December 3, 2018

Take a Disciplined Investment Approach in a Correction

Paul Christopher, CFA
Head of Global Market Strategy

Key takeaways

- *Following its November move into correction territory, the S&P 500 Index rebounded following comments by Federal Reserve (Fed) Chair Jerome Powell last week.*
- *Nevertheless, our view is that equity markets still are evaluating whether the economic slowdown that seems likely for 2019 will turn into a stall.*

What it may mean for investors

- *An investment decision weighs the known facts and the probabilities of the unknowns. This process can become more difficult when emotion overestimates the likelihood of the unknowns.*
- *We suggest three steps that investors can take to stay disciplined and focused on the risk/reward tradeoff for their investment decisions.*

Asset Group Overviews

On November 23, the S&P 500 Index marked a closing level that was 10% below its latest high on September 20—a decline that meets the definition of a correction. Even with the rebound since November 23, the S&P 500 and global equity prices may remain volatile into year-end and through 2019. Below, we consider how to think about these concerns and what potential opportunities the recent correction may create.

Corrections often are based on fear—but fears don't always materialize

Since 1959, there have been 24 corrections (including the one last month). The factors that most often prompt corrections are a slowing economy and rising inflation.[1] In nearly all of the 24 corrections, industrial production was slowing (and inflation was rising) before the correction, but the economy was still expanding (and inflation was moderate) six months after the correction's low point. Sometimes the fears are a false alarm.

In other cases, the economy heads into a contraction or recession. Since 1959, there have been nine periods when the S&P Index lost at least 20% (referred to as a "bear market"). Six of those nine bear markets coincided with recessions. To us, there are two lessons for the present: First, history suggests that fears prompt corrections, but that a bear market is unlikely unless the fears materialize. Second, the main question during a correction should be whether the fears will materialize.

[1] Investors watch many economic indicators, but we choose monthly changes in industrial production and inflation to represent the overall economic trend.

Take a Disciplined Investment Approach in a Correction

The recent financial market volatility likely comes as investors evaluate whether the economic engine's budding slowdown will turn into a stall. The markets are still evaluating the question, but our perspective is that the three main risks below are limited:

1. **The main concern is that the global economy is slowing—**U.S. economic growth is set to slow next year, and similar concerns persist about Europe and China. We expect the U.S. economy and earnings to keep a solid growth pace. Political uncertainties are delaying Europe's economic recovery, but growth should remain positive next year. For its part, Beijing has implemented various measures to stimulate the Chinese economy, but market unease may continue until the stimulus measures gain traction, probably early in 2019.

2. **Rising interest rates—**One of the main market concerns is that Fed rate hikes in 2019 will terminate the economic expansion. We continue to expect the Fed to hike rates in December, and to hike three more times next year and end the rate hike cycle in 2019. Investors can probably feel some relief that the Fed is not on a preprogrammed rate hike path every quarter next year.

3. **Oil-price declines—**Crude oil's recent and sharp price decline is one of the more remarkable market reversals this year. Investors are concerned that the price drop signals weakening oil consumption and economic growth. But we see excess supply as the main reason—and the ebb and flow of investment hedges and geopolitical stresses as the triggers—behind the oil-price drop.

Weigh the fear against the potential opportunity

Fear triggers corrections, and unknown factors are always present. But several potential opportunities should not be ignored.

- We see slightly slower U.S. economic growth (from 3-4% in 2018 to 2.5-3% in 2019), but only a small probability of a 2019 recession, barring some form of an exogenous event.

- The equity market has discounted substantially the growth risks above. Some market segments are in bear market territory already (e.g., emerging market equities and many U.S. equity issues in semiconductors, information technology, homebuilders, autos, and energy). As the fears fade, the market should remove much (or all) of the discount and create significant price recoveries, in our opinion.

