One Reason We Still Lean Toward Cyclicals

Key Takeaways

» We believe that recent cyclical/defensive equity sector performance comparisons suggest that the odds of a U.S. recession remain quite low for the next 12 months.

» In our view, the cyclical bull market has more room to run over the next 12-18 months.

What It May Mean for Investors

» We recommend that U.S. equity investors lean toward quality cyclical issues that can benefit from global growth, and capitalize upon opportunities to buy on market dips. We expect that volatility will remain a part of this later-cycle environment.

On a regular basis, we keep tabs on the 12-month performance of the S&P 500 Index and whether its performance has been driven by cyclically-sensitive or less economically-dependent defensive issues. Over the past 12 months, our “cyclical versus defensive” index has registered a 12 percent outperformance of cyclicals over defensive issues. Chart 1 plots that index from 1986 to today.

Chart 1. S&P 500 Index: Cyclical versus Defensive Market Outperformance
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Over the past year, roughly 99 percent of the S&P 500 Index’s performance was generated by five sectors: Information Technology (we have an evenweight recommendation), Financials (overweight), Industrials (overweight), Consumer Discretionary (overweight), and Health Care (overweight). The rest of the groups made up the balance: Utilities (underweight), Materials (evenweight), Consumer Staples (underweight), Real Estate/REITs (overweight), Telecommunication Services (evenweight), and Energy (underweight).

When our S&P 500 Index cyclical/defensive index has shown 10-14 percentage points of cyclical outperformance over 12 months, it is highly unusual for the next year to include a recession or major large cap equity-market downturn. Of the 29 instances studied, a recession only followed one time, representing three percent of the cases (in the period between July 2007 and July 2008). The other three times that the S&P 500 Index declined significantly following cyclical outperformance occurred in the year between December 2001 and December 2002 (a post-recessionary period during which investors lost confidence in the recovery), and in the 12-month periods following April and May 1987 (which were impacted by the October 1987 market crash that was not accompanied by a recession). In fact, after the 1987 correction, the S&P 500 Index rose to new highs by the end of 1988. Overall, the market was only down 4 out of 29 times following a period in which our cyclical versus defensive indicator registered 10-14 percent cyclical outperformance in the prior year (only 14 percent of the time, with an average move of -14 percent). The S&P 500 Index appreciated 86 percent of the time (with an average move of +18 percent).

Chart 2. S&P 500 Index Sector Performance for the Trailing 12-Month Period

Furthermore, data from 1986 through July 2017 shows that, when the market has leaned toward cyclicals (versus defensives) by 10 to 14 percentage points over a year, it continued to lean cyclically 59 percent of the time over the following 12 months (+13 percent cyclical outperformance relative to defensive sectors). On the other hand,
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following such periods, the S&P 500 Index’s defensive issues outperformed only 41 percent of the time with 7 percent outperformance versus cyclically-sensitive issues. More specifically, we reviewed the combination of times the market was higher or lower, and the lean was cyclical or defensive, over the course of the next year. The results were as follows (1986 through July 2017):

- S&P 500 Index was higher with cyclical outperformance in the following 12 months (58.6 percent of the time).
- S&P 500 Index was lower with defensive outperformance (13.8 percent of the time).
- S&P 500 Index was lower with cyclical outperformance (zero percent of the time).
- S&P 500 Index was higher with defensive outperformance (27.6 percent of the time).

Thus, overall, the data suggest that, given the cyclical versus defensive behavior of the S&P 500 Index over the past year, the tendency over the next year is likely to be:

- For there not to be a recession (only 1 in 29 occurrences).
- For the S&P 500 Index to move higher.
- For the market to continue to lean toward cyclicals (59 percent of the time versus 41 percent of the time).

To summarize, the most common occurrence (59 percent of the time)—in the year following a period with cyclical versus defensive sector behavior like what we have seen in the past year—was a higher large-cap equity market with a cyclical lean.

We do believe that volatility will remain higher during the later stages of this U.S. cyclical recovery—as the markets deal with Washington, D.C. and Federal Reserve (Fed) policy uncertainties, geopolitical tensions, and potential jitters over late-cycle inflation. Nonetheless, the continuation of moderate growth with (what appears most likely to be) moderate inflation should offer investors opportunities to dollar-cost average into quality, cyclically-sensitive equity positions in the coming quarters.
Storm Chasers

In light of the continued focus on Hurricane Harvey, we have summarized the Market Commentary report published on August 30.

A number of very preliminary estimates of Hurricane Harvey damages are in the $30-$40 billion range, but we have seen some predictions that are even higher. As a reference point, the National Oceanic and Atmospheric Administration (NOAA), a governmental organization housed within the Commerce Department, pegged the cost of 2005’s Hurricane Katrina at $108 billion. Some of Harvey’s damage will be covered by insurance companies. Many businesses will be shut down for days, weeks, or even months. Some might never reopen, at least at the same location.

