WELLS FARGO Asset Management

Investment Insights

2019 Midyear

A letter from Kirk Hartman

Kirk Hartman
WFAM President and Global Chief Investment Officer

As we head through the second half of 2019, we believe the U.S. economy will continue growing at a moderate rate. The big question: Will we go back to an environment of synchronized global growth or stay mired in a bog of synchronized slowing? Our teams, generally, expect this economic cycle will extend rather than contract imminently.

Accommodative central bankers are coming up against high market volatility—perhaps driven by investor worries about how long the good times can roll. At the end of 2018, the big worry was whether the Fed would make a policy mistake and hike until it hurt growth. Now the big question is whether the Fed has done the improbable—has it actually stuck the landing of full employment and moderate inflation? If that's true (and we think it is), then from our perspective, stock market valuations are at reasonable levels and Treasury yields aren't destined to rise too abruptly or too high. With this economic and valuation backdrop, we encourage investors to stay the course. We understand that market volatility can be upsetting. However, great disruption can often lead to new opportunities to uncover high-quality assets at attractive prices.

How long can yields fall and equities rise? And what might this mean for portfolio allocations?

Our Multi-Asset Solutions team thinks the answer lies in the idea of *balance*.

- Investors should consider focusing more on balancing the sources of risks than on balancing capital allocations.
- The risks to growth and inflation seem mild, while the risks of rising rates may be more elevated for the balance of the year.

Seeking portfolio balance in that manner aligns with what many of our investment teams are doing: Staying the course relative to their benchmarks with a heavy emphasis on security selection to uncover value regardless of the asset class.

Over the next pages, you'll hear from our investment teams, sharing their insights on the opportunities in today's market. They'll touch on a potential tale of two markets, like leveraged loans in Europe versus leveraged loans in the U.S. They will also highlight high-quality stocks and bonds, some selling at absolute discounts and others at relative discounts for alpha-generating opportunities. Just for some alternative perspective, we've also included macroeconomic insight from our research partner Wells Fargo Investment Institute on pages 4-6.

Across all of our portfolios, our number one priority is helping clients build portfolios for successful outcomes, defend those portfolios against risks, and create long-term financial well-being. We hope you find these insights helpful, and encourage you to lean on us for insights to help you navigate these markets.

