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INVESTMENT INSTITUTE

Investment Strategy

WEEKLY GUIDANCE FROM OUR INVESTMENT STRATEGY COMMITTEE

April 15, 2019

How Long Can the Good Times Roll for Municipals?

George Rusnak, CFA
Co-Head of Global Fixed Income Strategy

Key takeaways

» *Municipal bonds recently have performed well, driven partly by demand for tax-exempt assets in the wake of the tax law's cap on state and local tax deductions (SALT).*

» *While municipal-to-Treasury yield ratios have approached historically rich (low) levels, supply is limited and we expect demand to remain strong this year.*

What it may mean for investors

» *We are favorable on the municipal bond sector. Yet, we recommend selectivity and a higher-quality bias.*

Municipal bonds have performed well year to date (YTD), returning 2.9% last quarter.[1] We have a favorable view of municipals, and we anticipate solid near-term support for this sector overall. In fact, we recently upgraded our duration guidance from unfavorable to neutral to reflect this opportunity.[2] The new tax law's limit on SALT[3] deductions has fueled strong demand for municipals, which we expect to last through the summer (or longer). In fact, YTD fund flows of more than $20 billion already exceed all fund inflows from 2018 (according to Lipper). There also are some favorable credit developments that suggest some states' fundamentals are improving. Yet, we favor selectivity and a higher-quality bias, given municipals' recent outperformance and the historically low municipal-to-Treasury yield ratios.

Asset Group Overviews

Equities............................ 4
Fixed Income 5
Real Assets..................... 6
Alternative Investments.................. 7

Tax changes have fueled strong demand

As noted, municipal demand has been strong. The $23.4 billion in YTD municipal fund inflows are the strongest since records began in 1992.[4] In the wake of the new tax law and capping of SALT deductions, investors have responded with demand for municipal securities' tax benefits, particularly in higher-tax states, such as California, Connecticut, New Jersey, and New York. This has caused the yield spread (over the AAA Municipal Market Data curve)[5] for these states' municipal debt to decline to levels near 1-year lows.[6]

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

[1] Return of the Bloomberg Barclays Municipal Bond Index during the first quarter of 2019. *Index returns do not represent investment performance.* An index is unmanaged and not available for direct investment.
[2] Duration measures a bond's price sensitivity to interest-rate changes.
[3] SALT limits the itemized deduction on state and local taxes for joint filers to $10,000. It was newly implemented in the Tax Cuts and Jobs Act passed in December 2017. Tax laws or regulations are subject to change at any time and can have a substantial impact on an individual situation. Wells Fargo and its affiliates are not legal or tax advisors.
[4] Lipper data, fund flows through April 5, 2019.
[5] Thomson Reuters Municipal Market Data (MMD) AAA Curve is a proprietary yield curve that provides the offer-side of "AAA" rated state general obligation bonds, as determined by the MMD analyst team.
[6] Thompson Municipal Market Monitor, April 10, 2019.

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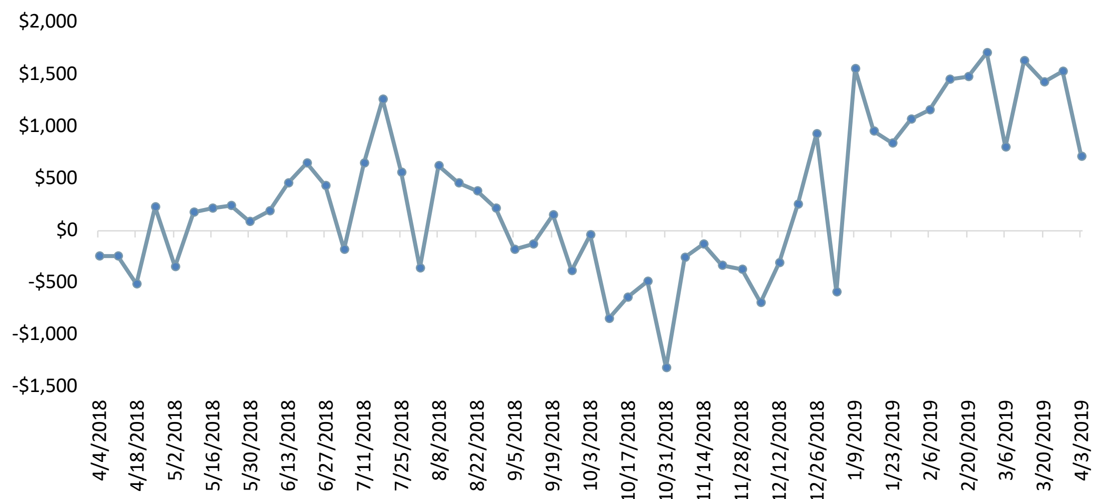
Chart 1. Weekly municipal fund flows



Source: Lipper, April 5, 2019.

