the debt issued. Furthermore, the report shed light on two newer findings: 1) banks have the largest direct exposure to leveraged loans and Collateralized Loan Obligations (CLOs), but assessment of the implications of exposures is challenging to the FSB; and 2) more work is needed to close out data gaps and to assess shocks in transmission channels in the space.

Although the alarm bells in leveraged loans have been sounding for a while, it was somewhat unsettling to see that currently FSB members don’t fully understand the underlying intricacies in this space. We do believe, however, that the findings are consistent with and solidify our unfavorable view on this fixed-income class. Corporate issuers in this space are displaying higher leverage metrics, and we believe that this situation could deteriorate further if earnings were to suffer, particularly in an environment where economic growth appears to be slowing. This could trigger potential credit downgrades—and with them—higher interest expense to the point of credit illiquidity for these issuers.

Key takeaways

» We have an unfavorable view on bank loans. We prefer allocating assets to investment-grade (IG) taxable fixed income and IG corporate bonds.

» A deterioration of earnings for these highly leveraged issuers could exacerbate the situation. This could trigger potential credit downgrades, and with them, higher interest expense to the point of credit illiquidity.

U.S. leveraged loans credit ratings: ratio of downgrades to upgrades

![Graph showing U.S. leveraged loans credit ratings ratio of downgrades to upgrades](image-url)
Baltic drop—A bad omen for commodity demand?
The Baltic Exchange Dry Index (BDIY) is an index that measures shipping rates for dry bulk goods, which include many relevant commodities (metal ores, coal, grains, etc.). The BDIY has dropped precipitously since its September 2019 peak. The recent drop has prompted the question: “Should investors worry about commodity demand?” In a word, “no.” Let’s discuss.

First of all, it has been a regular occurrence for BDIY to drop this time of year. A major influence is that imports into China slow as the country prepares for the Chinese New Year. In fact, the BDIY experienced a drop leading into the Chinese New Year 33 out of the past 35 years. This pattern has only intensified recently. The table below shows that in every single year since 2008, the BDIY has dropped over 30%—and the drop was over 60% in 7 of those years.

Second, the supply of ships and demand for goods was distorted in 2019. Earlier in the year, an escalating U.S.-China trade war caused many to front load goods purchases (increased demand). Additionally, new shipping regulations caused many ships to be idled (reduced supply). This caused shipping rates, and the BDIY, to spike significantly in the third quarter. Since then, the precipitous drop in the BDIY is likely being amplified by ships returning to service at a time of seasonal low demand.

In “strategist speak,” we caution against extrapolating implications for commodity demand from the recent drop in BDIY.

Key takeaways
» The BDIY has dropped substantially.
» We do not view this drop as a bad omen for commodity demand.

**Baltic Exchange Dry Index performance around Chinese New Year**

<table>
<thead>
<tr>
<th>Chinese New Year</th>
<th>Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>-44.4%</td>
</tr>
<tr>
<td>2009</td>
<td>-88.1%</td>
</tr>
<tr>
<td>2010</td>
<td>-44.8%</td>
</tr>
<tr>
<td>2011</td>
<td>-65.2%</td>
</tr>
<tr>
<td>2012</td>
<td>-61.2%</td>
</tr>
<tr>
<td>2013</td>
<td>-32.4%</td>
</tr>
<tr>
<td>2014</td>
<td>-52.6%</td>
</tr>
<tr>
<td>2015</td>
<td>-65.5%</td>
</tr>
<tr>
<td>2016</td>
<td>-73.2%</td>
</tr>
<tr>
<td>2017</td>
<td>-34.2%</td>
</tr>
<tr>
<td>2018</td>
<td>-37.9%</td>
</tr>
<tr>
<td>2019</td>
<td>-63.8%</td>
</tr>
<tr>
<td>2020*</td>
<td>-68.6%</td>
</tr>
</tbody>
</table>

Sources: Bloomberg, Baltic Exchange, Wells Fargo Investment Institute. Performance measured from the peak that occurred within 6 months of the Chinese New Year to the Chinese New Year. *2020 return as of January 8, 2020. Past performance is no guarantee of future results.
Hedging Middle Eastern tensions with Macro managers

With tensions mounting between the U.S. and Iran following the drone strike in early January, we have received numerous questions around the best way to “hedge” further fallout. Obviously, there is no perfect hedge against a geopolitical event, as it is difficult to predict how and when global assets will react and to what degree. That said, a common reaction to Middle Eastern tensions could be seen in the commodity pit, where oil futures tend to move higher as risks mount. Fortunately, many trend-following Macro strategies went long West Texas Intermediate (WTI) crude futures in mid-November, depicted by the yellow arrow in the chart below. This buy signal occurred as the short-term and long-term moving averages crossed.

While it is difficult to anticipate performance for the Macro strategy, there are several catalysts we are monitoring in the New Year. A pick-up in volatility may result in pricing dislocations, which could benefit discretionary macro managers. Furthermore, while trends in fixed income may be muted in the U.S. given the more dovish stance by the Federal Reserve this year, opportunity exists in other developed and emerging market fixed-income trading. The near-term could see trends in commodities, notably energy and precious metals, as investors digest geopolitical risks. Regardless of the source of opportunity, we continue to find value in the historical diversification benefit of the Macro strategy for qualified investors—especially at this point in the cycle.

Key takeaways

» Hedging geopolitical risk is difficult, but we believe the Macro strategy is best positioned to serve in that capacity under the right circumstances.

» With tensions mounting in the Middle East, we are looking for trend following Macro strategies—given their long oil positions—to help dampen volatility.

Trend followers have been long oil futures since mid-November

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.

Private equity investments are less transparent than public investments and private equity investors are afforded less regulatory protection than investors in registered public securities. Private equity funds are sold in private placements and may be offered only to individuals who are both “qualified purchasers” (as defined in U.S. Investment Company Act of 1940, as amended) and “accredited investors” (as defined in the Securities Act) and for whom the investment is otherwise suitable.

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 **ILPA Private Markets Benchmark-U.S./Canada Private Equity Index** is a horizon calculation based on data compiled from 934 U.S./Canada private equity funds, including fully liquidated partnerships, formed between 1986 and 2019. Private Indexes are pooled horizon internal rate of return (IRR) calculations, net of fees, expenses, and carried interest. The timing and magnitude of fund cash flows are integral to the IRR performance calculation. Public indexes, such as S&P 500 Index, are average annual compounded return (AACR) calculations which are time weighted measures over the specific time horizon, and are shown for reference and directional purposes only. Due to fundamental differences between the two calculations, direct comparison of IRRs to AACRs is not recommended.

**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.

An index is unmanaged and not available for direct investment.

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