WELLS FARGO
INVESTMENT INSTITUTE

Investment Strategy

WEEKLY GUIDANCE FROM OUR INVESTMENT STRATEGY COMMITTEE

September 10, 2019

Finding Income in a Low-Rate Environment

Chris Haverland, CFA
Global Asset Allocation Strategist

Key takeaways

- *Slowing global economic growth, along with modest inflation, has led to record low sovereign bond rates across the world.*
- *This low-rate environment has made it difficult for investors to generate enough income to outpace inflation. There are, however, other income opportunities investors can consider.*

What it may mean for investors

- *Diversifying income streams can potentially lessen portfolio volatility, reduce the probability of dramatic swings in the levels of income provided, and improve the likelihood of achieving long-term income and total return goals.*

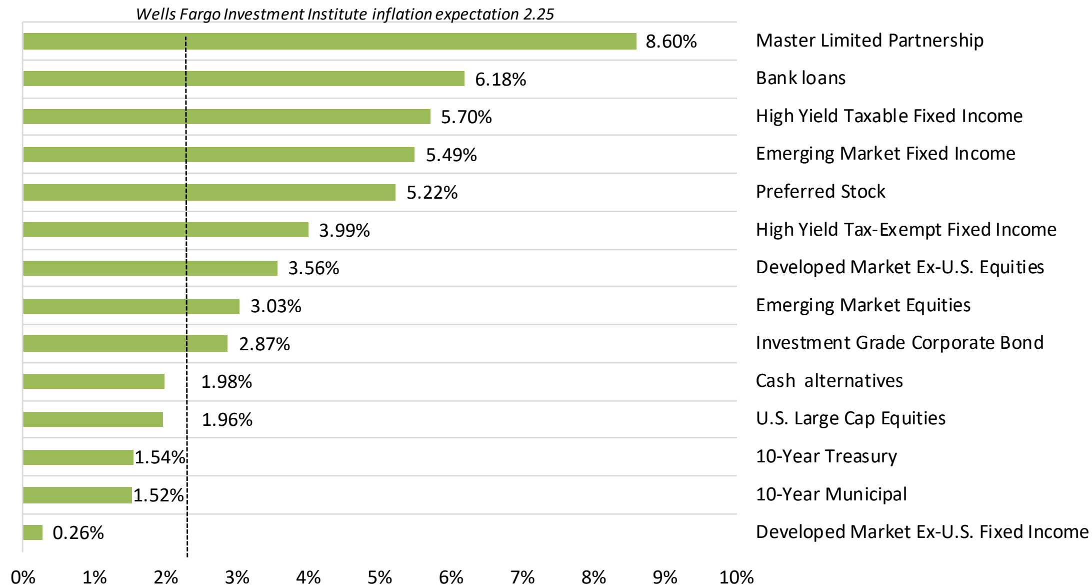
Record low sovereign bond rates around the globe have made it difficult for income investors to generate a desirable level of cash flow from their investment portfolios. Slowing global economic growth, along with modest inflation, could keep rates low for an extended period of time, hampering an investor's ability to source enough income to outpace inflation. With money-market funds yielding approximately 2.0% and 10-year U.S. Treasury securities earning less than 2% (as of September 6, 2019), it's not surprising that income-oriented investors may be frustrated with the current fixed-income environment.

Although U.S. Treasury bonds traditionally have provided a major income source for investors, a variety of investment vehicles are available for those constructing a portfolio focused on income generation (see chart). These investments may provide higher yields, but often come with the potential for higher volatility than U.S. Treasury bonds. Even so, investors may want to consider all opportunities available to them as part of a well-diversified, income-producing portfolio.

Asset Group Overviews

Finding Income in a Low-Rate Environment

Key yield comparison



Source: Bloomberg, FactSet, Morningstar September 6, 2019. **Past performance is no guarantee of future results.** See end of report for index definitions.