We expect municipal-market demand to remain strong as five of the last nine months of this year are scheduled to have record amounts of maturing bonds.[7] A large percentage of maturing municipal bonds historically has been reinvested in municipals. This reinvestment activity also should help to support the market.

Net negative supply

Despite our expectation for higher municipal issuance in 2019 than we saw last year, we anticipate that net municipal supply (after called and matured bonds) will remain negative this year. When maturing and called municipal debt is factored in, net municipal supply for 2019 is expected to cross -$50 billion.[8] In fact, some analysts have estimated that net negative supply could top -$60 billion by year-end.[9]

Many municipal yield ratios are historically rich

The combination of tremendous demand and net negative supply has caused municipal-to-Treasury yield ratios to approach historically low (rich) levels (Chart 2). On April 10, the yield for 10-year municipal securities stood at approximately 77% of 10-year Treasury security yields; this is close to a 1-year low. This ratio is important for "crossover" buyers like banks, insurance companies, and international sovereigns. These buyers are typically attracted to municipals' value as a high quality investment diversifier, rather than their tax-free benefits. Lower municipal-to-Treasury ratios typically will make these buyers less inclined to buy municipals.

[7] Siebert Cisneros Shank & Co. LLC, March 19, 2019.
[8] J.P. Morgan, April 2019.
[9] Ibid.

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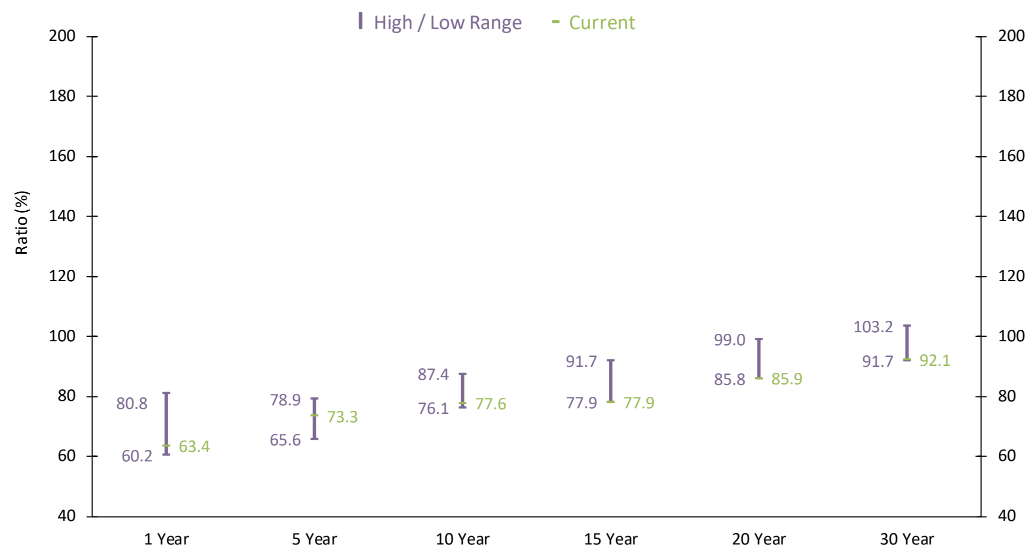
Chart 2. Municipal-to-Treasury yield ratios



Source: Thomson Municipal Market Monitor, April 10, 2019. Chart shows past 12-month ratios for AAA-rated securities, including the high, low, and current value. Bottom axis shows the maturity period for each security issue. The Municipal/Treasury Ratio is calculated by comparing the yield on an index of AAA-rated municipal bonds vs. the yield on the equivalent Treasury Note. *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.**

A mixed story for fundamentals

Fundamentally, some state municipalities are doing well, while others are facing challenges, especially for their pension plans. Overall, state tax receipts increased by 7.0% year-over-year (YoY) through September 30, 2018; this is above the 4.5% average since 2012.[10] On a national basis, state debt only rose by a modest 1.4% over the five years ended in April 2018.[11] This confirms that many states have trimmed their budgets and adopted austerity measures.

