June 10, 2019

Gold as a Perceived Safe-Haven

John LaForge
Head of Real Asset Strategy

Key takeaways

» *During past stock market corrections, gold has proven a good place to hide.*

» *Gold has not been perfect, however. Gold hasn't always risen when stocks have corrected.*

What it may mean for investors

» *Unless you're expecting a significant stock market pullback, which we're not, gold looks expensive (at $1340 today).*

"You can do anything you want with it, and to it, but you cannot make it disappear."
-- Peter L. Bernstein, The Power of Gold

Gold is a topic that never quite dies with investors. No matter the state of the economy, or the performance of other asset classes, we receive regular questions on gold. Why? Because gold has a history like no other asset.

Gold has a rich history as both a store of value (investments, jewelry, bars, etc.) and money (coins, etc.). Found nearly 5000 years ago, gold was first coined roughly 3700 years ago (in the area now known as Turkey). Stocks and bonds, on the other hand, were created in the last 400 years. Impervious to both air and water, gold has the unique benefit of literally surviving time, meaning essentially all of the gold ever mined still exists somewhere (even if sunk off the coast of Florida). The same cannot be said of other financial assets. By example, no country's paper currency has survived time. Not one.

Gold's long history has its downside. Gold has been around so long, surviving all types of social and economic turbulence, that many claim that gold has been the ultimate safe-haven during volatile investment times. The reality is that gold has been good, but not perfect. Gold has not always provided "golden" protection.

In recent months, global stock prices have stumbled. So clients have been asking two gold questions: 1) is gold a good place to hide when stock prices are falling? And 2) is gold a good buy today? We detail our answers below.

Asset Group Overviews

Gold as a Perceived Safe-Haven

Question: Is gold a good place to hide when stock prices are falling?

Answer: Typically, yes. When stocks have dropped, no matter how shallow or deep the stock correction, gold typically outperformed the S&P 500 Index (top row of Table 1).

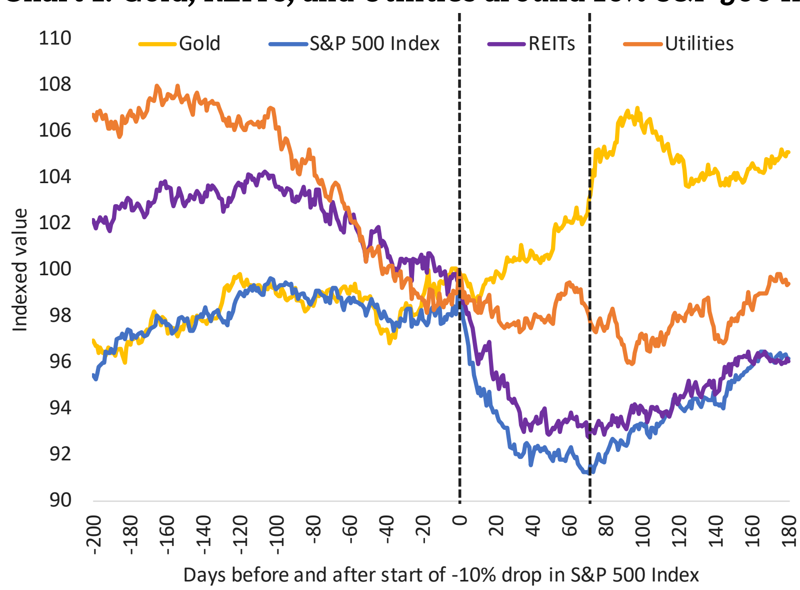
Table 1. Gold and S&P 500 Index performance during S&P 500 declines

Gold and S&P 500 Index performance during S&P 500 Index declines	-5% S&P 500 Index declines	-10% S&P 500 Index declines	-20% S&P 500 Index declines
Gold beats S&P 500 Index (% of time)	92.5%	90.2%	87.5%
Gold positive return (% of time)	53.8%	61.0%	75.0%
Average S&P 500 Index return (%)	-9.8%	-18.5%	-36.9%
Average gold return (%)	0.7%	3.8%	14.2%

Sources: Bloomberg, Ned Davis Research Group, Wells Fargo Investment Institute. Daily data: March 20, 1968–June 4, 2019.