Breaking down the different sources of diversified income

Fixed Income

- **U.S. Taxable Investment Grade Bonds:** High-quality, publicly issued bonds, such as government securities, corporate securities, and securitized products. From a tactical perspective, we favor high-quality corporate bonds as well as residential mortgage-backed securities—both of which have higher yields than comparable U.S. Treasuries, which we rate as unfavorable.
- **U.S. Municipal Bonds:** Investment-grade and high-yield general obligation and revenue bonds issued by U.S. state and local governments that offer federal (and sometimes state) tax-exempt income. Although municipal bond rates are typically below Treasury yields, they can be attractive to tax-sensitive investors. From a tactical perspective, we favor investment-grade taxable municipals and essential revenue bonds.
- **U.S. High Yield:** Corporate bonds and leveraged loans rated below investment grade. They are typically riskier than investment-grade bonds (reflecting higher debt and lower cash flow), but offer higher interest rates to compensate for the added risk. Tactically, we are unfavorable on high-yield bonds and leveraged loans, recommending that any exposure comes from the higher quality segment.
- **Preferred Securities:** Financial instruments with characteristics of both bonds and equities. From a bond perspective, there is a fixed yield that must be paid out to investors before common-stock shareholders receive a dividend. From an equity perspective, there is the potential for price appreciation (and depreciation). With relatively attractive yields, we currently have a favorable rating on the sector.

- **Emerging Market Debt:** Bonds issued in U.S. dollars or local currencies by countries (or corporations) whose economies are considered to be developing. Tactically, we're neutral on the asset class.
- **Developed Market Ex-U.S. Bonds:** Sovereign debt issued by developed countries outside of the U.S. Although this asset class can provide international diversification, the average yield is close to zero (with negative-yielding debt exceeding $16 trillion). Tactically, we're unfavorable on the asset class.

Equities

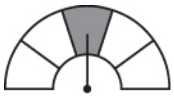
- **U.S. Equities:** The broader large-, mid-, and small-cap equity benchmarks have average dividend yields at or below 2.0% (as of September 6, 2019). However, there are several defensive sectors within these asset classes that can provide attractive yields for income investors. Those include Consumer Staples, Real Estate, and Utilities. We have a neutral tactical rating on all three.
- **Developed Market Ex-U.S. Equities:** Developed market dividend yields are typically higher than U.S. dividend yields and can provide international diversification for income-oriented investors. As with most equity asset classes, we have a neutral rating reflecting balanced risks going forward.
- **Emerging Market Equities:** Emerging market dividend yields are also attractive relative to U.S. equity dividend yields. Even though valuations are compelling, we recently reduced our rating to neutral given ongoing U.S.-China trade tensions and rising economic growth risks.

Other

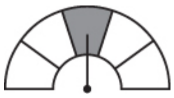
- **Master Limited Partnerships:** Partnership-based organizational structures that trade on traditional stock exchanges and can be highly volatile. Nonetheless, we believe that relative valuation, improving fundamentals, and the need for additional energy infrastructure are potential positives.

When constructing an income portfolio, we believe that it is important to consider a variety of diversified income sources. A diversified portfolio comprised of multiple income-generating asset classes, such as those mentioned above, can offer investors some of the same benefits that traditional diversification provides. Specifically, taking a diversified approach to obtaining income can potentially lower volatility; lessen the probability of dramatic swings in the levels of income provided; and improve the likelihood of achieving long-term income and total return goals.

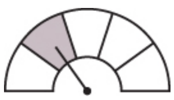
Audrey Kaplan, Head of Global Equity Strategy; ***Ken Johnson, CFA,*** Investment Strategy Analyst



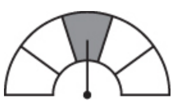
Neutral
U.S. Large Cap Equities



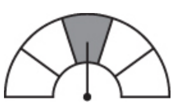
Neutral
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Neutral
Developed Market
Ex-U.S. Equities



Neutral
Emerging Market Equities

Many S&P 500 sectors currently provide attractive dividend yields

Corporate profits, the money left over after a company pays all of its expenses, may be used for corporate buybacks, capital expenditure (capex), and income in the form of dividends. S&P 500 buybacks, capex, and dividends remain fundamentally positive, year-to-date (YTD).

Buybacks: According to Standard & Poor's research, corporate buybacks peaked in fourth quarter (Q4) 2018, potentially a result of the 2018 tax rate cuts that created a favorable, record year of buybacks in 2018. That said, both quarters of 2019, still saw strong buyback activity, exceeding the 2017 quarterly levels.

Capex: During the latest quarter, companies in the S&P 500 reported capex higher than both Q1 2019 (quarter-over-quarter positive growth) and Q2 2018 (year-over-year positive growth). Again, we see evidence that capex is lower than Q4 2018, but higher than 2017 figures. This is fundamentally positive for the S&P 500 YTD.