- As of the November 28 market close, the S&P 500 Index was valued at a price-to-earnings valuation of 15.8 times our 12-month earnings per share forecast of $173 through October 1, 2019. That is a reasonable, if not cheap, level compared to the 30-year median of just below 17 times.

Take a Disciplined Investment Approach in a Correction

What investors can do now

An investment decision weighs the knowns and the probabilities of the unknowns. This process becomes more difficult when emotion overestimates the likelihood of the unknowns. Here are three steps that investors can take to remain disciplined and focused on the risk/reward tradeoff:

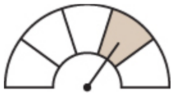
1. **Reassess what is in the portfolio**: If the original reason for holding a security is still valid, then there may be an opportunity to add to that position. If not, then it may be time to find an exit strategy. We still favor the cyclical U.S. sectors (Industrials and Consumer Discretionary), as well as Health Care, Information Technology, and Financials. In international markets, we hold a most favorable view of emerging market equities.

2. **Consider high-quality equities available at a discount**: Some equities with strong underlying fundamentals can become suddenly cheaper during a correction.[2] If the correction lingers, equity issues with perceived steady earnings flows may outperform lower-quality holdings.

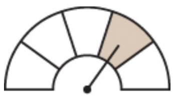
3. **Use cash wisely**: Cash alternatives may outperform equities during a correction, and fear can tempt investors to abandon equities for a less volatile (if smaller) return. The problem with this strategy is that fear can linger longer than the reason for the fear. Looking ahead, cash or cash alternative returns should underperform the S&P 500 Index significantly if, as we expect, concerns about growth ease and equity prices rebound. Adding cash incrementally and consistently to our favored sectors and geographies could be a disciplined way to add exposure to markets that we believe will recover from the recent correction.

[2] Measures of quality may include strong cash flow, greater interest coverage, and lower leverage. These qualities may help promote steady earnings growth.

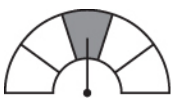
Scott Wren, Senior Global Equity Strategist
Audrey Kaplan, Head of Global Equity Strategy



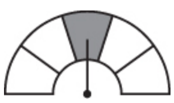
Favorable
U.S. Large Cap Equities



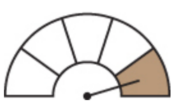
Favorable
U.S. Mid Cap Equities



Neutral
U.S. Small Cap Equities



Neutral
Developed Market
Ex-U.S. Equities



Most Favorable
Emerging Market Equities

Our view on the Energy sector

Given our more positive 12-month outlook on the price of oil, we thought it would make sense to review Energy-sector fundamentals. Our guidance on this sector has been unfavorable.

The Energy sector and crude-oil prices tend to have a positive correlation, and the S&P 500 Energy Index typically moves directionally with the price of oil. Yet that relationship does not mean that the sector will outperform the S&P 500 Index if oil prices rise. Our goal is to have favorable ratings on those sectors that we believe will outperform the index over our 6- to 18-month tactical time frame.

The Energy sector is typically a late-cycle outperformer. However, there are normally several macro factors that are key drivers. One is a robust global economy. Currently, the U.S. economy is growing quite well, and we expect "good" growth to continue. But the international economy is less vigorous. Strong economies here and abroad create demand for crude oil; yet oversupply has been an issue in this cycle. Additionally, inflation is typically on the rise late in a cycle. However, we do not expect this to be the case over the next 12 months.