Kirk D. Hartman

Table of contents

Wells Fargo Investment Institute macroeconomic outlook

Global economy outlook 4

Economic and market forecasts 6

Equities

U.S. large cap equities 7

U.S. mid/small cap equities 8

Developed non-U.S. 9

Emerging market equities 10

Global quantitative 11

Fixed income

Sovereign bonds 12

Global investment grade credit 13

Global high yield credit 14

Tax-exempt bonds 15

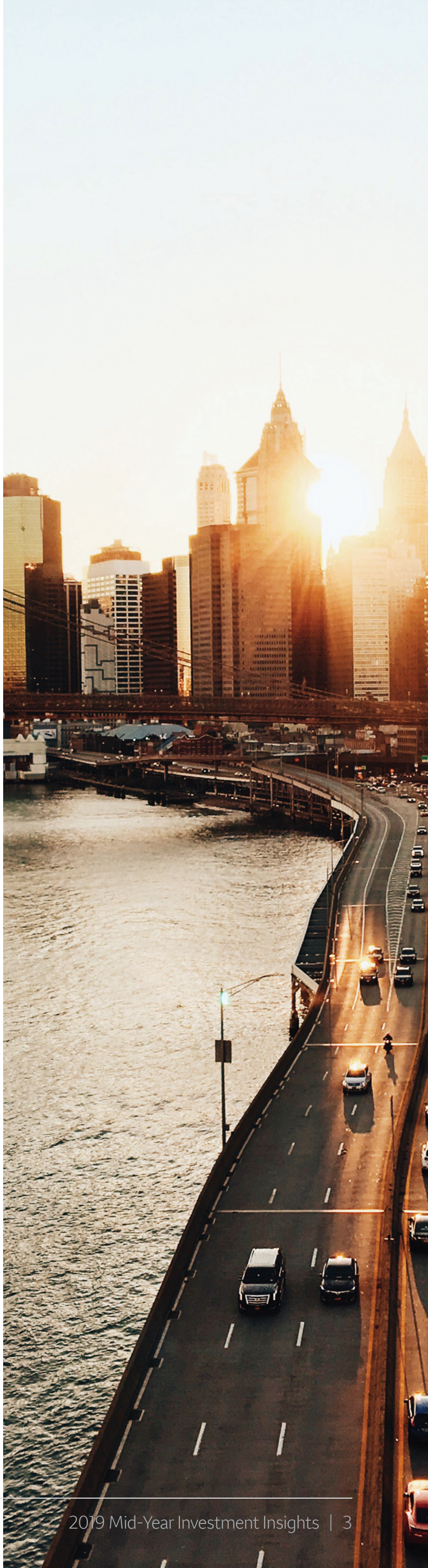
Short duration 16

Multi-asset

In search of balance 17

Conclusion 18

Contributors 19



Slow global growth, no recession

Macroeconomic perspective from Wells Fargo Investment Institute

Key takeaways

- Conditions globally should support continued economic growth, although with important regional differences.
- Strong labor markets around the world should support personal spending, but business spending remains tepid while policy uncertainties persist.

What it means for investors

- While we expect softer global growth this year, a U.S. economic recession seems unlikely.

Most regions look stable, but weaker in Europe and Japan

Our outlook for the second half of 2019 is for positive economic growth of varying strength around the world. A U.S. economic recession appears unlikely, and emerging economies probably will show stable growth. But European and Japanese economic growth seems comparatively weaker and may not stabilize until political uncertainties around Brexit and trade disputes fade. We also anticipate slightly higher but benign global inflation.

Rising political uncertainties since early 2018 have constrained economic confidence and still seem to be the main economic risk (see the chart on the next page). Fortunately, fiscal and monetary policymakers in the U.S., Europe, and China have added stimulus measures, and more global central banks are likely to cut interest rates. A U.S.-China trade agreement could help restore positive global trade growth and may particularly benefit Europe and Japan. However, business spending and global trade in materials and industrial goods are likely to remain constrained while the scope and timing of that agreement are unclear.

The U.S. and China anchor the global outlook

Ongoing U.S. job and wage gains and low debt costs should support positive yet modest household consumption growth. We expect 2019 U.S. economic growth to average 2.1% even after the economy's unexpected first-quarter strength. After all, businesses remain cautious about investments and are likely to let their inventories shrink in the balance of 2019. Modest household spending growth and restrained business investment should slow the economy from the 2.9% pace of 2018.

Weak economic growth in Europe and Japan could stabilize if political issues begin to settle and economic confidence rebounds. These economies should find underlying support in solid labor markets and household spending. The key for the developed markets should be the easing of trade tensions, avoiding the instability of snap elections in Italy, and finalizing Brexit.

Election-related policy uncertainties in India and Latin America led us to slightly downgrade emerging market economic growth, but China and East Asia should backstop the group as a whole. Steady Chinese private sector spending should promote positive economic growth and trade with other emerging economies. Chinese stimulus measures are modest and designed to offset the negative impacts of domestic economic reforms and the trade dispute with the U.S.

