2018 Midyear Outlook
Late Cycle Doesn’t Mean End of Cycle
As we publish this report, the current economic expansion turns nine years old and is the second longest since modern records began in 1945. It seems the further the expansion and the related equity bull market run, the more pointed the question, How much longer can they go?

Global economic growth remains solid, but some of the positives from the U.S. economic expansion’s early years now seem irretrievably lost. During most of the economic recovery, inflation and interest rates plumbed decades-long lows while households and businesses shed debt. Today, there are new paths higher in inflation, bond yields, and debt levels. These uptrends are more typical for an aging business cycle but are still emerging slowly, as they reverse the aftereffects from the 2008 financial crisis.

Our full-year 2018 outlook last December anticipated financial market volatility as investors reacquainted themselves to the pros and cons of a stronger economy—namely, earnings and profit margin growth, but also higher inflation and borrowing costs. The first half of 2018 certainly delivered market swings. Political news often was the spark, but we believe that, at root, investor sentiment is weighing each political and economic risk against the question of whether the economy can continue to grow fast enough to coexist with slowly rising inflation and interest rates.

This midyear outlook explores our perspectives on this question. As we explain in greater detail inside, a wide variety of indicators and trends convince us the cycle could run for another year or longer. Risks do build late in business cycles and can alter the risk/reward balance in portfolios. Therefore, we believe investors need to remain diligent to higher interest rates and growing trade tensions. Rising oil prices can dampen consumer spending, and a flattening yield curve has proven to be a trusted historical signpost for recession watch by investors; these events are worthy of a watchful eye. However, we believe positive feedback loops continue to promote expansion, as the rebound in corporate profits and sentiment should prove more durable in promoting broad-based upturns in business spending and continued hiring through the remainder of 2018 and into 2019. To put it succinctly, late cycle doesn’t mean end of cycle—and that difference has investment implications.

On behalf of my Wells Fargo Investment Institute colleagues, we are grateful for the trust you extend to us as our clients and wish you investment success in the balance of 2018.
Global economy, page 4
- Our forecasts reflect expectations of solid growth in global economies for 2018.
- Modestly higher inflation in developed markets and easing pressures in emerging markets suggest a balanced picture for global inflation.

Global equities, page 7
- We retain a favorable outlook for most U.S. equities based on a broadening economic recovery, driven by increasing household and business spending.
- We see more opportunities in U.S. equities in the second half than in either international developed market or emerging market equities.

Global fixed income, page 10
- Global central banks gradually are reducing the liquidity they provide to the markets, with the Federal Reserve (Fed) leading the way.
- A combination of increases in the Fed's key interest rate and significant new supply has resulted in significantly higher yields in short-term fixed-income securities.

Global real assets, page 12
- Real estate investment trust (REIT) fundamentals remain solid, but our expectation for higher yields leads us toward a neutral view for the second half of 2018.
- Master limited partnerships (MLPs) are struggling to grow but currently offer relatively generous dividend yields. MLPs could become more attractively priced later in the year.

Global alternative investments, page 14
- We believe that late-cycle dynamics such as rising interest rates, rising inflation, and rising volatility favor equity hedge and relative value hedge fund strategies.
- Lending conditions are beginning to tighten, setting up an environment in which long/short credit and private debt could thrive.

Opportunities and risks for the balance of 2018, page 17
- We close with strategies that we believe investors can use to navigate this late-cycle market.

Economic and market forecasts, page 19
- Our forecast includes a table of year-end targets for economic and market indices.

Selected year-end 2018 forecasts

<table>
<thead>
<tr>
<th>Category</th>
<th>Forecast</th>
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<tbody>
<tr>
<td>U.S. GDP growth</td>
<td>2.9%</td>
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<tr>
<td>U.S. inflation Consumer Price Index</td>
<td>2.4%</td>
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<tr>
<td>S&amp;P 500 Index</td>
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<tr>
<td>Federal funds rate</td>
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<tr>
<td>10-year U.S. Treasury note yield</td>
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</tr>
<tr>
<td>West Texas Intermediate crude oil per barrel</td>
<td>$50–$60</td>
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</table>

Source: Wells Fargo Investment Institute (WFII); June 14, 2018. A full list of WFII 2018 year-end forecasts is on page 19. Forecasts and targets are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.
We retain a positive view of global growth

We expect the balance of the year to deliver continued synchronized global growth and moderate inflation. We believe that a global trade war remains an unlikely scenario, so long as proposed and enacted tariffs remain precisely targeted instruments of negotiation and not blunt tools of protectionism. For example, the U.S. surprised the world by proposing tariffs on aluminum and steel but then quickly exempted many countries from the new duties, often in exchange for other concessions. Negotiations over the balance of the year between China and the U.S. bear watching, but we expect the talks to produce concessions that ease investor fears about broader and potentially escalating tariffs.

The U.S. expansion continues

We believe that investors should focus on the ongoing U.S. economic expansion, which appears to have more room to run. In our view, the economy is in the final third of its expansion—but likely only at the beginning of that phase. As we note in the business cycle chart on page 5, household and business spending and borrowing, along with inflation and interest rates, are important indicators to watch as the economic expansion matures. These measures have risen from historically low levels since 2015 but likely do not threaten a recession in 2018 or even in early 2019. Indeed, the overhaul of the U.S. tax system and significant new federal expenditures brought substantial economic stimulus into 2018 and 2019; in our view, these measures probably extended the economic expansion.