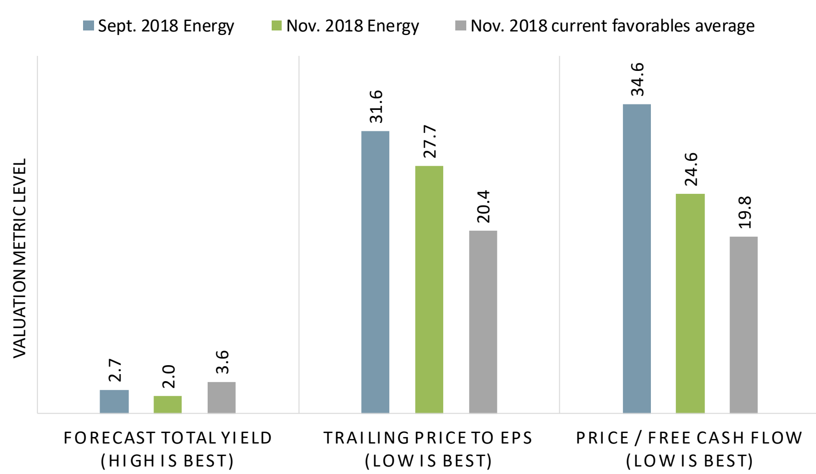
The chart illustrates how the Energy sector stacks up versus our current favorable sectors in terms of our Value Pillar. As shown, on a relative basis, this sector does not look attractive when comparing forecast total yield, trailing price/earnings (P/E) ratio, or the price to free cash flow ratio—even as crude-oil prices tumbled from late September into late November.

Key takeaways

» We have an unfavorable view of the Energy sector today and see more potential in the Financials, Industrials, Information Technology, Consumer Discretionary, and Health Care sectors going forward.

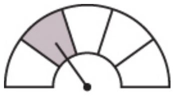
» Based on forecast total yield, P/E ratio, and other valuation metrics, the Energy sector appears less attractive than other favored sectors in the tactical time frame.

Based on our Value Pillar, the Energy sector appears unfavorable

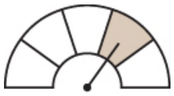


Earning Per Share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock and often serves as an indicator of a company's profitability. Price to Free Cash Flow (FCF) is a valuation metric that compares a company's market price to its level of annual free cash flow. Free cash flow is the amount of cash a company has remaining after expenses, debt service, capital expenditures and dividends. High free cash flow typically means stronger company value. There is no guarantee that forecast yields will be realized, Forecasts are based on certain assumptions and on our current views of market and economic conditions, which are subject to change. The S&P 500 Energy Index comprises those companies included in the S&P 500 that are classified as members of the GICS energy sector. Index returns are not investment returns. An index is unmanaged and not available for direct investment.

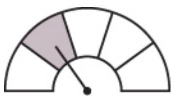
Luis Alvarado
Investment Strategy Analyst



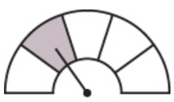
Unfavorable
U.S. Taxable Investment Grade Fixed Income



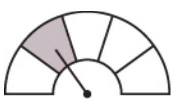
Favorable
U.S. Short-Term Taxable Fixed Income



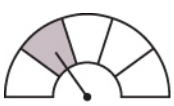
Unfavorable
U.S. Intermediate Term Taxable Fixed Income



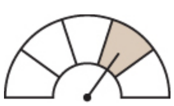
Unfavorable
U.S. Long-Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



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



Favorable
Emerging Market Fixed Income

Continuing the climb up the U.S. corporate maturity wall

While index returns recently have been challenged by rising rates in the corporate bond space, corporate bond issuers also are facing some headwinds. The situation could get tougher for some issuers as the wall of corporate debt maturities continues to steepen next year. This steepening is expected to extend well into 2021. In 2019 alone, more than $450 billion in investment-grade corporate debt and $101 billion in high-yield corporate debt will come due. Altogether, there is more than $1.7 trillion of U.S. corporate debt slated to mature between now and 2021 (see chart below). In a liquid and low-rate environment, most issuers would have little problem refunding the maturing debt. Yet, if growth unexpectedly slows or rates spike, some issuers may begin to see their financial soundness deteriorate.

Additionally, higher interest rates have led to a decline in new corporate bond issuance this year after issuance reached a record high in 2017.[3] It is projected that this downtrend will continue in 2019.