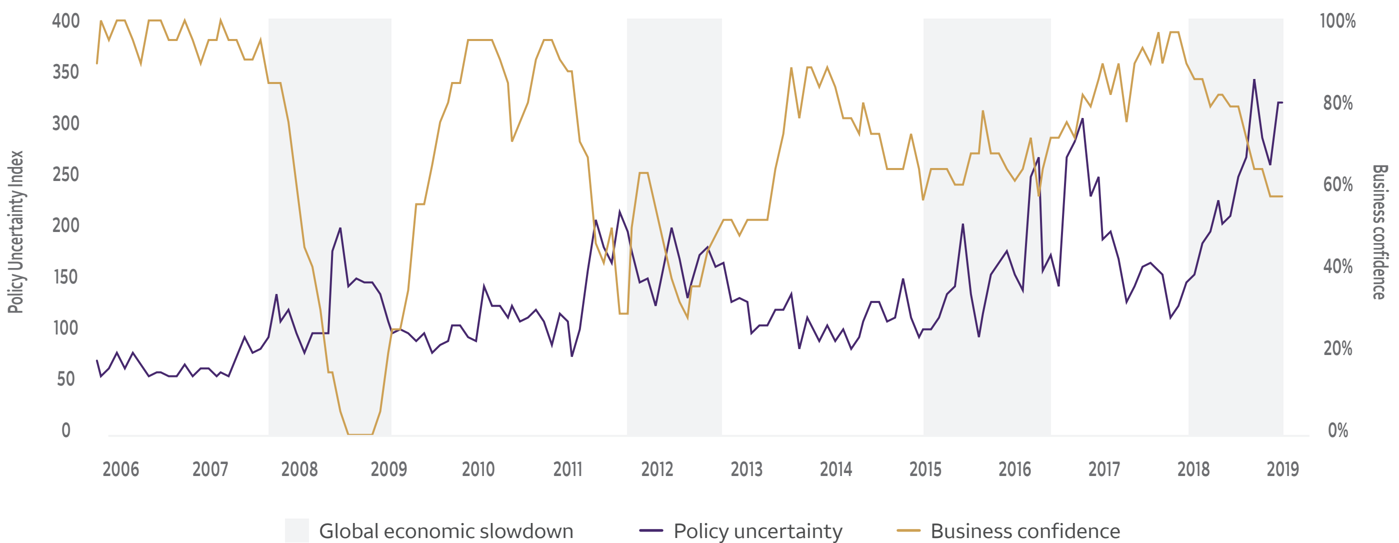
Contributors: Peter Donisanu | Craig Holke | Peter Wilson

We do not currently expect major currency volatility

We have reduced our expectations for dollar depreciation and now believe that the dollar will remain broadly stable against both developed and emerging market currencies. Interest rate and growth differentials, as well as uncertainty over trade, should continue to support the dollar, but expectations of a Fed rate cut and an eventual U.S.-China agreement will cap dollar strength. Sluggish growth, low inflation, and persistent political risk should constrain significant euro appreciation, but the yen may benefit from prolonged trade uncertainty.

Rising political uncertainty tends to dampen business confidence

Major political uncertainties such as Brexit and trade disputes have tended to depress business confidence. We hope to see the resolution of some of these uncertainties later in 2019.



Sources: Wells Fargo Investment Institute; Markit; Bloomberg; and Baker, Bloom, and Davis. Monthly data from January 31, 2006, to April 30, 2019.

Global economic slowdown periods defined by the Organisation for Economic Co-operation and Development (OECD). Policy uncertainty is represented by the Global Economic Policy Uncertainty Index produced by Baker, Bloom, and Davis. It measures changes in news coverage about policy-related economic uncertainty, tax code expiration data, and economic forecaster disagreements. Business confidence measures the share of global manufacturing purchasing managers' indices (PMIs) in expansionary territory (above 50). A PMI is a measure of dominant trends in manufacturing and is considered a leading indicator of economic activity.

Economic and market forecasts

Macroeconomic perspective from Wells Fargo Investment Institute

We expect moderating economic growth and inflation, but a sharper slowdown in Europe and Japan.

We expect a stable U.S. dollar

We have a neutral outlook on U.S. large- and mid-cap equities but an unfavorable view of small-cap equities.

We expect the Fed to cut rates at least once between now and year-end.

We expect most commodity prices to be steady into year-end 2019.