International markets still have room to run

Our forecasts reflect expectations of solid growth in international economies for 2018. We do see some moderation among certain economies, particularly for the eurozone and Japan, where growth last year was driven by a surge in fourth-quarter activity. It is not unusual for economic growth to ebb and flow during an expansion. In fact, we believe that developed markets as a whole are likely in the mid-cycle of their recovery, while emerging markets are bordering early- to mid-cycle (see chart on page 5).
Global inflation should stay in check

We expect inflation in developed markets (including the U.S.) to rise modestly this year as credit-related spending activity increases. Yet, little evidence suggests that a sustained inflation surge is around the corner. For emerging markets, aggressive central bank rate hikes in recent years broke inflation pressures, and we now expect lower inflation and U.S. dollar depreciation to support spending and investment activity, most notably in Latin American economies. Modestly higher developed market inflation and easing pressures in emerging markets suggest a generally balanced picture for global inflation.

Where we are in the business cycle
What to expect at different stages of a cycle

First-quarter corporate earnings were strong but were expected to be so. We expect strong economic growth to support earnings and to guide equity markets higher through at least the first quarter of 2019, and possibly longer.

Paul Christopher, CFA
Head of Global Market Strategy

Source: Wells Fargo Investment Institute, June 2018
**Investor watch**

- We believe that the U.S. economic expansion is entering the final third of its cycle. Various recession-related indicators that we track do not point to a recession this year.

- We still expect the global economy to post widely positive growth in 2018 based on broad gains in household spending and business investment, accommodative credit conditions, and buoyant business and consumer sentiment.

- Widening U.S. fiscal and trade deficits and rising hedging costs should combine to weaken the dollar further.

**Expect further U.S. dollar depreciation**

Despite its second-quarter rebound, we believe that the U.S. dollar will resume its fall later in 2018. Rising public deficits and the widening U.S. trade deficit should increase the supply of dollar-denominated assets and weigh on the dollar's value. Furthermore, higher U.S. interest rates have increased the cost of hedging dollar exposure for international investors. Adjusted for hedging costs, the negative yield gap between the 10-year U.S. Treasury note and eurozone, Japanese, and U.K. bonds (see chart below) suggests that the U.S. dollar may have further to fall versus international developed market currencies.

Other factors favor the dollar’s main competitor currencies as the global recovery continues. The euro may benefit from pent-up demand as the European Central Bank (ECB) moves to normalize interest rates and eurozone yields rise. Robust economic growth tends to favor the yen and emerging market currencies, although trade politics and local policy decisions might limit appreciation. For example, Japanese policymakers may try to cap any yen strength to support Japanese exporters.

**Hedging costs reduce the appeal of U.S. Treasury bonds to non-U.S. investors**

In this chart, the yield on the 10-year U.S. Treasury note is adjusted by taking into account the annual cost of hedging dollar risk back into the base currency for euro-, yen-, and pound-based investors (using currency forward contracts). Deducting hedging costs reduces the effective yield on the U.S. security and substantially lowers the yield differential with euro-, yen-, and pound-denominated bonds.

![Chart showing yield and index level](image)

**Sources:** Bloomberg and Wells Fargo Investment Institute. Daily data from January 1, 2015, through May 6, 2018. The U.S. Dollar Index, or DXY, is a popular broad gauge of the dollar’s value against a basket of major developed market currencies. The main constituents are the euro (58%), the yen (14%), and the pound (12%).

For illustrative purposes only. Yields represent past performance and fluctuate with market conditions. Past performance is no guarantee of future results.
Global equities
Earnings remain a tailwind

Investing in the U.S. late-cycle expansion

Our favorable outlook for most U.S. equities is based on a broadening economic recovery, driven by household and business spending. Faster economic growth and modest inflation should drive corporate sales growth. We also see significant profit margin expansion resulting from the tax overhaul; we forecast margins for large caps at an estimated 11.9% for 2018, versus a 2017 level of 10.8%, and similar upticks for mid and small caps. We also believe firms will hold the line on labor costs. For these reasons, we expect mid-single-digit sales growth as well as earnings-per-share (EPS) growth of 22.6% (large caps), 28.5% (mid caps), and 65.6% (small caps) for 2018.

The volatile first half for large-cap equities, including the first correction in two years, means valuations are more attractive now than they were at the start of the year. Earnings growth continued amid lackluster equity-price gains, resulting in more favorable price/earnings (P/E) ratios. Equity valuations are also reasonable when compared with those of bonds (see chart below).

The S&P 500 earnings yield versus the 10-year Treasury note yield

Equities still look cheaper than bonds

Sources: Bloomberg and Wells Fargo Investment Institute. Quarterly data from December 31, 1997, through March 30, 2018
Note: The year-end 2018 spread value is a forecast based on Wells Fargo Investment Institute targets.

For illustrative purposes only. The S&P 500 Index is a market-capitalization-weighted index generally considered representative of the U.S. stock market. An index is unmanaged and not available for direct investment. Past performance is no guarantee of future results. The risks associated with stock investing are materially different from investing in U.S. government securities. Unlike stocks, U.S. government securities are guaranteed as to payment of principal and interest if held to maturity. No investment decision should be made on the basis of yield alone. See the end of this report for additional asset class risk considerations.
We continue to favor sectors that tend to benefit most from economic growth

Our outlook for the economy and equity markets leads us to favor cyclical sectors, which tend to benefit the most from economic growth, over sectors that respond adversely to rising interest rates. That is why we are favorable on the Financials, Industrials, and Consumer Discretionary sectors and most unfavorable on Utilities. Sector-specific factors lead us to be favorable on Health Care—driven mainly by supportive demographics—and unfavorable on Energy—driven by our belief that the sector’s equities are still too expensive relative to expected earnings and that commodities remain in a bear supercycle. Bear cycles are multi-year periods in which the majority of commodities fight massive oversupplies. We are most unfavorable on Consumer Staples because of poor earnings growth prospects and rich valuations.