Gold has tended to outperform the most defensive stock sectors, when the S&P 500 was correcting. Chart 1 shows past average performances of gold (yellow line), Utilities (orange line), Real Estate Investment Trusts (REITs) (purple line), and the S&P 500, around S&P 500 corrections of -10% or more (space between the two vertical black dashed lines). This history has been a good guide in 2019. As the S&P 500 has corrected in recent months, REITs and Utilities have been the best performing S&P sectors, yet gold has bested them both.

Chart 1. Gold, REITs, and Utilities around 10% S&P 500 Index declines



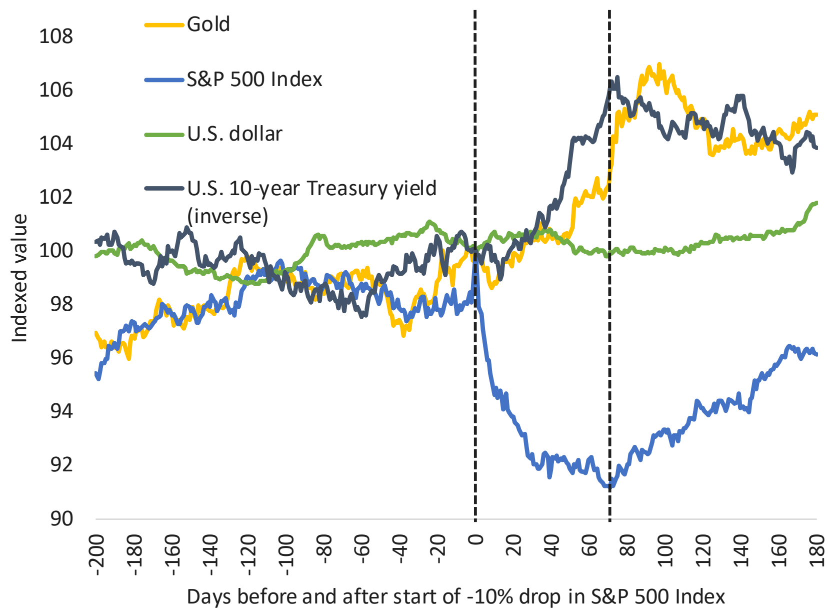
Sources: Bloomberg, Ned Davis Research, Wells Fargo Investment Institute. Daily data includes each 10% drop in the S&P 500 Index since 1976 (34 in total) until May 31, 2019. Data series indexed to 100 as of the peak before each 10% downturn (left dashed line). Right dashed line is placed at the average performance trough. REITs represented by the FTSE NAREIT All Equity Index (monthly data until 1999, daily afterwards). Utilities represented by the S&P 500 Utilities Sector (data available from 1989 on). Gold is represented by the gold spot price. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment.

Gold as a Perceived Safe-Haven

Gold does not offer "golden" protection. While gold has historically outperformed the stock market, and even the most defensive sectors when the stock market has corrected, gold has not always given investors a positive return. Row 2 of Table 1 highlights that gold prices are positive only about 60-70% of the time—when stocks have corrected.

Gold hasn't always been the best defensive asset to hide-in when stocks have corrected. As Chart 2 reveals, U.S. Treasuries, in the past, have given gold a run for its money during stock corrections. Chart 2 shows the average performances of gold (yellow line), 10-year Treasury bonds, the U.S. dollar, and the S&P 500 around S&P 500 corrections of -10% or more (space between the two vertical black dashed lines).

Chart 2. Gold, U.S. dollar, Treasuries around 10% S&P 500 declines



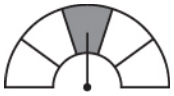
Sources: Bloomberg, Ned Davis Research, Wells Fargo Investment Institute. Daily data includes each 10% drop in the S&P 500 Index since 1976 (34 in total) until May 31, 2019. Data series indexed to 100 as of the peak before each 10% downturn (left dashed line). Right dashed line is placed at the average performance trough. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment.