Dividends: The dividends per share paid out during Q2 2019 set a record, and Q3 is forecast to beat that record pace. If this dividend payout persists, 2019 would be the eighth consecutive year of record payouts per share. The dividend yield is also above the 10-year Treasury in Q3 2019, one of the few times in the past 35 years. Relative to the 10-year Treasury yield, today's S&P 500 dividend yield is higher as are the majority of sectors (see chart). If you combine today's dividend and buyback yields, the S&P 500 has a forecast total yield of over 3.4% in 2019—over double that of the 10-year Treasury yield.

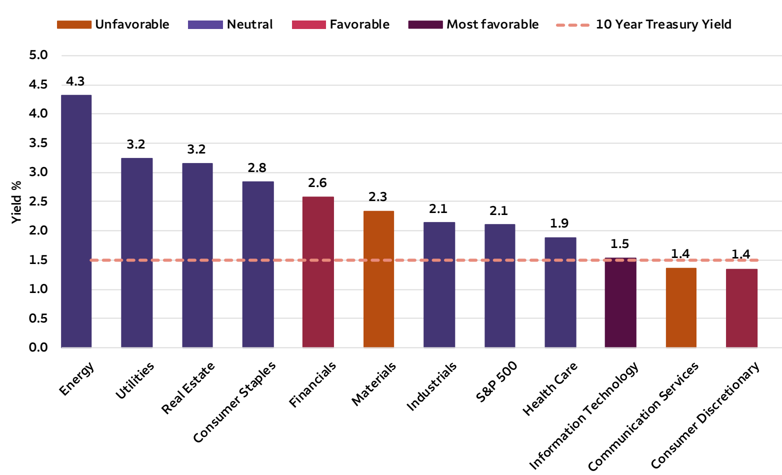
In the ongoing low Treasury yield environment, investors that favor yield may want to focus on our favored or neutral high-yield equity sectors.

Key takeaways

» S&P 500 company buybacks, capex, and dividends remain fundamentally positive (YTD).

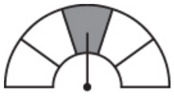
» Dividends have held steady or increased, while the 10-year Treasury yield has declined.

Today's S&P 500 forecast dividend yield is above the 10-year Treasury yield

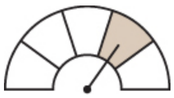


Sources: Wells Fargo Investment Institute, FactSet, IBES, September 4, 2019. Over the past year, the 10-year yield declined from 2.9% to 1.5%, as the S&P 500 forecast dividend yield increased from 1.8% (year-end) to 2.1% today. Sectors are defined by S&P Dow Jones Global Industry Classification Standard (GICS). An index is unmanaged and not available for direct investment. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

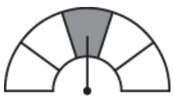
Luis Alvarado
Investment Strategy Analyst



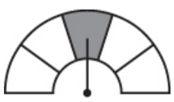
Neutral
U.S. Taxable Investment Grade Fixed Income



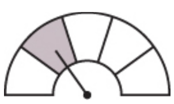
Favorable
U.S. Short-Term Taxable Fixed Income



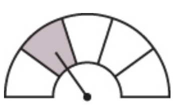
Neutral
U.S. Intermediate Term Taxable Fixed Income



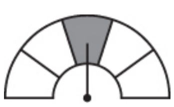
Neutral
U.S. Long-Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