The nuances of small- and mid-cap stocks

Although the earnings and valuation outlooks are generally positive for U.S. equities, investors should note some of the particular nuances of small and midsize companies. The cut in corporate tax rates generally holds greater benefits for small- and mid-cap companies because they tend to pay higher effective income tax rates. These companies also tend to be more domestically oriented, so international trade restrictions tend to be less of a headwind to small- and mid-cap equities, and the increase in fiscal spending may benefit them more relative to large caps. Also, smaller companies tend to be oriented more toward the growth-oriented cyclical sectors that we favor.

One final nuance to consider is how markets reacted to these advantages during the first half of the year. These positive factors largely played out for small-cap equities during their strong first-half performance, and we consequently moved small caps to neutral. By contrast, investors did not price these advantages as completely into large- and mid-cap stocks, where we retain our favorable ratings.

Developed markets offer limited earnings visibility ...

We have a neutral view of developed market equities. It’s possible that earnings growth rates may have peaked for this group; we would like to see greater visibility on forecasted EPS. In addition, U.S. tax cuts seem to be giving U.S. investors more reason to invest at home. The appreciation in the euro and the yen also may be giving investors pause because rapid currency appreciation can limit EPS growth in the trade-oriented markets of Japan and the eurozone.
... but attractive valuations

Still, valuations have improved. Out of all of the equity classes that we follow, the developed market group is the only one for which the trailing 12-month P/E ratio is below the 10-year average—specifically, the P/E ratio is at 16.09 versus an average of 20.18, based on the MSCI EAFE Index. Developed markets also look attractive based on other measures, such as the price/sales ratio of 1.14 and the price/book ratio of 1.48 for the MSCI EAFE Index. Looking at specific regions, we remain favorable on the Pacific, mainly due to positive economic trends and market internals, but have a more neutral view of Europe.

A neutral view of emerging markets

Among the emerging equity markets, we have a neutral rating. A sharp sell-off in those markets has caused valuations to look more attractive. We also expect some modest currency appreciation against the U.S. dollar, which should benefit exposures to local currencies in these markets.

We have only a neutral outlook, however, because we weigh these positives against the likely volatility from a number of ongoing risks. We particularly note the emerging markets’ vulnerability to external forces—including possible international trade restrictions via tariffs between the U.S. and other countries, rising U.S. interest rates, and U.S. corporate repatriation of overseas earnings. These vulnerabilities may create downward pressure in emerging markets if investors fear that these risks may redirect investment flows back to developed markets.

In sum, the sell-off in emerging markets improves the valuation but, in our view, only by enough to balance the risks and the volatility. In addition, we see no compelling regional opportunities and maintain a neutral outlook on Emerging Asia, EMEA (Europe, the Middle East, and Africa), and Latin America.

Investor watch

- A brightening economic backdrop supports our positive U.S. equity outlook.
- We do not expect normalizing interest rates and inflation to derail equity markets.
- We favor U.S. equities over international developed and emerging market equities.
Global fixed income
Maneuvering amid monetary tightening

Tightening the reins of liquidity
Supply and demand dynamics are driving significant shifts in fixed-income markets. Over the past decade, central banks supported markets with ample liquidity, a situation that is slowly changing. Currently, the Fed is not only increasing short-term rates but also shrinking its balance sheet, which ballooned through quantitative easing purchases (see chart below) after the global financial crisis. We expect that the ECB also will end its bond purchases in the near future. Even the Bank of Japan, which retains an easing stance, has been able to quietly reduce purchases while maintaining its control over the yield curve.

Although U.S. monetary easing is coming to an end, we have seen significant fiscal spending commitments over the past six months as a result of U.S. tax reform and a larger-than-expected bipartisan spending agreement. The increase in fiscal spending is resulting in a flood of new U.S. Treasury debt issuance, especially in shorter-term maturities. The greater supply has tended to pressure prices, resulting in higher short-term yields. Yields rise as bond prices fall.

The end to quantitative easing
The Fed is not selling bonds outright in the secondary market but, rather, decreasing the total reinvestment of principal payments from maturing positions. By the end of the year, we expect that $30 billion in Treasury securities and $20 billion in mortgage-backed securities (MBS) will roll off the Fed’s balance sheet each month.

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*“Other” includes federal agency debt securities, overnight securities lending, and net commitments to purchase mortgage-backed securities.
We expect higher short-term yields and more volatility

We expect short-term yields to remain elevated as the Fed increases the federal funds rate; we expect a total of three rate hikes for all of 2018. Our expectation is that longer-term rates will rise modestly as global rates slowly normalize. Our target for the 10-year U.S. Treasury note yield at year-end is 2.75% to 3.25%; our 30-year U.S. Treasury yield target is 3.25% to 3.75%. The path to interest rate normalization is likely to be marked by elevated volatility, at least when compared with the lack of volatility in bond markets throughout 2017.

Supply and demand also are affecting the municipal bond market

Municipal supply has declined, in part because the new tax law eliminated the ability of municipalities to advance-refund debt; this activity represented 20% to 40% of new municipal issuance over the past 10 years. Reduced supply—coupled with what we believe will be increasing demand over the second half of 2018—could lead to an attractive opportunity for municipal bond investors.