One challenge that continues to plague the municipal market is unfunded pension liabilities. Although 22 states contributed enough to reduce their pension liabilities YoY, those states that are underfunding their contributions are doing so at a much larger size and pace.[12] In fact, median state unfunded pension liabilities increased by 23% over the past five years.[13]

Investor implications

With the backdrop of tremendous demand (which we expect to continue through summer), and improving fundamentals, we believe that municipals are likely to continue performing well in the near term. Yet, it is important to note that municipals are coming off a solid performance run, which has left these securities at historically low yield ratios versus their taxable counterparts. We recommend that investors raise average credit quality and slightly favor short-to-intermediate maturities. We also believe that investors should use any market weakness as an opportunity to adopt a more neutral duration stance versus their individually selected benchmark.

[10] U.S. Census Bureau, December 18, 2018.
[11] Moody's Investors Service, April 24, 2018. Moody's report was as of April 24, 2018. Five-year period was based upon each individual state's fiscal year (so end dates could vary accordingly).
[12] Moody's Pension Liabilities, August 21, 2018.
[13] Ibid.

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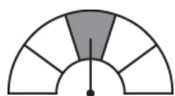
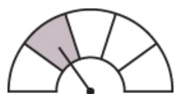
Scott Wren
Senior Global Equity Strategist

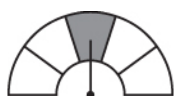


Neutral
U.S. Large Cap Equities

Neutral
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Neutral
Developed Market
Ex-U.S. Equities

Most Favorable
Emerging Market Equities

Global trade dampens intermediate developed market equity outlook

Like most countries included in the MSCI EAFE Index (Europe, Australasia, and the Far East), German companies earn the bulk of their earnings outside of their home country border. Recent data shows that companies making up the MSCI Germany Index (as a group) only earn 21.8% of their revenue from inside Germany.[14] In general, companies that make up the MSCI EAFE Index tend to rely heavily on exports for a major portion of their earnings. These companies operate in what are essentially export-driven economies (rather than consumption-driven ones). In sharp contrast, just over 61% of S&P 500 company revenues come from inside the United States. Our economy is driven primarily by consumer spending. Clearly, German companies are far more dependent on the health and well-being of the global economy than S&P 500 Index companies are, in aggregate (see charts). And right now, global trade volumes and economic growth have slowed.

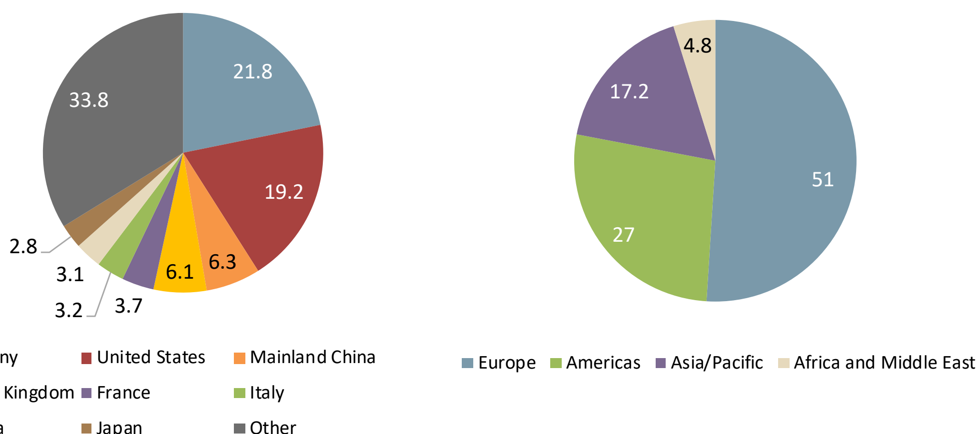
Investors have been asking about our concerns that have led to our long-held neutral rating on international developed market (DM) equities. We track these markets using the MSCI EAFE Index (among other factors). In addition to several political concerns, we also are focused on the global growth slowdown—and how this will affect this equity class. Slower global growth and falling trade volumes have a direct impact on the largest companies in the MSCI EAFE Index. We would need to see at least stabilizing growth to get more interested in the developed market equity class.