Global economy	2019 (year-end target)	2018 (Actuals)	2017 (Actuals)
U.S. GDP growth	2.1%	2.9%	2.2%
U.S. inflation	1.7%	2.5%	2.1%
U.S. unemployment rate	3.7%	3.9%	4.1%
Global GDP growth	3.3%	3.6%	3.7%
Developed market GDP growth	1.7%	1.8%	2.3%
Developed market inflation	1.6%	1.6%	1.7%
Emerging market GDP growth	4.4%	4.9%	4.7%
Emerging market inflation	4.3%	6.9%	5.2%
Eurozone GDP growth	1.2%	1.9%	2.7%
Eurozone inflation	1.5%	1.5%	1.4%
Dollar/euro exchange rate	$1.11–$1.19	$1.15	$1.20
Yen/dollar exchange rate	¥104–¥114	¥110	¥113
Global equities			
S&P 500 Index	2,800–2,900	2,507	2,674
Earnings per share	$167	$162	$134
Russell Midcap Index	2,200–2,300	1,857	2,078
Earnings per share	$128	$124	$95
Russell 2000 Index (small cap)	1,450–1,550	1,349	1,536
Earnings per share	$65	$62	$45
MSCI EAFE Index	1,850–1,950	1,720	2,051
Earnings per share	$135	$132	$132
MSCI Emerging Markets Index	1,070–1,170	966	1,158
Earnings per share	$84	$82	$81
Global fixed income			
10-year U.S. Treasury yield	2.00%–2.50%	2.68%	2.40%
30-year U.S. Treasury yield	2.25%–2.75%	3.01%	2.74%
Federal funds rate	2.00%–2.25%	2.40%	1.31%
Global real assets			
West Texas Intermediate crude price (barrel)	$60–$70	$45	$60
Brent crude price (barrel)	$65–$75	$54	$67
Gold price (troy ounce)	$1,250–$1,350	$1,281	$1,309

Sources: FactSet, Bloomberg, International Monetary Fund, and Wells Fargo Investment Institute, June 11, 2019. GDP=gross domestic product. 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.

Contributors: Peter Donisanu | Craig Holke | Peter Wilson

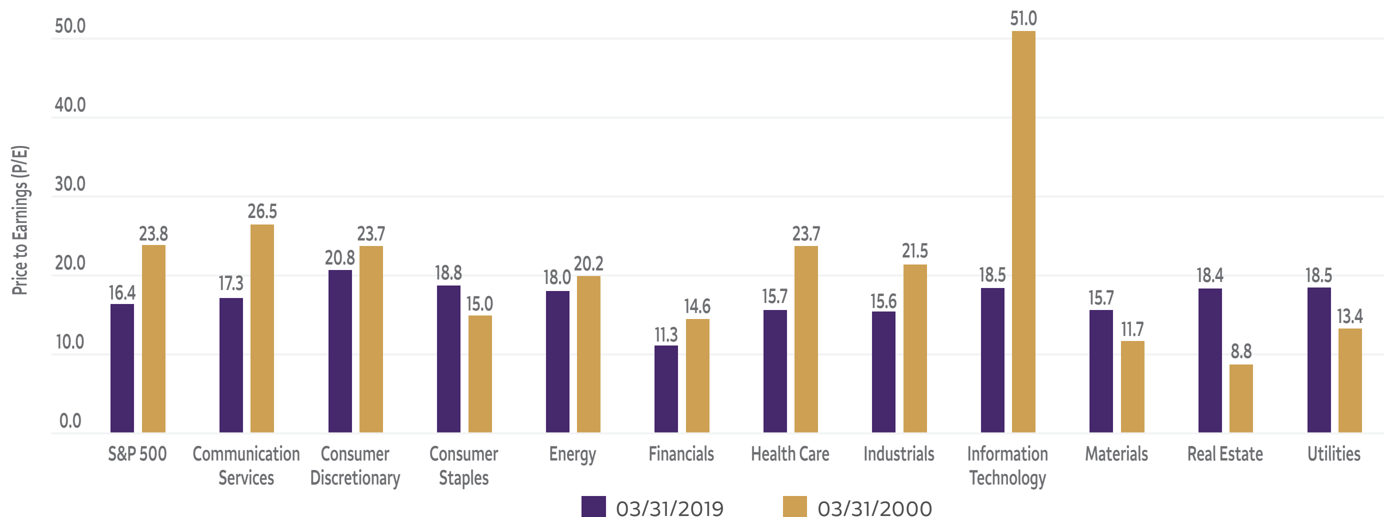
The universe of secular but scarce growth opportunities