Opportunities and risks for investors

Due to regular increases in the federal funds rate and significant new supply, short-term fixed-income securities now offer investors yields that have not been available in the past decade. We favor shorter-term maturities over longer-term maturities given relatively attractive short-term rates and the lack of a yield pickup when moving out on the interest rate curve.

We remain concerned that high-yield valuations give investors an asymmetric risk profile, with limited upside potential and meaningful downside risk. In our view, investors should look to move up in credit quality. However, we also believe that emerging market debt is attractive to income-oriented investors. These yields are comparable with the domestic high-yield asset class, with a more favorable risk/return profile, in our opinion. We continue to have an unfavorable view of developed market debt as yields remain at extremely low and unattractive levels. However, the asset class could continue to post positive returns should the dollar depreciate meaningfully from current levels. Risks to our fixed-income outlook include faster-than-expected economic growth and inflation or unexpected credit or geopolitical events.
Global real assets
Differing outlooks for 2018

A mixed start to the year
During the first half of 2018, real asset performance was a mixed bag. Commodities outperformed other asset classes, led by oil, but MLPs underperformed tremendously. As for REITs, quickly rising interest rates hit REITs hard in January and February. REITs then recovered in March and April because they were seen as a relatively defensive investment while equity markets struggled.

REIT fundamentals are sound, but keep an eye on interest rates and the economic cycle
REIT fundamentals remain relatively sound, and we’re expecting them to stay that way for a few more years. However, this group has rallied, and our outlook for higher rates caused us to move to neutral for the second half of 2018. Our favorite areas remain infrastructure and data centers. The two main risks to our neutral rating are additional spikes in long-term interest rates and the age of the economic cycle. That said, we’re not expecting either to be a major problem for REITs during the remainder of 2018.

MLPs could be an upgrade opportunity later in 2018
We do not believe that MLPs have great fundamentals; in fact, they are struggling to grow. However, they are super cheap, with 8% average dividend yields based on the Alerian MLP Index. (Please note that current dividend levels may not be sustainable should oil prices move lower.) We are thinking about upgrading MLPs based on their valuations, but we are not yet at that point. MLPs continue to lose strength relative to both energy equities and equities in general, which tells us that it’s still too early to turn favorable on the group. We’re also expecting lower oil prices later in 2018, which could drag on MLP market prices. If oil prices were to retreat into our $50 to $60 target range, however, that could very well be the trigger for an upgrade. Even so, we would need to see improved relative strength trends before any upgrade could occur.*

*The Alerian MLP Index is a composite of the 50 most prominent energy master limited partnerships calculated by Standard & Poor’s using a float-adjusted market capitalization methodology. An index is unmanaged and not available for direct investment. Past performance is no guarantee of future results. Although MLP yields are currently high, it is important to note that the distributions an investor receives may represent a return of capital, which will reduce the investor’s tax basis. Distributions from MLPs are not guaranteed and are subject to change.
Tariffs and late-cycle economics drive commodities

Tariffs quickly have become the commodity complex’s biggest issue for 2018, although it is unclear at this point how far the U.S. and China are prepared to go toward a trade war. Historically, local commodity prices have tended to rise at first in the face of tariffs because investors buy on fear of shortages. Yet, price gains eventually fade, as higher prices tend to result in lower demand. We therefore see tariffs as a net long-term wash for commodities.

Another key driver for commodities may be the timing of the U.S. economic cycle. We believe that the U.S. is in the latter stages of an economic expansion, and commodities—on average—have been late-cycle outperformers. We say on average because history shows that commodities tend to lose their late-cycle outperformance when in the midst of a commodity bear market supercycle, which is the case in 2018. The bottom line is we have an unfavorable view toward commodities, and we likely will retain that view for some time.

Late economic expansion plus a commodity bear market has historically resulted in underperformance

Commodities are in the middle of a bear market supercycle, which can last for years. In the late stages of an expansion, commodities that are in the midst of a bear market tend to underperform both stocks and bonds. Data set includes all recessions since 1902.

<table>
<thead>
<tr>
<th>Investor watch</th>
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<tbody>
<tr>
<td>• We remain neutral toward REITs; we believe sound fundamentals will be offset by higher rates.</td>
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<tr>
<td>• We currently have a neutral view of MLPs, but our view may become more positive if relative strength trends improve.</td>
</tr>
<tr>
<td>• Commodities remain in the midst of a bear market supercycle; we therefore have an unfavorable view toward the group, and we likely will retain that view for some time.</td>
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For illustrative purposes only. Lines represent average performance of commodities, commodities relative to stocks, and commodities relative to bonds in periods around the 22 U.S. recessions since 1902 (the 15 U.S. recessions since 1929 for bonds). Commodities represented by the Commodity Composite, stocks by the Dow Jones Industrial Average, and bonds by the Bloomberg Barclays Long Term Treasury Index. An index is unmanaged and not available for direct investment. Past performance is no guarantee of future results. Different investments offer different levels of potential return and market risk. Investing in commodities is not suitable for all investors and may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Investing in stocks involves risk, and their returns and risk levels can vary depending on prevailing market and economic conditions. 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. Please see the end of this report for index definitions and additional asset class risk considerations.
Late cycle dynamics favor alternative investment strategies

In the first half of 2018, both 10-year U.S. Treasury note yields and forward-looking inflation expectations rose. So far this year, we have seen four times the number of +/- 1% daily moves for the S&P 500 Index than we saw in 2017. We also saw an increase in equity dispersion, with nearly 60% of stocks in the Russell 2000® Index generating negative returns. Furthermore, there were nearly 40% more Standard & Poor’s downgrades than upgrades in the high-yield bond market. The cumulative impact of higher volatility and greater security dispersion was seen in the absolute and relative performance of equity hedge and relative value hedge funds.