In his speech before the Economics Club of New York last week, Fed Chair Jerome Powell stated that, "over the past year, firms with high leverage and interest burdens have been increasing their debt loads the most. Other measures of underwriting quality have deteriorated, and leverage multiples have moved up."

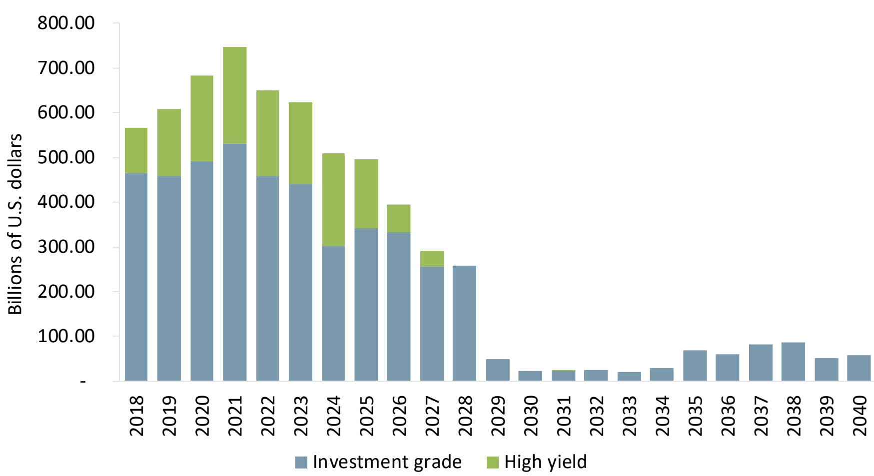
If these trends do continue, we could potentially begin to see ratings deteriorate, further damaging the ability of some companies to issue new debt and keep their currently elevated leverage.

Key takeaways

» Liquidity risks may increase next year as the amount of maturing U.S. corporate debt rises, while financial conditions tighten. We recommend that corporate bond investors move up in credit quality and emphasize selectivity.

» For now, corporate default rates remain low and most issuers are keeping up with their debt service. Yet, rising rates and other headwinds to global economic growth could begin to impact corporate debt issuers.

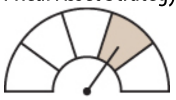
Maturity profile of U.S. corporate debt



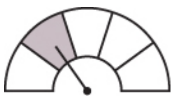
Source: Bloomberg, as of November 23, 2018. Chart shows only the maturity profile of the bonds that comprise the Bloomberg Barclays U.S. Corporate Bond Index (of investment-grade bonds) and the Bloomberg Barclays U.S. High Yield Corporate Bond Index.

[3] Moody's Analytics, Weekly Market Outlook as of November 15, 2018.

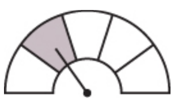
John LaForge
Head of Real Asset Strategy



Favorable
Commodities



Unfavorable
Private Real Estate



Unfavorable
Public Real Estate

"Some people come in your life as blessings. Some come in your life as lessons."
--Mother Teresa

How low can oil go?

Oil's -33% price cliff dive since October has been a good lesson for investors that insist that commodity prices are always an accurate picture of supply and demand. We believe that this view is too simplistic. For one, "always" is a long time—and second, markets can be quite irrational at times.

Oil has been nothing but irrational in 2018, in our opinion. As oil prices climbed into the $70s and $80s, we repeatedly warned investors that these high prices could not be sustained. The main reason: too much supply. Not only did the world have plenty of oil, but higher prices incentivized more production, especially in the U.S.—where breakeven costs were closer to $40 (see chart below).

The black dashed line in the top panel of the chart shows the price of West Texas Intermediate (WTI) oil. The other lines in the top panel represent crude-oil breakeven production prices in major U.S. shale basins. Oil prices that were consistently, and meaningfully, above producers' breakeven prices kept U.S. production rates high throughout 2018. In fact, the U.S. is now producing the most oil it has ever produced in its history at 11.7 million barrels per day.

