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Investment Strategy

WEEKLY GUIDANCE FROM OUR INVESTMENT STRATEGY COMMITTEE

May 14, 2019

Small-cap Earnings Miss Supports Our Unfavorable View

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Key takeaways

- *In April, we reduced our earnings-per-share (EPS) growth targets from 13% to 9.6% for U.S. small-cap equities to reflect slower earning growth from greater company vulnerability as the economic cycle matures.*
- *Small-cap valuations and companies who reported negative earnings in 2018 (36% of companies), along with potential margin pressures, may limit further valuation gains.*

What it may mean for investors

- *We prefer U.S. large-cap and mid-cap over small-cap equities and recommend investors consider using active strategies to seek growth opportunities in the small-cap space. We believe earnings forecasts for the Russell 2000—generally considered representative of small capitalization issues in the U.S—have been broadly overestimated.*

Small-cap reported and forecast growth is overestimated

As of year-end 2018, bottom-up consensus forecasts[1] for U.S. small-cap EPS growth was expected to exceed 30% for both the first quarter (Q1) and the full-year 2019 year-over-year (YoY) growth rates. However, Wells Fargo Investment Institute started the year expecting a more modest increase of 13% YoY growth for full-year 2019. Q1's current actual reported growth is 4.7%—a significant earnings miss versus consensus expectations for the quarter. The size of this earnings guidance miss in Q1 is much larger relative to other equity asset classes we monitor (see Chart 1).

Based on corporate guidance reports, the consensus has cut 2019 EPS forecasts from 30% to a more achievable 17.4%.[2] However, we revised modestly lower to a conservative 9.6% YoY growth rate based on our economic and fundamental forecasts, including our view that margins may compress more in this asset class versus others in 2019.

Both large cap and small cap companies are raising earnings estimates versus year-end 2018. For example, 55% of large-cap companies' earnings forecast revisions for the next two fiscal years are upgrades, but small-caps revisions are still below neutral (47%), indicating more downgrades occurring than upgrades as Wall Street analysts dissect underwhelming Q1 results (see Chart 1). We believe Q2 forecasts are also too high, and we have expected this trend of underperformance in the small-cap relative large-cap

Asset Group Overviews

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

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

[1] Combined estimates of analysts covering all public companies in the Russell 2000 Index which measures the performance in the small cap equity market.
[2] FactSet, May 8, 2019.

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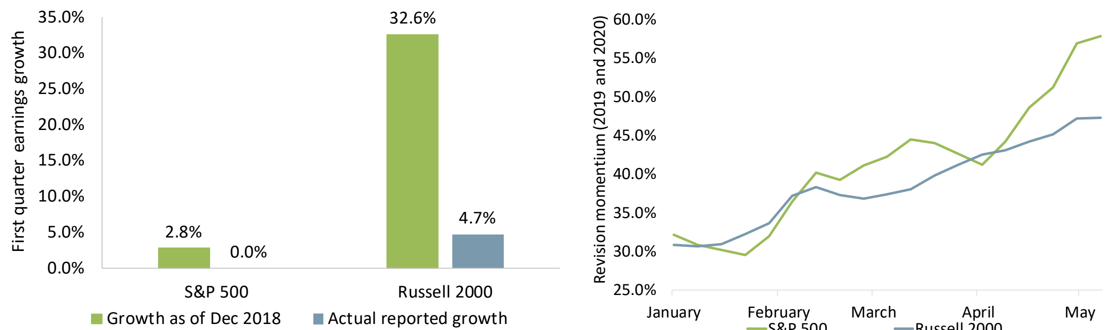
revision momentum to continue. On the bright side, we see more encouraging revision momentum and find several attractive growth areas for longer-term investors. Two Russell 2000 sectors that we prefer for investors include the Financials and Energy sectors, both of which have strong next 12-month forecasts and positive revision momentum.

Chart 1. Small-cap earnings growth missed expectations in Q1 (left chart), while recent EPS revision momentum favors large caps over small caps (right chart)



Sources: FactSet, Wells Fargo Investment Institute, May 8, 2019. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment. Revision momentum (right chart) contains sums from fiscal years 2019 and 2020. Please see the end of this report for the definitions of the indices.