Tepid economic expansion caused a scarcity of growth—an environment particularly challenging for those companies hamstrung by legacy business models. So we continue focusing on companies offering secular growth opportunities and aren't necessarily tied to fiscal or monetary stimulus. Where are these opportunities? Often, they live in the technology sector, given its many disruptors—that's nothing new. But here's where it gets interesting: Disruption is no longer the exclusive property of Silicon Valley. These days, companies from a range of sectors outside of IT are using tech-based innovation to transform themselves. As a result, we have overweight positions both to the technology sector and to companies that have been successfully using technology to adjust their business models.

Less compelling in our view: Consumer staples companies with legacy brands that have lost relevancy with customers. Such companies are facing long-term headwinds. By way of our underweight position in the space, we've voted with our feet.

In what feels like a winner-takes-all environment, it's likely that investors will continue to reward better-positioned businesses with higher valuations. And current valuations appear reasonable to us, given two variables: A more dovish monetary policy and the lower-for-longer interest rate environment.

Investors often worry about technology stocks' high valuations, citing the technology, media, and telecom (TMT) bubble of yesteryear. While we've seen some bubblish pockets of activity—such as software in early 2018—today is not the 1990s redux. Let's put it in context: as illustrated in the accompanying chart, the tech-sector P/E was more than 100% higher than the S&P 500 Index P/E in March 2000. And today, it's a mere 13% higher. In addition, modern-day technology and communications services are more influential across a variety of industries than they were 20 years ago.



Source: Factset, Price to Earnings (P/E) is the price of a share of a stock divided by next twelve months earnings per share. Price to Funds from Operations (P/FFO) was used for the real estate sector. P/FFO, a measurement of real estate cash flow is the price of a share of stock divided by the next twelve months funds from operations per share.

The “large” opportunity within mid/small cap

Mid and small cap stocks, in contrast with longer-term averages have recently underperformed large cap stocks. However, we believe the vast universe of mid and small cap stocks, coupled with expected earnings growth, provide significant opportunity.

We see another opportunity to help combat tepid economic growth: mid and small cap stocks that provide two potential benefits: The opportunity for diversification and faster earnings growth. In fact, small- and mid-cap companies' earnings estimates for 2019 and 2020 are set to outpace those of the S&P 500 Index.

As with large caps, disruptive growth in the tech sector prompted us to take an overweight position in that space. We are also overweighting the industrials and materials sectors, where the long-term benefits of price increases have been offsetting short-term cost pressures.

We remain underweight in sectors many investors often use as proxies for bonds, such as utilities and Real Estate Investment Trusts (REITS). The underweight has created performance headwinds as longer-term rates have rolled over—yet again. Moreover, we're finding better reward-to-risk opportunities in areas where profitability is not capped by regulators nor stock performance unduly buoyed by interest rates.