Question: Is gold a good buy today?

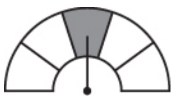
Answer: In our opinion, no, it's not. While gold can help on the downside for well allocated portfolios during stock market corrections, we're not recommending investors load-up on gold today. Our year-end 2019 S&P 500 target (2950) is about 8% higher from here. On the flip-side, our year-end 2019 gold target ($1300) is actually -3% lower than today's prices. For clients willing to endure some short-term choppiness in 2019, equity markets appear to have more upside than gold.

To be clear, we believe that gold holds a place in most investors' portfolios—most of the time. But like other investments, timing and position sizing are keys. At $1340 today, we do not think that gold is any great bargain. We're waiting for much lower prices.

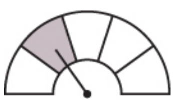
Craig P. Holke, Investment Strategy Analyst
Audrey Kaplan, Head of Global Equity Strategy



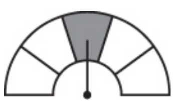
Neutral
U.S. Large Cap Equities



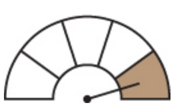
Neutral
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Neutral
Developed Market
Ex-U.S. Equities



Most Favorable
Emerging Market Equities

Now is not the time to get defensive with sector allocations

Increased trade conflicts and concerns about slowing global growth continue to cause headaches for U.S. equity markets. Following the increased market volatility amidst the equity market downturn in the fourth quarter, we reduced our equity allocation from overweight to neutral. Yet, we still maintained our cyclical sector allocations based on our view that the business cycle still has room to run. The post-Christmas recovery confirmed that cyclical sectors may lead as markets move higher over time.

The table below shows the top and bottom performing sectors during the fourth quarter decline and the subsequent recovery through the end of April. For the most part, sectors played their typical roles. During the sell-off, defensive sectors (Utilities and Consumer Staples) outperformed, but they also underperformed during the rally. Cyclical sectors (Information Technology, Industrials, and Consumer Discretionary) were some of the worst performers in the downturn and likewise outperformed during the following market recovery. We have seen the sectors play out in a similar fashion during the recent trade-related downturn.

However, we continue to believe the trade conflicts will be resolved, even if not as swiftly or completely as originally anticipated. Markets likely will respond favorably to a lessening of these trade-related headwinds. Economic growth in the U.S. is forecast to be slower than last year, but still above 2%. As such, we believe this environment will continue to favor cyclical sectors as the most likely beneficiaries going forward.

Key takeaways

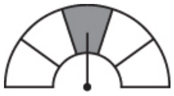
- U.S. equity markets have been subject to increased volatility as trade and growth concerns increase. Markets sold off and then recovered, with cyclical and defensive sectors performing accordingly.
- We continue to believe trade conflicts will be resolved, even if not as swiftly or completely as originally anticipated. A positive resolution, combined with solid U.S. economic growth, may lead cyclical sectors to outperformance.

Sector performance during recent market downturn and recovery

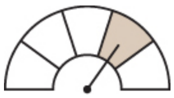
	Uncertainty-driven downturn (09/20/18 – 12/24/18)	Market recovery (12/24/18 – 04/30/19)	Trade-escalation downturn (04/30/19 – 06/04/19)
Top three performers	Utilities (-2.4%) Real Estate (-9.9%) Consumer Staples (-11.5%)	Info Tech (36.6%) Consumer Discretionary (31.6%) Industrials (29.7%)	Real Estate (0.8%) Utilities (-0.2%) Health Care (-0.6%)
Bottom three performers	Info Tech (-23.1%) Industrials (-24.1%) Energy (-27.9%)	Consumer Staples (18.6%) Utilities (13.8%) Health Care (10.6%)	Comm Services (-7.0%) Info Tech (-7.6%) Energy (-9.1%)

Sources: Bloomberg, Wells Fargo Investment Institute. Price return for S&P 500 sectors. Returns are as of daily close, June 4, 2019. **Past performance is no guarantee of future results.**