One-year performance: Small caps have underperformed large caps

Year-to-date, small-caps have outperformed. However, for longer horizons, including the 1-year horizon, the Russell 2000 has lagged. There are several potential contributors indicating why small caps have been trailing over 1-year, 3-year, and 5-year annualized returns:

- Historically, small caps are negatively sensitive to rising interest rates as they have more debt relative to large caps. Following two years with a total of eight rate hikes, we anticipated that small caps would underperform.
- Small caps are negatively sensitive to rising wage costs, which make up a larger portion of cost-of-goods sold versus large caps. Both of these conditions—interest rate hikes and wage increases (which drag on corporate margins)—tend to weigh heavily on small caps later in the economic cycle.
- We believe the main reason small caps are underperforming is the record 36% of Russell 2000 constituents with negative (trailing) earnings in 2018. This high number of “no earnings” companies exceeds the prior peak (35%) hit in September 2009 during the financial crisis. Even during the technology bubble, the peak of companies not making earnings was 30%. While small caps have outperformed in the short term, we believe the current negative earnings, combined with the Q1 earnings miss, will weigh on the asset class in 2019.

Long-term performance: Small caps typically underperform when rates rise

The Russell 2000 Index measures the performance of about 2000 small companies, ranging in market capitalization from $300 million to $2 billion, essentially the smallest 10% of public companies. While small size defines small caps, investors tend to favor

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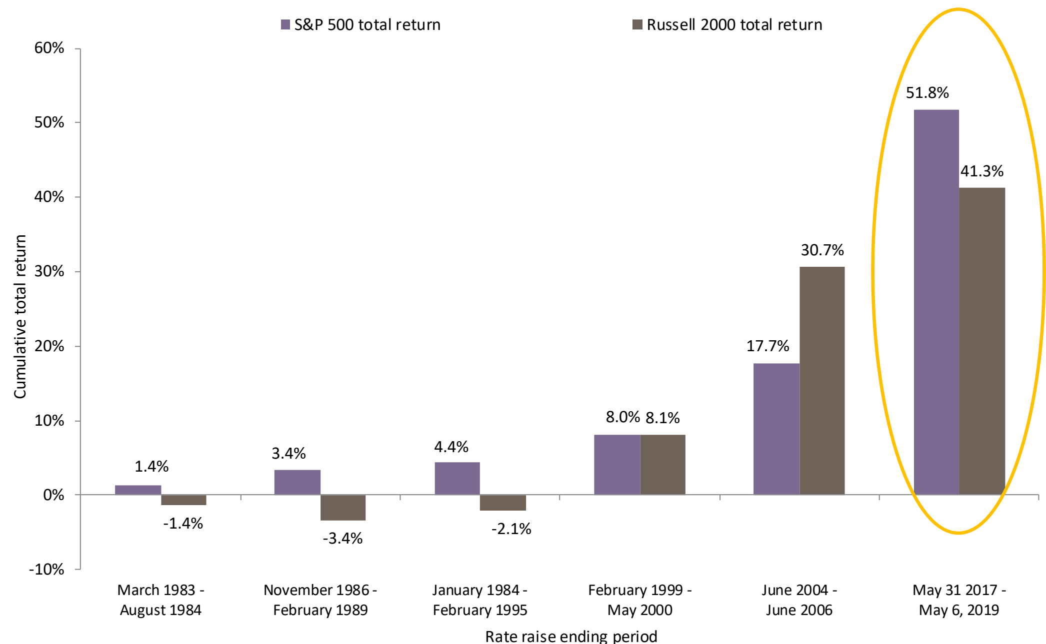
these companies due to their potential for rapid growth. Moreover, small caps are typically riskier than large caps; yet, over long periods (e.g. during 1926-2018, small caps returned 11.8%, and large caps returned 10.0%, annually), they may have larger returns than large-cap companies—so investors tend to be paid to take the additional risk. Small caps have tended to have better returns when rates are not rising (Chart 2).