Key takeaways

» Companies in the MSCI EAFE Index rely heavily on global trade for earnings growth.

» Global trade volumes, and global growth, have slowed. We retain our neutral rating on DM equities.

Revenue sources of companies in MSCI Germany Index (Percent of revenue by country and region)



Sources: FactSet, Wells Fargo Investment Institute; April 11, 2019. *For illustrative purposes only*. 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 Germany Index is designed to measure the performance of the large and mid-cap segments of the German market. With 54 constituents, the index covers about 85% of the equity universe in Germany.

[14] FactSet, April 11, 2019.

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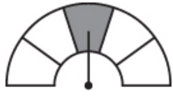
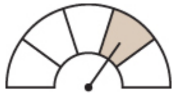
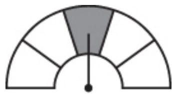
Luis Alvarado
Investment Strategy Analyst



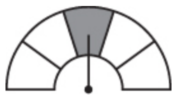
Neutral
U.S. Taxable Investment Grade Fixed Income



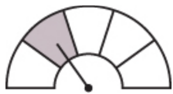
Favorable
U.S. Short-Term Taxable Fixed Income



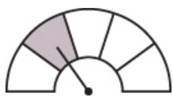
Neutral
U.S. Intermediate Term Taxable Fixed Income



Neutral
U.S. Long-Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



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

Neutral
Emerging Market Fixed Income

Risks lie under the surface for high-yield corporate debt

The high-yield (HY) corporate bond market has delivered YTD gains as investors focus on the positive dynamics of the economy. This has caused spreads to continue tightening. Despite HY's YTD outperformance, we still believe that there are embedded risks for this bond class that deserve attention. These include weakening fundamentals in the CCC-rated bond space—along with the potential for overly optimistic default expectations.

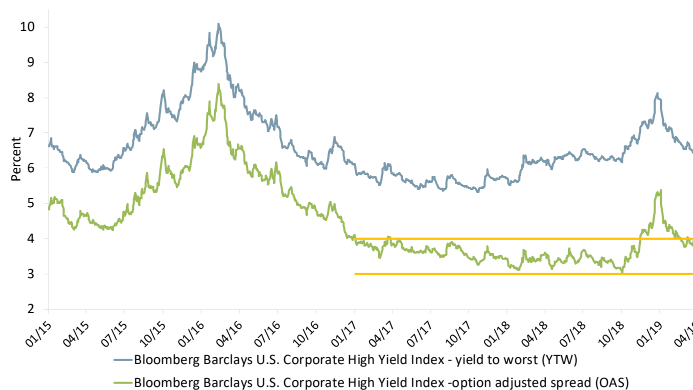
As we move further into the business cycle, HY fundamentals are beginning to deteriorate. This is particularly so for the CCC-rated HY space, with net leverage now three times higher than it was in December 2007.[15] While 12-month forward default expectations for HY companies equal approximately 1.5% of total debt outstanding—below the historical average of 3.3%—this may be overly optimistic, given how late we are in the business cycle (and the struggle of some CCC-rated issuers to access the primary debt markets).[16]

We remain in a relatively low-rate environment today, and some investors may be seeking higher yields through exposure to HY debt. While there may be potential for positive low-single-digit HY returns in 2019 and for the next 12 months, we see better opportunities in other asset classes. In our view, the HY risk/return profile remains asymmetric, with little upside potential and significant downside risk (particularly given how quickly conditions can change in this debt class). As a result, we have an unfavorable view of the HY fixed-income class.

Key takeaways

- Any substantial shift to a "risk-off" environment could cause risks to quickly surface and lead to HY debt underperformance. Market conditions can change rapidly in the HY space.
- We have an unfavorable view of the HY debt class. We prefer allocating assets to U.S. short-term taxable fixed income and others fixed-income classes, within a well-diversified portfolio.

We expect HY corporate debt spreads to rise over the next 12 months



Source: Bloomberg; April 5, 2019. *For illustrative purposes only*. Option-adjusted spread (OAS) measures the spread between a fixed-income security rate and the risk-free rate of return (often a Treasury yield), which is adjusted to take into account an embedded option. Yield to worst (YTW) is the lowest potential yield that can be received on a bond without the issuer actually defaulting. The YTW is calculated by making worst-case assumptions and by calculating returns that would be received if provisions, including prepayment, call or sinking fund, are used by the issuer. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results**.