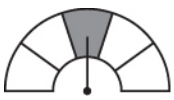
Luis Alvarado
Investment Strategy Analyst



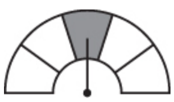
Neutral
U.S. Taxable Investment Grade Fixed Income



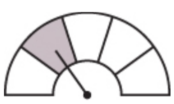
Favorable
U.S. Short-Term Taxable Fixed Income



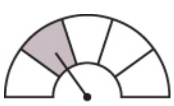
Neutral
U.S. Intermediate Term Taxable Fixed Income



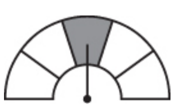
Neutral
U.S. Long-Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

Fervor in the muni market

U.S municipal bonds (munis) have been an attractive asset class for fixed-income investors so far this year, mainly because munis are generally viewed to be isolated from global economic woes and financial stress and more aligned with the U.S. economic outlook. Additionally, recent changes in tax law have attracted investors, particularly from those in high tax states seeking shelter from the cap on deductions for state and local taxes. Net asset flows towards mutual funds and exchange-traded funds in this asset class continued to climb year to date.

We believe overall issuance for municipals will be slightly larger than last year, as 2018's supply was negatively impacted by the rush of issuance pushed forward into late 2017 due to uncertain impacts of the tax law changes. Overall net supply of munis may remain negative for 2019; however, we believe it will be less negative than 2018. This strong demand, coupled with reduced supply, has pushed munis to somewhat of an extended level from a historical perspective.

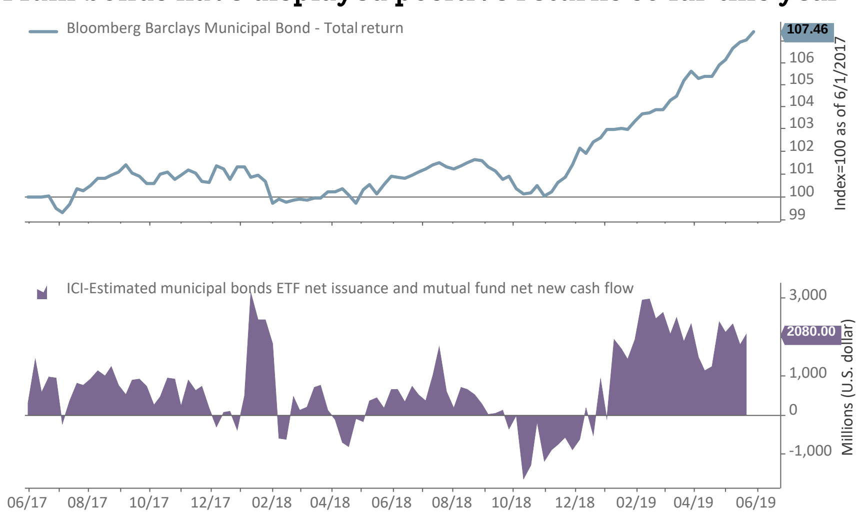
Additionally, we are concerned that yields for munis may continue to decline. The 10-year muni/Treasury ratio rose slightly in May from April's low level as treasuries rallied. Yet, they remain below averages. We believe investors can find the most value in the 8-13 year part of the curve, which has seen strong performance (year-to-date) and is where investors can pick up as much as 80% of the yield of longer high-grade bonds (while taking on less duration risk).[1]

Key takeaways

» Strong demand, coupled with lower supply, has pushed muni valuations to historically rich levels.

» Relative value in yields and lower macro risk exposure continue to make municipal bonds attractive. We remain favorable in this asset class.

Muni bonds have displayed positive returns so far this year

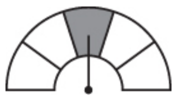


Source: FactSet, data as of June 3, 2019. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment.

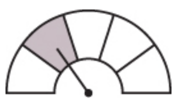
[1] Duration is a measure used to determine a bond/s or bond portfolio's sensitivity to movements in interest rates. Generally, the longer the duration the more sensitive a bond or bond portfolio is to changes in interest rates.