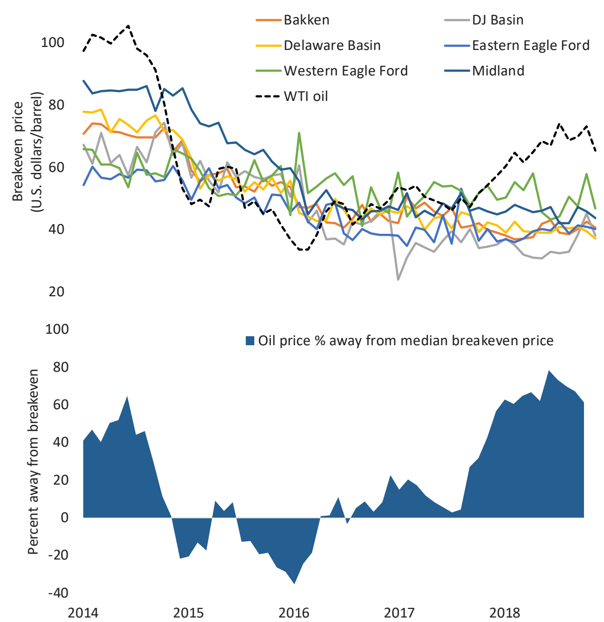
WTI's cliff dive to $50, though, is not a rational picture of supply and demand either, in our view. If oil prices were to persist below $50, U.S. shale producers likely will begin shutting down production. We believe that the "rational" supply/demand balance is best reflected between $60 and $70 per barrel, our October 1, 2019, target range.

Key takeaways

» Oil prices have been irrational through most of 2018. A $50 WTI oil price is likely too low, and $80 is too high.

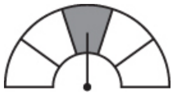
» WTI prices in a range between $60 and $70 best reflect the global supply/demand balance, in our view.

Crude oil breakeven production price versus oil price

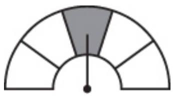


Sources: Bloomberg, BTU Analytics, Wells Fargo Investment Institute. Monthly data January 31, 2014 – October 31, 2018. West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing. The breakeven level is essentially the cost it takes to produce a barrel of oil. If oil prices are above the breakeven level, oil producers will profit by selling the barrel of oil for a price above costs. As long as oil prices are above the breakeven level, oil producers are incentivized to increase production. If the price drops below breakeven, then oil producers are incentivized to cut production.

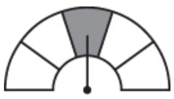
Ryan McWalter, CAIA
Investment Research Analyst



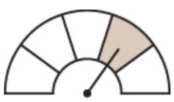
Neutral
Private Equity



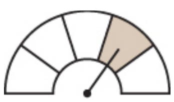
Neutral
Hedge Funds-Macro



Neutral
Hedge Funds-Event Driven



Favorable
Hedge Funds-Relative Value



Favorable
Hedge Funds-Equity Hedge

Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not suitable for all investors and are only open to "accredited" or "qualified" investors within the meaning of U.S. securities laws.

Macro strategy performance in volatile markets

Discretionary Macro managers' ability to be nimble and anticipate shorter-term trading opportunities appears to have put them in a better position than Systematic Macro managers to navigate recent episodic bouts of volatility. More specifically, Systematic Macro managers' use of quantitative trend following models, based on historical price action, has made them less equipped to navigate volatility spikes. However, during periods of more prolonged volatility and persistent trends, Systematic Macro strategies have outperformed their Discretionary Macro counterparts.

In recent years, two larger equity market declines have shown clear performance dispersion among Discretionary and Systematic Macro strategies. There was a prolonged period of volatility in 2015-2016, driven by an energy market downturn and slowing Chinese growth. Systematic Macro managers clearly outperformed Discretionary counterparts and generated gains, which were largely driven by sustained trends in fixed income and energy markets.