Chart 2. Small caps underperformed large caps in this Fed rate hiking cycle



Sources: Wells Fargo Investment Institute, Bloomberg, as of May 6, 2019. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment. A total return index includes the reinvestment of dividends or other distributions. Cumulative total returns are not annualized. Please see the end of this report for the definitions of the indices.

Valuation: Small caps more expensive than large caps

The forward price-to-earnings (P/E) ratio is a fundamental measure used to determine if an investment is valued appropriately based on the forecast for company (or companies') earnings. In the case of the Russell 2000, many market data providers exclude negative earners for the Russell 2000 Index when calculating the index-level P/E ratio. We believe this is misleading and values small caps more favorably on a P/E ratio of 17.9x. We calculate a forward P/E ratio that includes all negative and small earnings companies. The current forward P/E is 25.1x versus the S&P 500 of 17x.

In the months leading into tax reform, investors were willing to pay an even higher price per unit earnings in the P/E range 28-29x. However, during the December 2018 market trough, P/E broke below 21x. We expect the P/E will remain in a range near the 5-year mean of 24-25x, while we remain at a cross-roads on global growth. Should a U.S.-China trade deal be reached as we anticipate, we could see valuations fall as EPS rises on improving global growth. Alternatively, if global growth decelerates due to increasing trade tensions and rising tariffs, valuations may rise.

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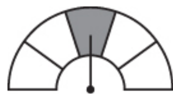
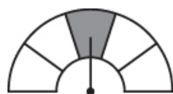
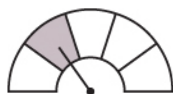
Scott Wren
Senior Global Equity Strategist



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

First quarter earnings update: Better than the consensus expected

With a touch over 85% of companies in the S&P 500 Index already reporting first quarter earnings results, we believe it is a good time to give an update on the progress thus far. In short, the reporting season can be summed up in just three words: better than expected.

From our perspective, coming into the reporting season, our work suggested year-over-year earnings growth would be flat to slightly positive. The "Street" was more pessimistic than we were, looking for a decline of 3% to 4%. However, with 430 companies in the S&P 500 reporting, earnings so far are coming in flat (0%), according to the latest FactSet analysis. Of those reporting, just over 74% have come in ahead of consensus expectations, while just over 57% have beat on the revenue line. Historically, it is common for 65% to 70% of companies to beat the consensus earnings estimate.

Of course, it is also common for corporations to issue conservative guidance reports as the typical range of estimate beats reflects. So far this year, S&P 500 companies appear to have been conservative in their guidance as uncertainties over trade, tariffs, and global economic growth have all come together and resulted in some degree of caution. Looking ahead, while we are likely past the peak earnings growth rates witnessed last year, we continue to see earnings per share increasing to record levels in 2019.

Key takeaways

» Coming into the first quarter earnings reporting season, the consensus was looking for earnings to be down 3% to 4% on a year-over-year basis. We were more optimistic.

» With more than 85% of companies in the S&P 500 reporting, S&P 500 earnings are coming in unchanged versus the prior year period.

Sector and index first quarter 2019 earnings performance

Sector/index	Year-over-year % gain*
Consumer Discretionary	12.2%
Healthcare	9.8%
Utilities	8.7%
Real Estate	6.8%
Industrials	3.8%
Financials	1.9%
Consumer Staples	1.4%
S&P 500 Index	***0.0%***
Materials	-6.6%
Information Technology	-6.8%
Communication Services	-7.3%
Energy	-26.6%

Sources: FactSet, Wells Fargo Investment Institute, May 8, 2019. *In order of performance from best to worst. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment. The S&P 500 Sector Indices measure the performance of the widely-used Global Industry Classification Standard (GICS®) sectors and sub-industries. Each index comprises those companies included in the S&P 500 that are classified as members of their respective GICS sectors. Please see the end of this report for the definition of the S&P 500 Index.