Austin Pickle, CFA
Investment Strategy Analyst

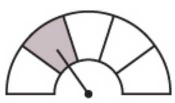
"How wonderful it is that nobody need wait a single moment before starting to improve the world."
--Anne Frank



Neutral
Commodities



Unfavorable
Private Real Estate



Unfavorable
Public Real Estate

Déjà vu—China stops buying U.S. soybeans again

Recently, the trade dispute between the U.S. and China has escalated. In response to U.S. tariffs, China has stopped buying U.S. soybeans. It is understandable if you feel a bit of déjà vu reading this—China took similar measures roughly one year ago. They slapped a 25% tariff on U.S. soy, which brought U.S. soy sales to China to a near halt. Why has China targeted soybeans again and what are the possible ramifications?

Prior to the trade dispute, the majority of U.S. soybean exports went to China, which represented roughly $12 billion of exports in 2017. Additionally, the majority of states that grow soybeans supported Trump in the 2016 presidential election. By targeting soybeans, China seeks to pressure Trump politically and the U.S. financially. Investors should not be surprised that China was quick to pull the soybean trigger.

The silver lining is that farmers have had time to secure new trading relationships to replace the China void. As a result, soybean prices in the U.S. have shrugged off the news (unlike last year when prices dropped over 20%). What will be impacted are trade flows. Instead of China sourcing its soybeans from the U.S. and Brazil—the only two major exporters (see table below)—Brazil will be called upon to almost exclusively export to China. As a result, the markets that Brazil abandons will turn to the U.S. for its supply. Fortunately for U.S. farmers, they have had a year to prepare, potentially muting the negative implications of this development.

Key takeaways

» China has stopped buying U.S. soybeans in retaliation for U.S. tariffs...again.

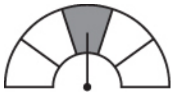
» While not good news for the American farmer, they are better situated to deal with the China ban this time around, which should mute the impact of this news.

2018 soybean production, export, and import rankings by country

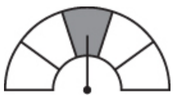
2018 soybean production, export, and import rankings by country								
Production			Exports			Imports		
Rank	**Country**	**Amount (mmt)**	**Rank**	**Country**	**Amount (mmt)**	**Rank**	**Country**	**Amount (mmt)**
1	U.S.	125.2	1	Brazil	81.0	1	China	94.1
2	Brazil	122.0	2	U.S.	51.7	2	EU	14.6
3	Argentina	55.5	3	Paraguay	5.8	3	Mexico	4.9
4	China	16.0	4	Canada	5.3	4	Japan	3.3
5	Paraguay	9.8	5	Argentina	5.0	5	Thailand	2.5

Sources: Bloomberg, United States Department of Agriculture (USDA), Wells Fargo Investment Institute. mmt = millions of metric tons. Data as of December 31, 2018 and accessed June 3, 2019.

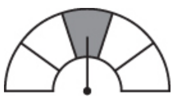
Justin Lenarcic
Global Alternative Investment Strategist



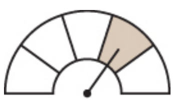
Neutral
Private Equity



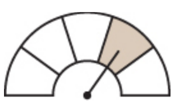
Neutral
Hedge Funds-Macro



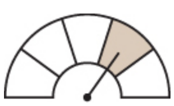
Neutral
Hedge Funds-Event Driven



Favorable
Private Debt



Favorable
Hedge Funds-Equity Hedge



Favorable
Hedge Funds-Relative Value

Interest-rate volatility: No longer a "missing ingredient"

In mid-November 2018, we highlighted an increase in interest-rate volatility as a potential "missing ingredient" for the Macro strategy. Less certainty around the future direction of monetary policy led to an increase in the price of interest-rate derivatives, specifically swaptions, as shown in the chart below. Historically, interest-rate volatility has been closely linked with the performance of Macro hedge funds. As volatility increases, typically so does performance.