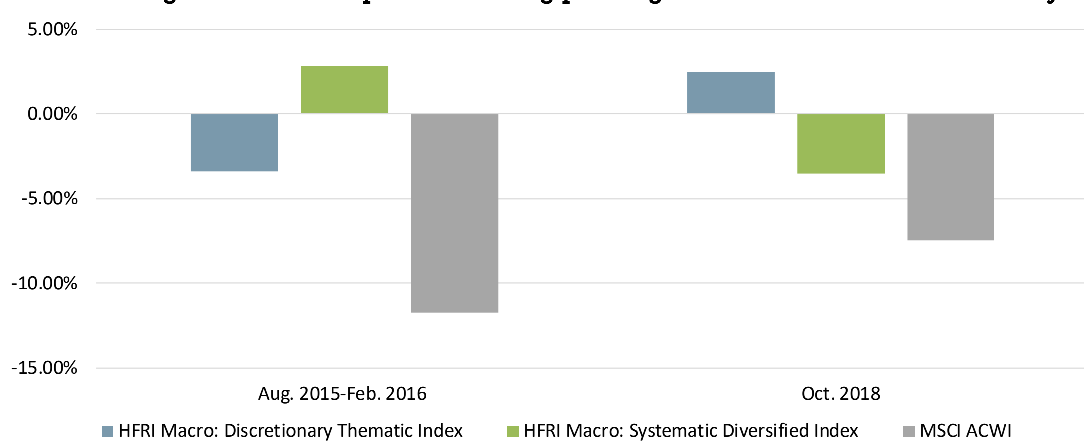
The Discretionary Macro strategy has outperformed during shorter-term market declines such as the October equity downturn. A combination of higher U.S. rates, weaker-than-expected earnings for technology companies, and aggressive trade rhetoric rattled investor sentiment. Discretionary managers generated gains by anticipating trading opportunities in fixed income, currency, and equity markets.

We are in the latter stages of the cycle, but a recession does not seem imminent. Yet, we anticipate higher volatility, stemming from higher rates globally, inflation fears, and geopolitical tensions. All of these can lead to abrupt, shorter-term volatility spikes, which we believe more tactical, nimble Discretionary traders can navigate best.

Key takeaways

- While Systematic Macro managers can provide value during prolonged volatility with persistent trends, they are more vulnerable to episodic bouts of volatility.
- Discretionary Macro managers' ability to be nimble and anticipate trading opportunities during shorter-term volatility spikes is a key reason why we prefer this Macro strategy today.

Macro managers' return dispersion during prolonged and short bouts of volatility



Sources: MPI, Wells Fargo Investment Institute; November 2018. MSCI ACWI = MSCI All Country World Index Systematic traders typically trade using computerized trading rules which have been tested on historic data. Most systematic traders use a trend following approach to trading. Discretionary trading refers to investment decisions that are based on the subjective judgment of the investment team and their view of global macroeconomic trends. Both strategies have unique risks. Please see the end of this report for the definitions of the indices and a description of the asset class risks.

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.

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. 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. **Financial** services companies will subject an 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. 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.

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% of portfolio in either dedicated currency or commodity exposures over a given market cycle.

HFRI Macro: Discretionary Thematic Index. Strategies primarily rely on the evaluation of market data, relationships and influences, as interpreted by individuals who make decisions on portfolio positions; strategies employ an investment process most heavily influenced by top-down analysis of macroeconomic variables. Investment Managers may trade actively in developed and emerging markets, focusing on both absolute and relative levels on equity markets, interest rates/fixed income markets, currency and commodity markets; they frequently employ spread trades to isolate a differential between instrument identified by the Investment Manager as being inconsistent with expected value. Portfolio positions typically are predicated on the evolution of investment themes the Manager expects to develop over a relevant time frame, which in many cases contain contrarian or volatility-focused components.

MSCI All Country World Index (MSCI ACWI) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of 23 developed and 23 emerging markets.

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.

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 1118-04570