Importantly, we see this outperformance as further confirmation that the environment for active management has changed. That change was initiated by a gradual removal of monetary stimulus, is now supported by an aging U.S. economic expansion, and is reflected in normalizing correlations among stocks. Although correlations increased in response to February’s sudden increase in volatility, we expect correlations to revert to lower levels over the coming months.

Removal of stimulus coincides with a decline in equity correlations

Investors have become more selective with their stock purchases as the Fed removes liquidity from the market.

Sources: Bloomberg, Federal Reserve Bank of St. Louis, and Wells Fargo Investment Institute. Monthly data from December 31, 2008, through March 29, 2018. The chart measures the average rolling 65-day pair-wise correlation of the stocks within the S&P 500 Index. There is no guarantee that correlations among the individual stocks that currently comprise the S&P 500 Index will remain the same. Correlation represents past performance. Past performance is no guarantee of future results.
We believe this environment demands selectivity

Given increased volatility and greater dispersion among stocks, we favor equity hedge and relative value hedge fund strategies more so than directionally long strategies such as activist and, to a certain extent, systematic macro. Indeed, we anticipate a robust opportunity set for equity hedge strategies over the next 12 to 24 months.

We also are becoming very interested in opportunities arising from stresses within the corporate credit markets. We believe that still-accommodative monetary policy and a nearly insatiable investor appetite for income continue to suppress borrowing costs, but we are starting to see cracks in the foundation. U.S. commercial and industrial loan lending standards are beginning to tighten, and money supply is slowing. Lower-rated issuers are beginning to have difficulty accessing primary markets for loans, which historically has been a precursor to rising distress and default ratios.

As lending conditions tighten, defaults may increase

Based on recent trends, we believe that lower-rated issuers may have increased difficulties refinancing maturing debt, which would tend to result in higher default rates.

Top hedge fund strategies for the second half of 2018

- Relative Value—Long/Short Credit
- Relative Value—Structured Credit/Asset Backed
- Macro—Discretionary
- Event Driven—Distressed
- Equity Hedge—Directional

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.


Debt rating is from Standard & Poor’s. An issuer rated CCC is currently vulnerable and is dependent upon favorable business, financial, and economic conditions to meet its financial commitments. The universe of CCC-rated issuers is based on broad market data. The percentage of issuers accessing the primary market is calculated by taking the average number of CCC deals and dividing it by the number of CCC-rated issuers. It is then annualized by multiplying by four.
Investor watch

• The characteristics of a maturing economy—rising rates, inflation, and volatility—are all tailwinds for long/short equity and relative value strategies.

• We see emerging opportunities in corporate credit markets, where early indications of tighter lending standards and deteriorating fundamentals may lead to opportunities to benefit from short exposures and distressed situations. We believe this bodes well for long/short credit and private debt.

Long/short credit and private debt strategies look more attractive

An environment in which lending conditions are beginning to tighten is precisely the type of environment in which long/short credit and private debt could thrive. Regarding the former, highly leveraged companies susceptible to declining economic growth and tighter lending conditions may provide compelling short-selling opportunities. The latter strategy could benefit because companies with stronger balance sheets, less leverage, and higher free cash flow may trade at attractive valuations during bouts of volatility.

Looking more closely at long/short credit, we believe we are at the very beginning of a shift in the investing environment, with decreased liquidity, tighter lending standards, and increased volatility. This likely will be a trading-oriented environment initially, highlighting the benefits of active management at this point in the cycle. An equally important catalyst could be a changing mindset by exchange-traded fund and mutual fund investors, who might become concerned about rising interest rates or slowing economic growth and begin to sell positions. Indiscriminate selling by a large percentage of the high-yield market could provide an excellent opportunity for hedge fund strategies not beholden to daily liquidity. We have been waiting patiently for a better entry point for the long/short credit strategy and believe now is the time for qualified investors to consider accumulating exposure.

We expect private debt strategies to also capitalize on tighter lending conditions. In particular, companies with less than $50 million of earnings before interest, taxes, depreciation, and amortization (or EBITDA, a commonly used proxy for cash earnings) historically have faced challenges securing loans from commercial banks. This was made even more difficult by the postcrisis wave of regulations. Yet, these companies historically have had higher recovery rates and lower loss-adjusted default rates. As the economic cycle matures, we see a compelling, multiyear opportunity for private debt strategies to lend capital at attractive yields to well-run companies that are simply shut out of the capital markets.

A look at distressed debt

We are becoming more constructive on distressed debt. With valuations high and volatility increasing in the high-yield market, there likely will be bouts of selling that allow distressed debt managers to purchase bonds well below their fundamental value. With the benefit of time and active management, these managers could restructure the debt and strengthen balance sheets, hopefully exiting the position at a premium to the purchase price.

Top private capital strategies for the second half of 2018

Private Equity—Specialty
Private Equity—Direct Lending
Private Debt—Distressed
Private Real Estate—Opportunistic
Financial markets have oscillated between confidence and concern. Yet, knowledgeable investors realize that volatility can accompany a maturing recovery, and they prepare their portfolios as opportunities evolve. We close with strategies that we believe investors can use to navigate this late-cycle market.

1 **We prefer stocks over bonds and U.S. over international**

We do not see the signs that typically indicate an expansion is nearing an end; the double shot of tax reform and fiscal spending, front-loaded to 2018 and 2019, could extend the U.S. recovery. The economy and U.S. equity markets still could register some of their best returns of this cycle. Consequently, we continue to favor equities over bonds and also favor cyclical U.S. sectors that should benefit the most from faster economic growth.