Initially, the economic consequences of Hurricane Harvey likely will be to dampen economic activity in the affected areas. Gasoline prices nationwide are also a wild card given the refining activity in the impacted region. Some sources are predicting losses in daily economic activity of at least several billion dollars. The magnitude of the effect will be hard to gauge until a better evaluation of the damage to transportation and oil industry infrastructure (as well as the power grid) is reported in coming days.

But consider the fact that the size of the American economy is more than $18 trillion. If we assume Harvey did $100 billion in damage—that represents less than 0.6 percent of total annual domestic economic output. While the devastation doled out by this massive storm certainly has been meaningful, it is unlikely that the ebb and flow of the overall U.S. economy will be impacted in a major way or for an extended period of time.

We think long-term investors should stick to their plan and not try to make significant changes to their portfolios in an attempt to capture quick profits in the wake of last weekend’s hurricane. The market has experienced a minor pullback over the last few weeks and could very well see more downside as trading resumes this week. We continue to see the S&P 500 Index modestly lower than current levels at year-end, but we do not believe the cycle is over.

We recommend that investors seek out quality companies for longer-term investment and not turn into storm chasers looking for a short-term thrill ride in the stock market.

Key Takeaways

» In the wake of large-scale natural disasters, some investors attempt to make quick profits by purchasing the stock of companies they believe will benefit from the cleanup and rebuilding process that will follow.

» In our opinion, most investors should stick to their long-term plan of building wealth over time and not try to storm chase for short-term profits.
Preferred Stock—Evaluating the Income Risk

Even though preferred security yields have declined in recent years, yields near 5.5 percent remain available in a well-diversified portfolio of preferred securities. Preferred securities remain among the highest-yielding fixed-income sectors today. We currently recommend a neutral weighting for the preferred-security sector.

For investors, the main attraction in owning preferred securities should not be price appreciation at this time; rather, in our opinion, the focus should be on income generation. The chart below shows that preferred securities generally have experienced no material price appreciation over the past five years. At current levels, preferred securities appear to be fully valued from a price-valuation perspective. Yet, the S&P U.S. Preferred Stock Index price chart does not capture the income that can be generated from these securities. A total-return view of the preferred-security sector shows that, over the past five years, this sector was among the best-returning fixed-income sectors that we track. The five-year average annual return of the S&P U.S. Preferred Stock Index through August 25, 2017 was 6.4 percent; its year-to-date total return was 8.5 percent. Of course, past performance is no guarantee of future results.

Should we enter a period in which the markets become risk-averse, and/or interest rates rise sharply, we would expect preferred securities to fall in value. Investors should expect preferred securities to be one of the more volatile fixed-income classes, and this volatility must be accepted as a trade-off for the higher yields inherent in the sector. We are not predicting that we will see this type of environment in the near term. Yet, investors should not purchase preferred-security holdings without a full understanding of the sector’s risks. It is important to also understand the specific risks related to these securities before investing bearing in mind that investment in preferreds differs from the risks inherent with other investments. Although preferred securities may offer attractive yields, capital appreciation potential is generally less than that available on common stocks. These securities should not be purchased on the basis of yield alone.

Key Takeaways

- Given the higher volatility of the preferred-security sector, we recommend that exposure be diversified among a variety of issuers, sectors and structures. We strongly recommend that investors consider a professional manager to oversee their preferred allocations.

- As the credit cycle continues to mature, the potential for a credit-based correction in the preferred sector will increase.

S&P U.S. Preferred Stock Index

Sources: Wells Fargo Investment Institute, Bloomberg, 8/30/17
Hurricanes Are Now Negative for Oil Prices

Ask an investor if a hurricane is typically negative or positive for oil prices, and “positive” is the answer you’ll hear most often. But is this true? Yes, hurricanes that make landfall in the U.S. have typically translated to higher oil prices in the short term. Table 1 shows that West Texas Intermediate (WTI) crude-oil prices have risen by an average of 2.2 percent, leading into the 37 hurricanes the U.S. has seen since 1983. We also can see that WTI continued to rise in the month following these hurricanes by an average of 0.8 percent. Both of these gains are better than the average monthly gain for WTI since 1983—which has been roughly 0.5 percent.

Yet, there is a recent wrinkle to the story. In six of the last seven hurricanes, which covers 2005 through 2011, WTI prices were absolutely clobbered leading into, and coming out of, hurricanes. For the past seven hurricanes, WTI prices lost an average of -6.3 percent in the month leading up to the hurricane, and then another -6.7 percent the month after. Unfortunately, there is no simple answer connecting these recent drops. WTI price losses in three of the past seven hurricanes do make sense—as they took place during the 2008 financial crisis, when commodity prices were collapsing. But the severe WTI price losses around the hurricanes in September 2005, October 2005, and August 2011, are not as easy to explain.