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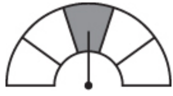
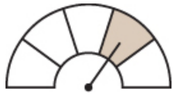
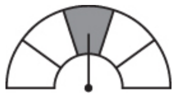
Peter Wilson
Global Fixed Income Strategist



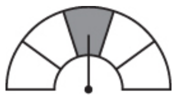
Neutral
U.S. Taxable Investment Grade Fixed Income



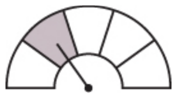
Favorable
U.S. Short-Term Taxable Fixed Income



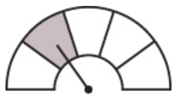
Neutral
U.S. Intermediate Term Taxable Fixed Income



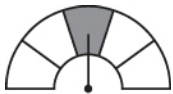
Neutral
U.S. Long-Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

EM credit tightening stalled amid global uncertainty

Without a doubt, last year was volatile for emerging markets (EM). Back in May 2018, we upgraded our EM debt view to favorable when spreads versus U.S. Treasuries rose above 350 basis points[3] (around the average for the post-2008 period), and index yields climbed above 6.5% (more than one standard deviation[4] above the average yield for the same period).

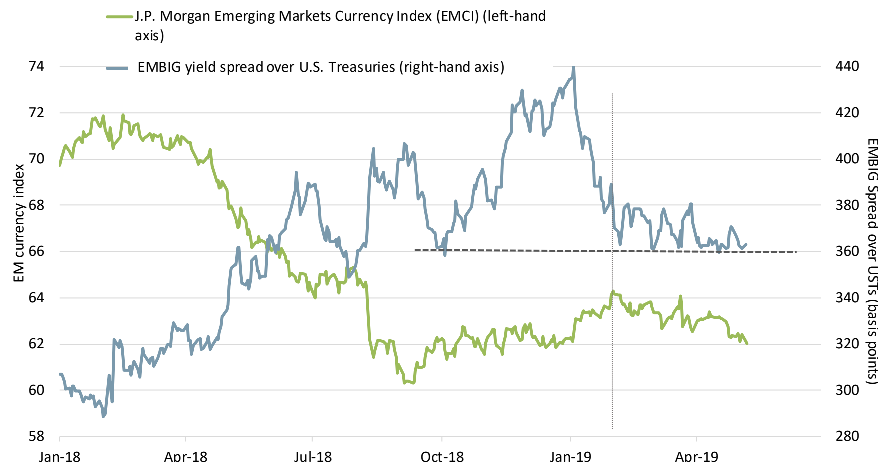
EM currencies also had a bumpy ride. EM currency indices are generally good bellwethers of global risk sentiment, and, as the chart shows, they bottomed out at the end of the third quarter, while U.S. equity and credit markets were still weakening. Sovereign credit spreads on EM debt, along with U.S. credit, continued to widen until the end of the year; but by January 2019, both EM currencies and EM sovereign credit were rallying strongly. Yet, as the chart also shows, by the end of the month, the J.P. Morgan Emerging Markets Currency Index (EMCI) had already peaked, and further narrowing of sovereign credit spreads was stalled at a level of 360 basis points.

The inability of EM debt and currencies to recover further reflects real uncertainty about the global growth outlook, U.S. trade relationships with the rest of the world, and the direction of central bank interest rates. Acknowledging these uncertainties, as well as the market action, we recently shifted much of our fixed-income strategy to a more neutral stance, including lowering EM debt from favorable back to neutral.

Key takeaways

- After a sharp rally at the start of the year, both EM credit spreads and EM currencies have stalled since late January. The EMCI, in particular, is a good bellwether for global risk sentiment.
- As uncertainty remains elevated over the global growth outlook and U.S. trade relations with major partners, we believe this market caution supports our decision to move our favorable weighting on EM sovereign credit back to neutral.

EM currencies and credit markets have stalled since January



Sources: Bloomberg, J P Morgan, Wells Fargo Investment Institute, May 7, 2019. The Emerging Markets Currency Index used the in the chart (and referenced in the text) is the J.P. Morgan Emerging Markets Currency Index (EMCI). For dollar-denominated bonds, the index used in this chart is the J.P. Morgan Emerging Markets Bond Index Global (EMBIG). **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment. Please see the end of this report for the definitions of the indices.

[3] 100 basis points equal 1 percent.
[4] Standard Deviation is a statistical measure of the volatility of a portfolio's returns. The higher the standard deviation, the greater volatility has been.