Source: FactSet. The Mid/Small-Average is represented by the average of the Russell Midcap Index® and Russell 2000 Index®. Large is represented by the S&P 500 Index. The years of 2013–2018 are annualized bottom-up actual earnings. The years of 2019 and 2020 are annual bottom-up estimates as of May 2019. **Past performance is no guarantee of future results.**

Contributors: F. Jon Baranko | Jeffrey A. Doinoff | John G. Krueger | Ann Miletti

Looking beyond the location of the company's headquarters

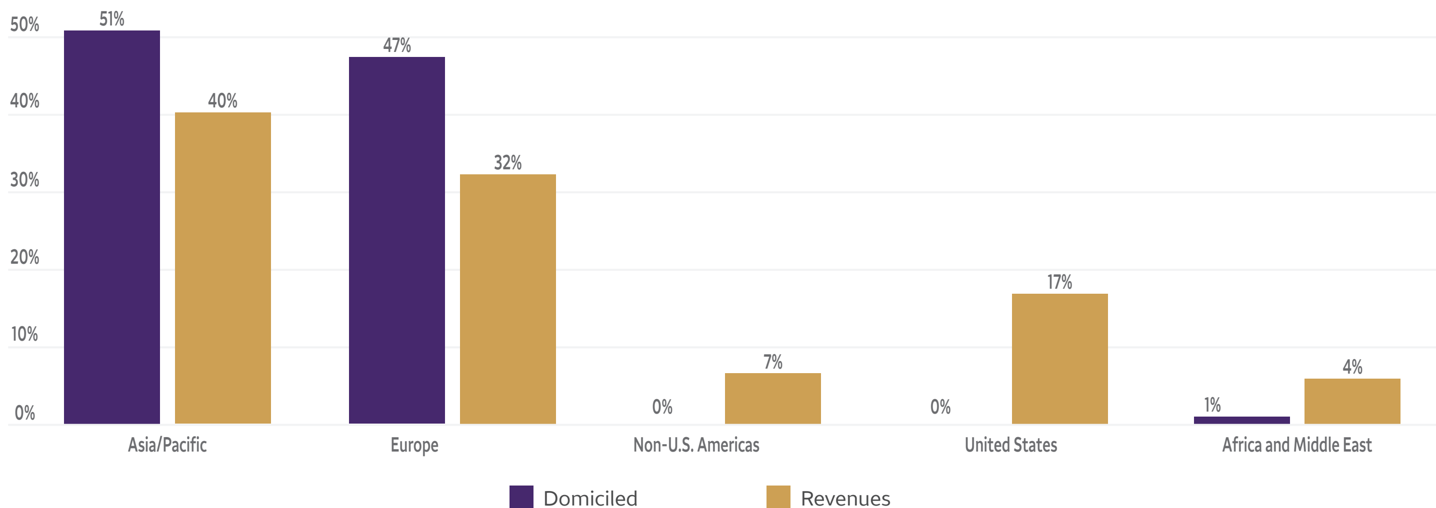
It's true that non-U.S. economic growth has been slowing. But it hasn't stopped. A host of issues slowed growth—including Brexit in the U.K., auto manufacturing in Germany, the debt burden in Italy, and geopolitical unrest across continents. Global central banks have responded to these challenges with a firm accommodative stance. And, in turn, this environment has created a valuation discount to the U.S. that is well beyond historical averages. While our managers take these macroeconomic conditions into account, our primary focus is analyzing a business' fundamentals and applying a macroeconomic cross-check.

Being mindful of the physical location of a company's headquarters might be relevant for geopolitical and currency effects. But we find it more important to understand where (and how) companies generate their revenues, earnings, and cash flows. To that end, we are overweight U.K., Germany, and Italy domiciled companies despite some of their local challenges. Why? Because the economic exposures we use to value these businesses differs significantly from the location of their headquarters.

Sector positioning abroad is similar to that of the U.S., with overweights to technology and industrials, and an underweight to consumer staples.

A company can be based in one region but derive most of its revenues from elsewhere, as shown in the below graph. Case in point: While zero percent of MSCI EAFE Index companies are domiciled in the Americas, nearly 25% of their revenues come from this region. Although European domiciled companies generate a large percentage of their revenues from Europe, the revenue percentage is significantly less than their domicile weight.