**Equity markets tend to post attractive returns late in a bull market**

History suggests that the years before a recession are often lucrative (albeit volatile) for stocks.

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**Sources:** Morningstar Direct and Wells Fargo Investment Institute, March 31, 2018

Monthly data from August 31, 1926, to September 30, 2007. All returns are for one-year intervals—the first, second, and third year before a recession—as defined by the National Bureau of Economic Research. Performance results are for illustrative purposes only and do not represent the performance of any investment, nor should they be interpreted as a forecast or as an indication of how the asset classes may perform in any future recession period. An index is unmanaged and not available for direct investment. Past performance is no guarantee of future results. Index returns represent general market results; assume the reinvestment of dividends and other distributions; and do not reflect deduction for any fees, expenses, or taxes applicable to an actual investment.


Different investments offer different levels of potential return and market risk. Investing in stocks involves risk, and their returns and risk levels can vary depending on prevailing market and economic conditions. Small-cap stocks are generally more volatile, are 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. Government bonds are guaranteed as to payment of principal and interest if held to maturity and are subject to interest rate. Please see the end of this report for index definitions and additional asset class risk considerations.
2 Weigh risk and reward even more carefully than usual

Some of the characteristics of a maturing cycle are already apparent.

- **Tighter monetary policy may lead to greater disparity in individual stock returns.**
  Active managers may more effectively exploit the maturing cycle than the passive investment structures that have outperformed in recent years. Alternative investments may offer opportunities related to these potential return differentials.

- **Risk and reward may reverse for some asset classes late in the cycle.**
  High-yield bonds, for example, were attractive while interest rates remained at low levels but today appear to have more downside than upside. International developed market bonds and U.S. long-term bonds look comparatively riskier than U.S. high-quality shorter-term debt as interest rates gradually rise. Likewise, commodities appear to offer no particular benefit, contrary to the pattern in certain previous cycles.

3 Take advantage of volatility

2017’s exceptionally steady gains encouraged complacency, which makes this year’s fluctuations more jarring. Still, there may be opportunities to benefit from volatility.

- **Maintain investment horizons.** Later in the market cycle, volatility may result in lower prices that can improve valuations, offering attractive entry points for investors.

- **Stay with a disciplined and diversified investment plan.** Different scenarios can imply opposite portfolio implications. For example, a trade war may favor U.S. small and midsize companies, but an escalated conflict with North Korea may not favor any U.S. markets. A diversified portfolio does not try to predict which risks may materialize but can help mitigate a variety of risks while also participating in positive market developments. Keep in mind, diversification strategies do not guarantee investment returns or eliminate the risk of loss.

- **Volatility offers a chance to rebalance.** Investors who followed our advice last year to take profits in equity positions (or other investors who are holding cash) now may have a chance to reallocate to more attractively priced assets, even as the fundamental outlook remains positive.
## Economic and market forecasts

<table>
<thead>
<tr>
<th>Global economy</th>
<th>2018 (estimate)</th>
<th>2017 (actual)</th>
<th>2016 (actual)</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. GDP growth</td>
<td>2.9%</td>
<td>2.3%</td>
<td>1.5%</td>
</tr>
<tr>
<td>U.S. inflation</td>
<td>2.4%</td>
<td>2.1%</td>
<td>2.1%</td>
</tr>
<tr>
<td>U.S. unemployment rate</td>
<td>3.9%</td>
<td>4.1%</td>
<td>4.7%</td>
</tr>
<tr>
<td>Global GDP growth</td>
<td>3.7%</td>
<td>3.8%</td>
<td>3.2%</td>
</tr>
<tr>
<td>Developed market GDP growth</td>
<td>2.3%</td>
<td>2.3%</td>
<td>1.7%</td>
</tr>
<tr>
<td>Developed market inflation</td>
<td>2.0%</td>
<td>1.7%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Emerging market GDP growth</td>
<td>4.7%</td>
<td>4.8%</td>
<td>4.3%</td>
</tr>
<tr>
<td>Emerging market inflation</td>
<td>4.3%</td>
<td>4.0%</td>
<td>5.7%</td>
</tr>
<tr>
<td>Eurozone GDP growth</td>
<td>2.0%</td>
<td>2.8%</td>
<td>1.8%</td>
</tr>
<tr>
<td>Eurozone inflation</td>
<td>1.6%</td>
<td>1.4%</td>
<td>1.1%</td>
</tr>
<tr>
<td>Dollar/euro exchange rate</td>
<td>$1.18–$1.26</td>
<td>$1.20</td>
<td>$1.05</td>
</tr>
<tr>
<td>Yen/dollar exchange rate</td>
<td>¥102–¥112</td>
<td>¥113</td>
<td>¥117</td>
</tr>
</tbody>
</table>

### Global equities

<table>
<thead>
<tr>
<th></th>
<th>2018 (estimate)</th>
<th>2017 (actual)</th>
<th>2016 (actual)</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 Index</td>
<td>2,800–2,900</td>
<td>2,674</td>
<td>2,239</td>
</tr>
<tr>
<td>S&amp;P 500 operating EPS</td>
<td>$152</td>
<td>$131</td>
<td>$117</td>
</tr>
<tr>
<td>Russell Midcap® Index</td>
<td>2,200–2,300</td>
<td>2,078</td>
<td>1,784</td>
</tr>
<tr>
<td>Russell Small Cap Index</td>
<td>1,650–1,750</td>
<td>1,536</td>
<td>1,357</td>
</tr>
<tr>
<td>MSCI EAFE Index</td>
<td>2,050–2,150</td>
<td>2,051</td>
<td>1,684</td>
</tr>
<tr>
<td>MSCI Emerging Markets Index</td>
<td>1,160–1,240</td>
<td>1,158</td>
<td>862</td>
</tr>
</tbody>
</table>