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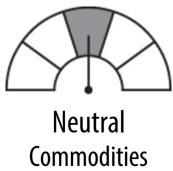
John LaForge
Head of Real Asset Strategy

"Great minds discuss ideas; average minds discuss events; small minds discuss people."
--Eleanor Roosevelt



Neutral
Commodities

Unfavorable
Private Real Estate

Unfavorable
Public Real Estate

Gold—No great bargain

After a relatively calm start to 2019, global market volatility spiked last week, hitting many stock and commodity markets. Whether by coincidence or design, President Trump seemed to be center stage arguing with China and Iran over trade. All 11 S&P 500 sectors turned in negative performances last week, as did most commodity prices.

Gold, on the flipside, was up about 1% on the week, which makes sense, historically speaking. During periods of past market stress, investors have often turned to gold as a perceived safe haven asset. Gold is that one asset that has (as my 17 year old daughter would say) *literally* survived time. Gold is impervious to air and water, meaning every ounce that has been mined in history still resides somewhere.

Gold has other unique characteristics that have allowed it to outshine other major assets throughout time. The best example is that gold's combination of radiance, scarcity, and density has allowed it to act as a trusted source of physical money for centuries. Gold prices fixed by governments can be seen in the chart (flat gold line).

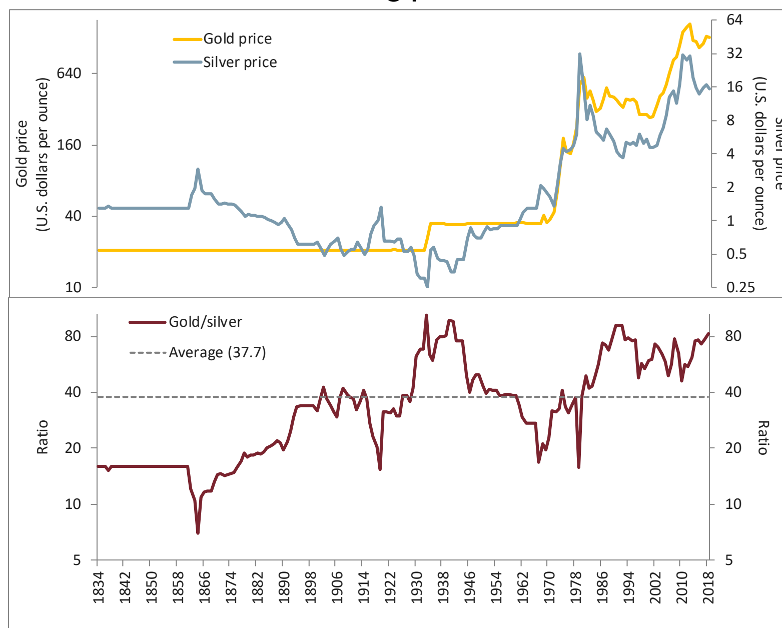
We caution investors, though, not to get too excited about buying gold today. At $1285, and fairly valued versus both stocks and bonds, we believe gold is no great bargain. The global gold supply/demand balance also continues to tip in favor of too much supply. Should global volatility continue to spike, gold prices could too, but we doubt that gains can be held. Our 2019 target range remains $1250-$1350.

Key takeaways

» Gold, at $1285, is no great bargain.

» Our 2019 year-end target range remains $1250-$1350.

Gold versus silver since 1834



Sources: Bloomberg, Kitco, Wells Fargo Investment Institute. Yearly data: 1833 - 2018. Ratio is the price of gold divided by the price of silver. **Past performance is no guarantee of future results.**

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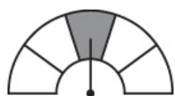
Ryan McWalter, CAIA
Global Alternative Investment Strategist



Neutral
Private Equity

Neutral
Hedge Funds-Macro

Neutral
Hedge Funds-Event Driven

Favorable
Private Debt

Favorable
Hedge Funds-Equity Hedge

Favorable
Hedge Funds-Relative Value

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 importance of stock selection in the current environment

Over the last 10+ years, U.S equity markets have experienced historically low volatility. However, at times this has been interrupted by sporadic and violent market corrections. From March 2009 to the present, there have been fifteen instances when the S&P 500 Index declined by 5% or more. Importantly, the time it has taken to recover from these losses has been relatively short, resulting in multiple instances of "V" shaped market recoveries.[5] In nearly half of these instances, the S&P 500 fully recovered losses in less than 30 days.