Investment-grade corporates benefit from yield hunt

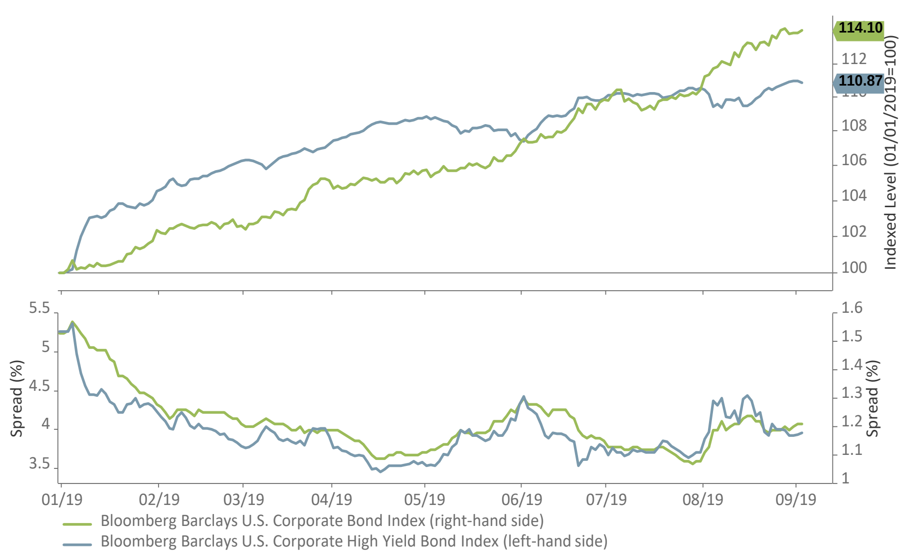
Recent fears of a global slowdown have benefited U.S. government bonds as Treasury yields have declined. Despite the move, we believe that there are other opportunities inside the U.S. taxable fixed-income sector. On August 19, we upgraded investment-grade (IG) corporates to favorable from neutral (following an upgrade to "favorable" on residential mortgage-backed securities on June 11). Demand for high-quality assets remains elevated as investors continue to search for quality yields in the U.S. market. If future geopolitical or market events create a "risk-off" environment, we believe Treasuries would likely be the primary beneficiary of risk-off fund flows. However, we believe higher-quality IG corporates can continue to benefit from the chase for yield even under a more stressed scenario. This rise in quality bias has been a good trade this year, as YTD IG bonds have generally outperformed high yield (HY).

Supply, on the other hand, is beginning to catch-up as IG issuers continue to take advantage of the relatively low interest-rate environment, particularly those attempting to refinance their debts. IG refinancing volume increased to $254 billion, up more than 40% year-to-year and up from YTD totals of $241 billion in 2017 and $178 billion in 2016.[1] We expect issuance to remain elevated over the next few weeks ahead of the September Federal Open Market Committee meeting. IG corporate bond spreads are currently well below early-2019 peak levels. As markets price-in more rate cuts, we believe IG corporate spreads will remain well supported and less volatile compared to HY spreads.

Key takeaways

- If risk-off sentiment in financial markets continues, we expect that the strong demand for yield, coupled with high-quality credit, will benefit IG bonds over lower-rated securities in the next 12 months.
- Further rate cuts should continue to support IG corporate spreads.

Investment-grade versus high-yield corporate bond returns year to date

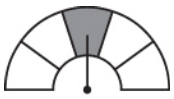


Sources: FactSet, Wells Fargo Investment Institute, September 3, 2019. Daily data: January 2, 2019 to September 3, 2019. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment.

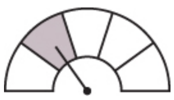
[1] LCD, an offering of S&P Global Market Intelligence, August 30, 2019.

John LaForge
Head of Real Asset Strategy

"When patterns are broken, new worlds emerge."
--*Voltaire*



Neutral
Commodities



Unfavorable
Private Real Estate

Why oil and gas haven't held a rally

In case investors haven't noticed, making money in energy commodities (and energy stocks for that matter) has been hard. This isn't a new phenomenon. Since 2015, oil and natural gas prices have effectively gone nowhere. Both fossil fuels have been volatile, for sure, but making money in either has been difficult.

All-time record U.S. production is a big reason why energy prices remain stuck. The green line in the chart below represents U.S. oil production, while the blue line is U.S. natural gas production. Notice the parabolic production moves since 2006/2007. This is the U.S. shale revolution. Since 2006, the U.S. has more than doubled its oil production and added 80% more natural gas. As a result, oil and natural gas prices have been stuck, especially since 2015 when production jumped to all-time highs.