### Global fixed income

<table>
<thead>
<tr>
<th></th>
<th>2018 (estimate)</th>
<th>2017 (actual)</th>
<th>2016 (actual)</th>
</tr>
</thead>
<tbody>
<tr>
<td>10-year U.S. Treasury yield</td>
<td>2.75%–3.25%</td>
<td>2.40%</td>
<td>2.44%</td>
</tr>
<tr>
<td>30-year U.S. Treasury yield</td>
<td>3.25%–3.75%</td>
<td>2.70%</td>
<td>3.07%</td>
</tr>
<tr>
<td>Federal funds rate</td>
<td>2.00%–2.25%</td>
<td>1.50%</td>
<td>0.75%</td>
</tr>
</tbody>
</table>

### Global real assets

<table>
<thead>
<tr>
<th></th>
<th>2018 (estimate)</th>
<th>2017 (actual)</th>
<th>2016 (actual)</th>
</tr>
</thead>
<tbody>
<tr>
<td>West Texas Intermediate crude price (barrel)</td>
<td>$50–$60</td>
<td>$60</td>
<td>$54</td>
</tr>
<tr>
<td>Brent crude price (barrel)</td>
<td>$55–$65</td>
<td>$67</td>
<td>$57</td>
</tr>
<tr>
<td>Gold price (troy ounce)</td>
<td>$1,250–$1,350</td>
<td>$1,309</td>
<td>$1,152</td>
</tr>
</tbody>
</table>

Wells Fargo Investment Institute forecasts and targets. Forecasts and targets are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.

**Sources:** FactSet, Bloomberg, International Monetary Fund, and Wells Fargo Investment Institute; June 14, 2018

*GDP = gross domestic product*

West Texas Intermediate crude oil is a light, sweet (that is, low sulfur) crude oil, which is the main type of U.S. crude oil traded in U.S. futures markets. Brent crude oil is a light, sweet crude oil extracted from the North Sea. It serves as a major benchmark price for purchases of oil worldwide.
What we’re watching in the second half

Sharp equity market swings returned in the first half of 2018. We had been expecting more volatility and issued guidance in late 2017 that the unusually calm markets of 2017 were unlikely to persist. We expect volatility to continue through the end of 2018.

Here is what we’re watching that could change our year-end outlook. Geopolitical events, Fed policy, and global economic surprises top the list.

Trade policy and midterm elections likely will be big factors in the second half and cause more volatility in the markets. We also would expect to see a continued focus on the state of the synchronized global growth story, with market participants looking for signs that these dynamics are still intact. Any sign of a decoupling of growth from either Europe or China could send mixed signals throughout the markets.

Adam Taback
Head of Global Alternative Investments

Looking at the second half of the year, we will be watching for signs that tightening monetary policy is creating stress in the global financial markets. Such stress could be in the form of rising defaults or continued price weakness across asset classes.

Tracie McMillion, CFA
Head of Global Asset Allocation Strategy

We are watching the Fed. We expect a total of three rate hikes this year. However, if the Fed increases its pace, the risks of a policy mistake increase. One particular concern is whether the yield curve will invert.

Brian Rehling, CFA
Co-Head of Global Fixed Income Strategy
What to watch in 2018 and beyond

Each quarter, Wells Fargo Investment Institute publishes a special focus report that examines themes that could affect investors today and in the years ahead. Below are descriptions of the reports that were released and are scheduled for the balance of 2018.

Focus theme one: Balancing Risk and Reward

*Published February 2018*

Market participants must weigh the amount of risk they are willing to take in exchange for return or income. When asset prices begin to rise ahead of fundamental valuation measures, we believe that investors should exercise greater caution, even as they maintain a diversified portfolio consistent with their long-term objectives.

Focus theme two: Investing Late in a Bull Market

*Published April 2018*

We believe U.S. economic data supports the case for continued economic recovery and further stock market gains. The challenge for investors is to remain alert to the risks that accompany the latter stages of a bull market—including heightened volatility—while also taking advantage of the market’s potential for still-sizable returns.

Focus theme three: Tomorrow’s Technology

*Scheduled for third quarter 2018*

We have seen mounting investor interest in the Information Technology sector, yet new technologies come with both pitfalls and benefits. We examine how technology is influencing businesses and economic sectors as well as the possible effect of robotics and automation on the labor force and productivity.

Focus theme four: The New Approach to Retirement

*Scheduled for fourth quarter 2018*

Today, planning for life in retirement is often left up to the individual. Yet, many wonder if they can afford to retire. We will look at how different generations—Baby Boomers, Generation Xers, and Millennials—are approaching retirement. We will also examine the steps we believe investors should take to prepare for retirement given the potential for longer life spans.
Index definitions

The Bloomberg Barclays Long-Term Treasury Index is comprised of fixed-income securities with various maturities greater than 10 years.

The Commodity Composite measures a basket of commodity prices as well as inflation. It blends the historical commodity index from George F. Warren and Frank A. Pearson, the U.S. Bureau of Labor Statistics Producer Price Index for Commodities, the National Bureau of Economic Research Index of Wholesale Prices of 15 Commodities, and the Thomson Reuters Equal Weight Commodity Index.