[15] Bloomberg, December 31, 2018.
[16] Moody's, February 28, 2019. CCC-rated securities are judged to be of poor standing and are subject to very high credit risk.

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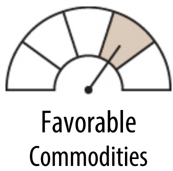
John LaForge
Head of Real Asset Strategy

"He never was a friend who ceased to be one."
--French proverb



Favorable
Commodities

Unfavorable
Private Real Estate

Unfavorable
Public Real Estate

Potential implications of the oil-price rally

When oil prices make big moves, there often are consequences. And the 2019 rally in West Texas Intermediate (WTI) oil, a grade of crude oil used as a benchmark in oil prices, which was 40% over 3.5 short months, is both rare and significant. One such potential consequence could be slower stock-market gains later in 2019.

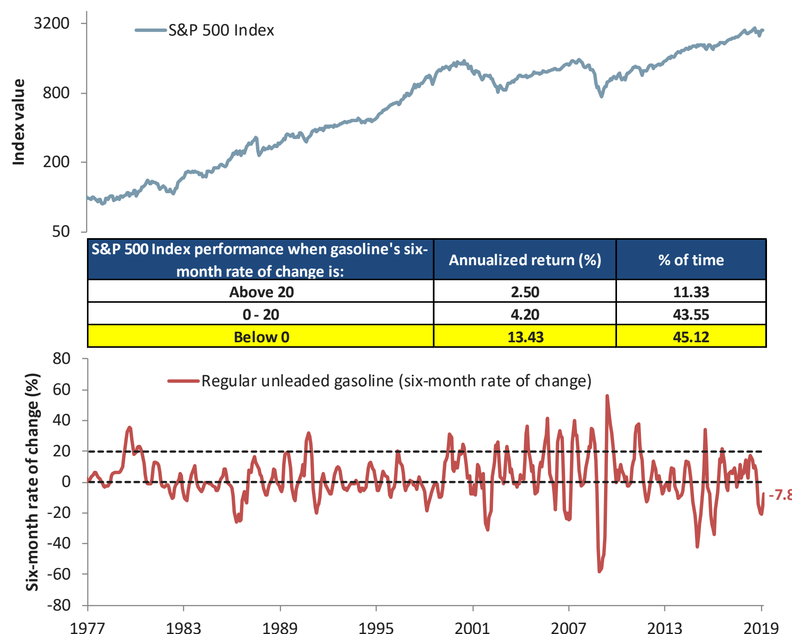
Oil-price moves are felt most acutely by consumers as gasoline price changes. To measure the impact of oil-price swings, we like to track the corresponding change in gasoline prices. The chart below shows that falling gasoline prices, over a six-month period, often can lead to strong stock-market gains (yellow highlight). Gasoline prices tanking in the back half of 2018 likely added fuel to the 2019 stock-market rally. Of course, price consequences can swing both ways. The chart also suggests that gasoline's 21% YTD rally has the potential to slow stock-market gains later in 2019. We are not necessarily at that point yet, as the red line in the chart still indicates that prices have declined -7.8% over the past 6 months (even including the 2019 rally).[17] Should gasoline prices hold near current levels through June, gasoline's six-month rate of change could swing from a tailwind to a headwind for stock gains. Again, history suggests that oil's—and gasoline's—rally has not become a problem for stock gains. Yet.

Key takeaways

» The size and speed of the 2019 oil and gasoline price rallies are both rare and significant.

» History suggests that, if such a strong rise in prices were to hold, it could become a headwind for stock gains.

S&P 500 Index versus the change in gasoline prices



S&P 500 Index performance when gasoline's six-month rate of change is:	Annualized return (%)	% of time
Above 20	2.50	11.33
0 - 20	4.20	43.55
Below 0	13.43	45.12

Sources: Bloomberg, U.S. Department of Energy, Wells Fargo Investment Institute. Monthly data: January 31, 1977 – March 31, 2019. Top panel shown in log scale. *For illustrative purposes only.* 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. **Past performance is no guarantee of future results.** There is no guarantee any asset class will perform in a similar manner in the future.

[17] Through March 31, 2019.