So far, Hurricane Harvey has been following the more recent path of being “net negative” for WTI prices—also shown in Table 1. No matter; Hurricane Harvey does not change our 2017 WTI year-end 2017 target price range of $40-$50 per barrel.

Key Takeaways

» Hurricanes have historically been positive for oil prices, but not in recent years.

» Hurricane Harvey does not change our year-end 2017 WTI target range of $40-$50 per barrel.

WTI Crude-Oil Performance around 37 Hurricanes Since 1983

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<thead>
<tr>
<th></th>
<th>One Month Prior to Hurricane</th>
<th>One Month After Hurricane</th>
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<tr>
<td></td>
<td>Average Crude Oil Performance</td>
<td>Positive Oil Performance</td>
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<tr>
<td></td>
<td>One Month Prior to Hurricane</td>
<td>One Month Prior to Hurricane</td>
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<tr>
<td>37 Hurricanes (1983-2011)</td>
<td>2.2%</td>
<td>25 of 37</td>
</tr>
<tr>
<td>Last 7 Hurricanes (2005-2011)</td>
<td>-6.3%</td>
<td>1 of 7</td>
</tr>
<tr>
<td>Hurricane Harvey (2017)</td>
<td>-0.3%</td>
<td>-3.9%</td>
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Sources: Commodity Systems Inc. (CSI), [www.csidata.com](http://www.csidata.com). Oil = West Texas Intermediate (WTI) generic futures contract. WTI is a grade of crude oil used as a benchmark in oil pricing.
Systematic Macro Managers Are Now Short Equity

Systematic Macro strategies are sometimes perceived as portfolio “hedges”—as these strategies can take both long and short positions on many global assets. The prime example may be performance in 2008, when the S&P 500 Index declined by 37 percent, while the HFRI Macro Systematic Diversified Index returned 18 percent return. But that was clearly a very different environment than we face today. Since 2012, we have not seen major changes to equity exposure from Systematic Macro strategies—either long or short. In fact, the chart below shows that non-commercial “speculator” futures positions have generally been net long equity for most of the past five years.

Yet, we find it notable that recent analysis points to short equity exposure by non-commercial speculators. Since early 2012, this is just the fifth time that speculators were short S&P 500 Index futures for at least three consecutive weeks. Recently, one of our main concerns was that Systematic Macro strategies were generally long equities (in some cases with significant levels of risk), and that a correction could prove to be very painful for these strategies. The recent move to a net short position alleviates some of that concern. But we anticipate that the Systematic Macro strategy will continue to face challenges as long as volatility and interest rates remain at historically low levels.

Key Takeaways

» While 2008 was a positive performance environment for Systematic Macro managers, investors should not allocate to this strategy solely based on that abnormal period.

» Recent data indicates that speculators are short S&P 500 Index futures, which is rare over the past five years.

Non-Commercial “Speculators” Are Short S&P 500 Index Futures

Sources: U.S. Commodity Futures Trading Commission (CFTC), Bloomberg, 8/30/17. The CFTC classifies traders as “commercial” or “non-commercial.” A trader is classified as commercial if all of the traded positions are used for hedging commodity exposure. Non-commercial speculators are CFTC members that are trading futures and options seeking financial gain, not to hedge exposure.
Risks Considerations

There are special risks associated with investing in preferred securities. Preferred securities are subject to interest rate and credit risks. Interest rate risk is the risk that preferred securities will decline in value because of changes in interest rates. Credit risk is the risk that an issuer will default on payments of interest and principal. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer’s capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. Preferred dividends are not guaranteed and are subject to deferral or elimination.

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.

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

HFRI Macro Systematic Diversified Index: Diversified strategies employing mathematical, algorithmic and technical models, with little or no influence of individuals over the portfolio positioning. Strategies are designed to identify opportunities in markets exhibiting trending or momentum characteristics across individual instruments or asset classes. Strategies typically employ quantitative processes which focus on statistically robust or technical patterns in the return series of the asset, and they typically focus on highly liquid instruments and maintain shorter holding periods than either discretionary or mean-reverting strategies. Although some strategies seek to employ counter-trend models, strategies benefit most from an environment characterized by persistent, discernible trending behavior. Typically have no greater than 35 percent of portfolio in either dedicated currency or commodity exposures over a given market cycle.

Note: HFRI Indices have limitations (some of which are typical of other widely used indices). These limitations include survivorship bias (the returns of the indices may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information self-reported by hedge fund managers that decide on their own, at any time, whether or not they want to provide, or continue to provide, information to HFRI Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.

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

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