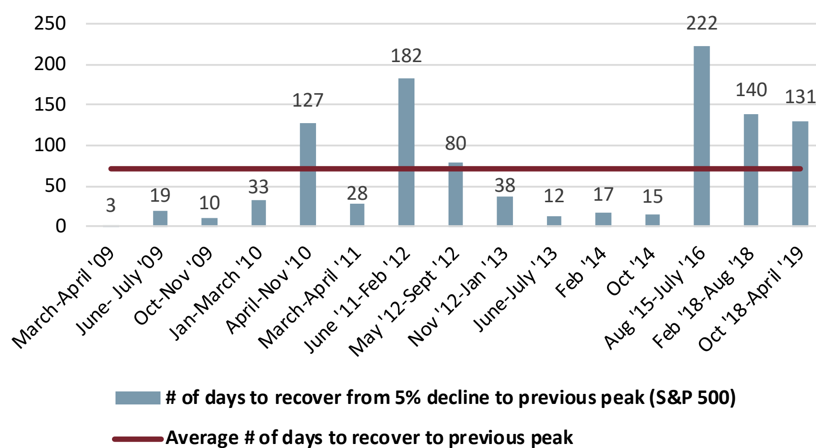
More recent stock market declines have differed significantly—the last three drawdowns averaged 164 days to recover, peak-to-trough, which is substantially greater than the post-financial-crisis average (see chart below). While the more protracted recoveries can be explained by several factors, the current environment indicates to us a return to more fundamentally-driven market dynamics as opposed to technically-driven central bank intervention.

We believe the recent market drawdowns and longer recoveries indicate that security selection is becoming more important as correlations decline and dispersion increases. This could be a fertile environment for the Equity Hedge strategy, which can deliver value through both long and short exposure, allowing investors to navigate periods of sustained volatility and complementing long-only equity exposures.

Key takeaways

- We expect higher and more sustained levels of volatility as we enter the later stages of the economic cycle and as central banks exert less influence on capital markets.
- Stock dispersion could be more pronounced following broader market drawdowns as stronger, more fundamentally sound companies can recoup market value, potentially rewarding more selective fundamental strategies, such as Equity Hedge.

More selective recoveries to come?



Sources: Bloomberg, Wells Fargo Investment Institute, May 7, 2019. Periods when the S&P 500 declined by 5% or more and recovered to the previous peak. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment.

[5] A V-shaped recovery is a period of market decline, then a short trough, and finally a rapid recovery.

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Our forecasts, targets and estimates are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.

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.

Investing in sovereign debt involves the risk that the governmental entity that controls the repayment of sovereign debt may not be able or willing to repay the principal and/or pay interest when due in accordance with the terms of such debt.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. Communication services companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. Risks associated with the Consumer Discretionary sector include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players; reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. Consumer Staples industries can be significantly affected by competitive pricing particularly with respect to the growth of low-cost emerging market production, government regulation, the performance of the overall economy, interest rates, and consumer confidence. The Energy sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. Investing in the Financial services companies will subject a investment to adverse economic or regulatory occurrences affecting the sector. Some of the risks associated with investment in the Health Care sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market. There is increased risk investing in the Industrials sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio’s performance. Materials industries can be significantly affected by the volatility of commodity prices, the exchange rate between foreign currency and the dollar, export/import concerns, worldwide competition, procurement and manufacturing and cost containment issues. Real estate investments have special risks, including possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions. Risks associated with the Technology sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks smaller, less-seasoned companies, tend to be more volatile than the overall market. Utilities are sensitive to changes in interest rates, and the securities within the sector can be volatile and may underperform in a slow economy.

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

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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

JPMorgan Emerging Markets Bond Index Global (EMBI Global), which currently covers 27 emerging market countries. Included in the EMBI Global are U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

JPMorgan Emerging Market Currency Index is a tradable benchmark for emerging markets currencies vs the U.S. Dollar (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.

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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