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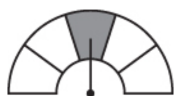
Ryan McWalter
Global Alternative Investment Strategist



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.

Understanding the opportunities in distressed debt investing

Distressed debt investing is a strategy in which an investor buys the debt of a troubled company—often at a discount—and seeks to profit if the company turns around. This typically follows a careful "due diligence" review of the firm. Investors also may profit if a distressed company goes bankrupt, because, in some cases, investors will end up owning the company's equity.

Three measures that gauge the environment for distressed investing are stress ratios (for bonds trading between $75-95), distress ratios (for bonds trading below $75) and default rates. Default rates are the percentage of borrowers in an index who failed to make a scheduled principal or interest payment over the past 12 months. The higher these three measures are—the greater the opportunity typically is for distressed investing. An increase in stress and distress ratios often is a precursor to higher default rates—as a company's debt can experience selling pressure because of credit downgrades, weaker growth forecasts, or earnings misses prior to the company defaulting on debt.

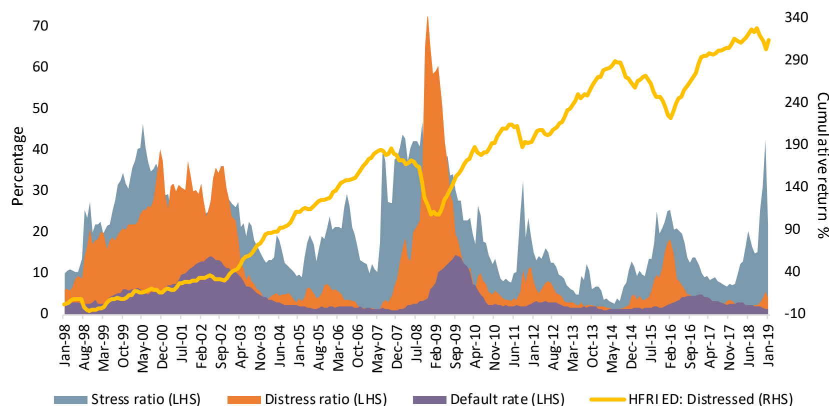
While default rates are currently low, there were notable increases in stress and distress ratios during the fourth quarter. This could lead to future upticks, and eventually, higher default rates. History has proven that outsized returns for the Distressed strategy often follow increases in these measures. As we are in the latter stages of the economic cycle, we believe that investors may benefit from an allocation to the Distressed Debt strategy—allowing them the potential to capitalize upon the next distressed cycle.

Key takeaways

» While default rates remain low, stress and distress ratios have increased. This historically has been a precursor to higher default rates and outsized returns for the Distressed Debt strategy.

» Over multiple market cycles, investors have been rewarded for being patient throughout the course of distressed cycles.

Investors have been "paid to be patient" with distressed debt investing



Sources: Hedge Fund Research, Inc., Bank of America, Wells Fargo Investment Institute, April 2019. Monthly data: January 1998 – January 2019. Please see the end of the report for the definition of the HFRI ED: Distressed Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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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. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. 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.

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 involves a high degree of risk. Distressed companies most likely will declare bankruptcy shortly, could currently be in bankruptcy proceedings or just emerging from bankruptcy. Because of their distressed situation, these securities may be illiquid, have low trading volumes, and be subject to substantial interest rate and credit risks.

Definitions

Bloomberg Barclays Municipal Bond Index is an index of a broad range of investment-grade municipal bonds that measures the performance of the general municipal bond market.

HFRI ED Distressed/Restructuring Index. Distressed/Restructuring strategies which employ an investment process focused on corporate fixed income instruments, primarily on corporate credit instruments of companies trading at significant discounts to their value at issuance or obliged (par value) at maturity as a result of either formal bankruptcy proceeding or financial market perception of near term proceedings. Managers are typically actively involved with the management of these companies, frequently involved on creditors' committees in negotiating the exchange of securities for alternative obligations, either swaps of debt, equity or hybrid securities. Managers employ fundamental credit processes focused on valuation and asset coverage of securities of distressed firms; in most cases portfolio exposures are concentrated in instruments which are publicly traded, in some cases actively and in others under reduced liquidity but in general for which a reasonable public market exists. In contrast to Special Situations, Distressed Strategies employ primarily debt (greater than 60%) but also may maintain related equity exposure.

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