A combination of trade tensions, weaker economic data, and perhaps most importantly comments from Federal Reserve officials about the potential to adjust policy have recently led to a higher degree of uncertainty around future interest-rate decisions. As expected, we have seen a spike in interest-rate volatility, as the market grapples with monetary policy direction.

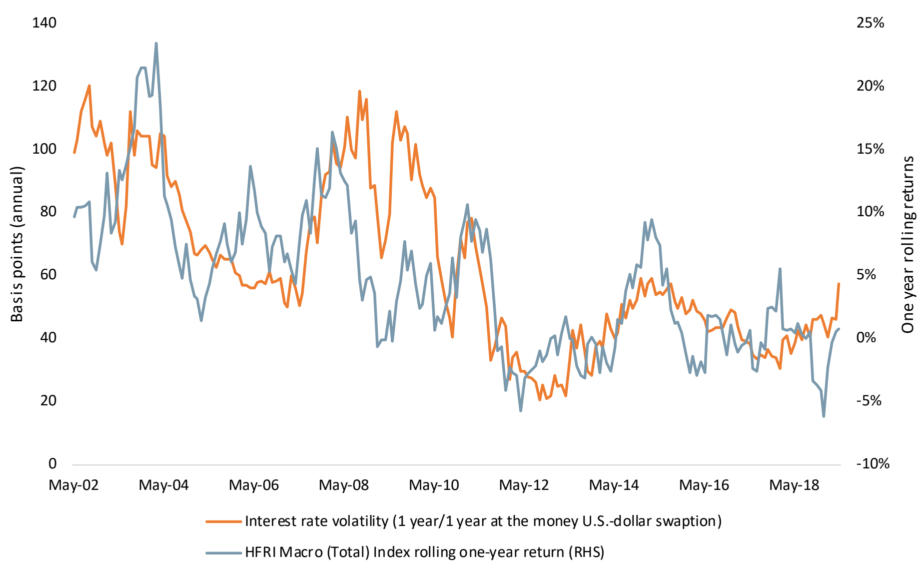
We believe this uncertainty will serve as a tailwind to Macro strategies, specifically those managed using a Discretionary, rather than Systematic approach. Both relative value and directional trading within the fixed-income sector has long been a core driver of returns for Macro traders, and a more volatile environment is a welcomed change from much of the post-crisis era.

Key takeaways

» Rising interest rates benefit Macro returns—also important is increased uncertainty around interest-rate decisions and the ensuing fixed-income volatility.

» Interest-rate volatility continues to increase off of a low in early 2018. We believe this will result in better returns for Macro traders.

Macro returns tend to track interest-rate volatility



Sources: Hedge Fund Research, Inc., Wells Fargo Investment Institute, June 2019. RHS = right hand side. Interest-rate volatility is represented by the price of a one-year, at the money swaption one-year from now. A swaption is an option to enter into an interest-rate swap at terms that are established in advance, and it is directly related to expectations for future volatility. An interest-rate swap involves the exchange of interest-rate payments benchmarked against an interest-rate index.

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.

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. **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. **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.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

Bloomberg Barclays Municipal Bond Index represents municipal bonds with a minimum credit rating of at least Baa, an outstanding par value of at least $3 million and a remaining maturity of at least one year. The index excludes taxable municipal bonds, bonds with floating rates, derivatives and certificates of participation.

FTSE NAREIT All Equity REITs Index, a subset of the All REITs Index, is designed to track the performance of REITs representing equity interests in (as opposed to mortgages on) properties. It represents all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets, other than mortgages secured by real property that also meet minimum size and liquidity criteria.

HFRI Macro Index: Investment Managers which trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom up theses, quantitative and fundamental approaches and long and short term holding periods. Although some strategies employ RV techniques, Macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments, rather than realization of a valuation discrepancy between securities. In a similar way, while both Macro and equity hedge managers may hold equity securities, the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposes to EH, in which the fundamental characteristics on the company are the most significant are integral to investment thesis.

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.

S&P 500 Utilities Index comprises those companies included in the S&P 500 that are classified as members of the GICS utilities sector.

An index is unmanaged and not available for direct investment.

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