The Dow Jones Industrial Average is an unweighted index of 30 blue-chip industrial U.S. stocks.

The Ibbotson Associates Stocks, Bonds, Bills and Inflation Series (IA SBBI) U.S. Intermediate-Term Government Bonds TR Index consists of one-bond portfolios that are used to construct the intermediate-term government bond index. The bond chosen each year is the shortest noncallable bond with a maturity not less than five years, and it is held for the calendar year. Total returns of the intermediate-term government bonds for 1987 to 2014 are calculated from The Wall Street Journal prices, using the coupon accrual method. Returns for 1934 to 1986 are obtained from the Government Bond File at the Center for Research in Security Prices at the University of Chicago Booth School of Business.

The Ibbotson Associates Stocks, Bonds, Bills and Inflation Series (IA SBBI) U.S. Small Stock TR Index is based on the S&P Composite Index. This index is a readily available, carefully constructed, market-value-weighted benchmark of small-cap stock performance. The small-capitalization stock total return is provided by S&P Dow Jones Indices, which calculates the total return based on the daily reinvestment of dividends on the ex-dividend date.

The MSCI EAFE Index is designed to represent the performance of large- and mid-cap securities across 21 developed markets, including countries in Europe, Australasia, and the Far East, excluding the U.S. and Canada.

Risk considerations

All investing involves risks, including the possible loss of principal. There can be no assurance that any investment strategy will be successful. Investments fluctuate with changes in market and economic conditions and in different environments due to numerous factors, some of which may be unpredictable. Each asset class has its own risk and return characteristics, which should be evaluated carefully before making any investment decision. Some of the risks associated with the representative asset classes discussed in this report include:

General market risks

Stock markets, especially foreign markets, are volatile. A stock's value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. International investing has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets. Investing in small- and mid-cap companies involves additional risks, such as limited liquidity and greater volatility. Small- and mid-cap stocks are generally more volatile, are subject to greater risks, and are less liquid than large-company stocks.

Investments in fixed-income securities, including municipal securities, are subject to market, interest rate, credit, liquidity, inflation, prepayment, extension, and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in a decline in the bond's price. High-yield fixed-income securities are considered speculative, involve greater risk of default, and tend to be more volatile than investment-grade fixed-income securities. Municipal securities may also be subject to the alternative minimum tax and 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. If sold prior to maturity, fixed-income securities are subject to market risk. All fixed-income investments may be worth less than their original cost upon redemption or maturity.

Similar to bonds, preferred securities are interest rate sensitive. Their dividends are not guaranteed and are subject to change. Some preferred securities include a call provision, which may negatively affect the return of the security. A prerefunded bond is a callable bond collateralized by high-quality securities, typically Treasury issues. U.S. government securities are backed by the full faith and credit of the federal government as to payment of principal and interest if held to maturity. Although free from credit risk, they are subject to interest rate risk. Mortgage-related and asset-backed securities are subject to prepayment and call risks in addition to the risks of investing in debt securities. Call risk is the risk that the issuer will redeem the issue prior to maturity. This may result in reinvestment risk, which means the proceeds will generally be reinvested in a less favorable environment. Changes in prepayments may significantly affect yield, average life, and expected maturity.
Sector investing

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. Consumer Staples industries can be significantly affected by competitive pricing particularly with respect to the growth of low-cost emerging market production, government regulation, the performance of the overall economy, interest rates, and consumer confidence. The Energy sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. Investing in the Financials sector will subject a portfolio 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. Risks associated with investing in Industrials include the possibility of a worsening in the global economy, acquisition integration risk, operational issues, failure to introduce to market new and innovative products, further weakening in the oil market, potential price wars due to any excess industry capacity, and a sustained rise in the dollar relative to other currencies. 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. Utilities are sensitive to changes in interest rates, and the securities within the sector can be volatile and may underperform in a slow economy.

Alternative investments

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, and 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 Driven, Equity Hedge, Relative Value, Structured Credit, Long/Short Credit, and discretionary Macro, 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 because 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.

Long/short credit strategies seek to mitigate interest rate and credit risks regardless of market environment through investment in credit-related and structured debt vehicles. These strategies involve the use of market hedges and involve risks such as derivatives, fixed income, foreign investment, currency, hedging, leverage, liquidity, short sales, loss of principal, and other material risks. Private debt strategies seek to actively improve the capital structure of a company, often through debt restructuring and deleveraging measures. Such investments are subject to potential default, limited liquidity, the creditworthiness of the private company, and the infrequent availability of independent credit ratings for private companies. Investing in distressed companies is speculative and involves a high degree of risk. Because of their distressed situation, these securities may be illiquid, have low trading volumes, and be subject to substantial interest rate and credit risks.

Real Assets

Real assets are subject to the risks associated with real estate, commodities, MLPs, and other investments and may not be suitable for all investors.

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. Investments in commodities may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies, which may expose investors to additional risks.

Investment in securities of MLPs involves certain risks that 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. In addition, there are certain tax risks associated with an investment in MLP units, and conflicts of interest may exist between common unitholders and the general partner, including those arising from incentive distribution payments. 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.

Investment in real estate securities include risks, such as the possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.
Investment expertise and advice to help you succeed financially

Wells Fargo Investment Institute is home to more than 120 investment professionals focused on investment strategy, asset allocation, portfolio management, manager reviews, and alternative investments. Its mission is to deliver timely, actionable advice that can help investors achieve their financial goals.

For assistance with your investment planning or to discuss the points in this report, please talk to your investment professional.