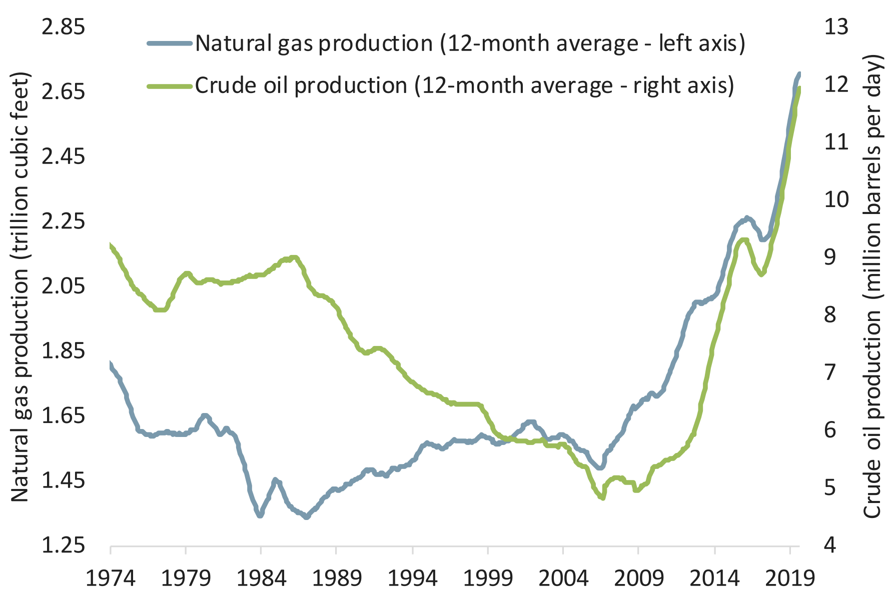
For those wondering when oil prices will again top and hold above $100/barrel and natural gas prices above $5/MMBtu, we say pay attention to U.S. production trends.[2] The U.S. is currently the global leader in fossil fuel production from shale and arguably the world's most important marginal producer. Should production begin to slow, or decline, we believe it very well could signal the beginning of a new bull market for oil and natural gas prices.

Key takeaways

» Record U.S. production has kept a lid on oil and natural gas prices recently.

» Slowing growth, or an outright decline, in production could signal the beginning of a new bull market for oil and natural gas prices.

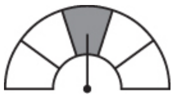
U.S. oil and natural gas production



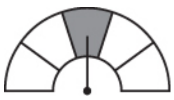
Sources: U.S. Energy Information Administration (EIA), Bloomberg, Wells Fargo Investment Institute. Monthly data: January 31, 1974 – August 31, 2019.

[2] MMBtu stands for one million British thermal units. A Btu is a measure of the energy content in fuel.

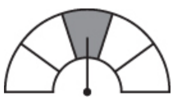
Justin Lenarcic, Global Alternative Investment Strategist



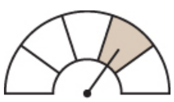
Neutral
Private Equity



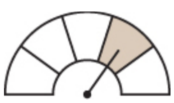
Neutral
Hedge Funds-Macro



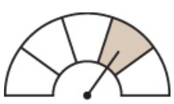
Neutral
Hedge Funds-Event Driven



Favorable
Private Debt



Favorable
Hedge Funds-Equity Hedge



Favorable
Hedge Funds-Relative Value

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.

Is the sweet spot for hedge funds (rapidly) approaching?

Further escalation in the U.S.-China tariff war, coupled with the first contraction in U.S. manufacturing activity since 2016, not to mention the growing anxiety of Brexit, are all stoking fears of a slowdown in the global economy. Perhaps it is no surprise that internet queries for "recession" spiked to peak levels in recent weeks.[3] Many investors may be growing concerned about the composition of their investment portfolios and if they are sufficiently prepared for the next recession, whenever it arrives.

We have long viewed hedge funds as more favorable during the latter half of the economic cycle, when growth slows and recession ensues. This is when security selection, both long and short, becomes paramount, and when the ability to potentially capitalize on a decline in capital markets may not only add to diversification, but also has the potential to generate a more efficient portfolio.

Our expectation for an improving opportunity set for hedge funds is supported by historical analysis. The chart shows that over the last two recessions the relative outperformance of hedge funds versus the S&P 500 began approximately 12 months prior to the peak of the economic cycle; persisted through the recession; and then continued in the early phases of the recovery (past performance is not an indicator of future results). We are beginning to see similarities in this cycle as well, with hedge funds posting their best returns in years amid an increase in volatility and a market more "discerning" to weakening corporate fundamentals and slowing growth. If history is any guide, we believe there may be opportunities hedge funds.

Key takeaways

» The latter half of the economic cycle has historically provided more opportunities for hedge fund strategies when considering general performance during the last two U.S. recessions, with relative outperformance beginning within 12 months of the cycle peak.

» While a recession may not be imminent, hedge funds are having one of their best years on record, thanks to many late-cycle dynamics that has rewarded active management.

Relative performance versus S&P 500 before and during recent recessions

Sources: Hedge Fund Research, Inc., Bloomberg, August 2019. This chart shows the relative return of the HFRI Fund Weighted Composite Index versus the S&P 500 Total Return Index over the two more recent recessions. The analysis begins 12 months before the peak of the economic cycle, as defined by the National Bureau of Economic Research (NBER). The green line uses a start date of April 2000 through November 2002, with the recession occurring from April 2001 through November 2001. The blue line uses a start date of January 2007 through June 2010, with a recession occurring from January 2008 through June 2009.

[3] Google Trends, September 3, 2019.

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. In addition to the risks associated with investment in debt securities, a fund's investments in **mortgage-backed securities** will be subject to prepayment, extension and call risks. Changes in prepayments may significantly affect yield, average life and expected maturity. Extension risk is the risk that rising interest rates will slow the rate at which mortgages are prepaid. Call risk is the risk that If called prior to maturity, similar yielding investments may not be available for the Fund to purchase. These risks may be heightened for longer maturity and duration securities. 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. **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. **Utilities** are sensitive to changes in interest rates, and the securities within the sector can be volatile and may underperform in a slow economy.

Investment in Master Limited Partnerships (MLPs) involves certain risks which differ from an investment in the securities of a corporation. MLPs may be sensitive to price changes in oil, natural gas, etc., regulatory risk, and rising interest rates. A change in the current tax law regarding MLPs could result in the MLP being treated as a corporation for federal income tax purposes which would reduce the amount of cash flows distributed by the MLP. Other risks include the volatility associated with the use of leverage; volatility of the commodities markets; market risks; supply and demand; natural and man-made catastrophes; competition; liquidity; market price discount from Net Asset Value and other material risks.

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

Chart 2 index definitions:

Bank Loans: The **S&P/LSTA U.S. Leveraged Loan 100 Index** is designed to reflect the performance of the largest facilities in the leveraged loan market. An index is unmanaged and not available for direct investment.

Cash Alternatives/Treasury Bills: **Bloomberg Barclays US Treasury Bills (1-3M) Index** is representative of money markets.

Developed Market Ex-U.S. Equities: **MSCI EAFE Index** is a free float-adjusted market capitalization index that is designed to measure the equity market performance of 21 developed markets, excluding the U.S. and Canada.

Developed Market Ex-U.S. Fixed Income: **J.P. Morgan GBI Global ex-US Index (Unhedged)** in USD is an unmanaged index market representative of the total return performance in U.S. dollars on an unhedged basis of major non-U.S. bond markets.

Emerging Market Equities: **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of 23 emerging markets.

MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI.

Emerging Market Fixed Income: **J.P. Morgan Emerging Markets Bond Index (EMBI Global)** currently covers more than 60 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.

High Yield Taxable Fixed Income: **Bloomberg Barclays US Corporate High-Yield Index** covers the universe of fixed-rate, non-investment-grade debt.

High Yield Tax-Exempt Fixed Income: **Bloomberg Barclays U.S. Municipal High Yield Index** measures the non-investment grade and non-rated U.S. dollar-denominated, fixed-rate, tax-exempt bond market within the 50 United States and four other qualifying regions (Washington DC, Puerto Rico, Guam and the Virgin Islands).

Investment Grade Corporate Bonds: **Bloomberg Barclays U.S. Corporate Index** includes publicly-issued U.S. corporate and Yankee debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

Master Limited Partnerships: **Alerian MLP Index** is a composite of the 50 most prominent energy Master Limited Partnerships (MLPs) that provides investors with an unbiased, comprehensive benchmark for this emerging asset class. The index, which is calculated using a float-adjusted, capitalization-weighted methodology, is disseminated real-time on a price-return basis and on a total-return basis.

Preferred Stock: **ICE BofAML Fixed Rate Preferred Stock Index** measures the performance of fixed rate US dollar denominated preferred securities issued in the US domestic market.

U.S. Large Cap Equities: **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.

The **Bloomberg Barclays US Corporate Bond Index** measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

The **Bloomberg Barclays US Corporate High Yield Bond Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2000 single-manager funds that report to HFR Database. Constituent funds report monthly net-of-all-fees performance in U.S. dollars and have a minimum of $50 Million under management or a 12-month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

General Disclosures

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS' opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company. CAR 0919-00873