MSCI EAFE Index
Geographic Exposure vs. Domicile



Source: Factset, USD, MSCI EAFE (Europe, Australasia, Far East) Index, values are estimated based on Factset's proprietary algorithm as of May 2019.

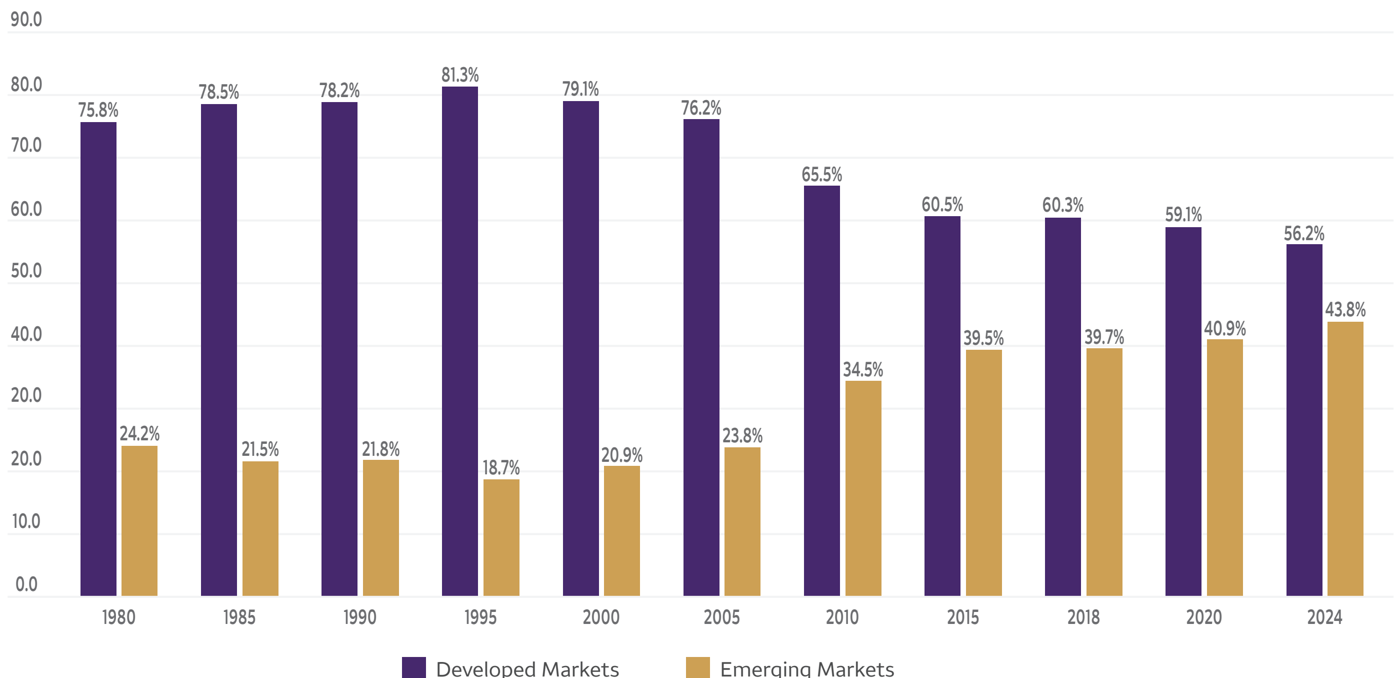
It seems time for more than just a tactical allocation

The emerging markets demographic trends of population growth and a rising middle-class consumer still have a ways to run. These trends should continue driving demand for a broad range of products, services, and conveniences in China that consumers in the developed world have long taken for granted.

As the chart below highlights, emerging markets have continued to grow as a percentage of world gross domestic product (GDP), picking up more than one percentage point per year over the last 15 years. While hiccups might slow this trajectory, we believe that the secular demographic trends of population growth and the rising middle-class consumer are too powerful to upend.

China is likely to be the growth linchpin within emerging markets for the foreseeable future—and 2019 is no exception. Despite recent fiscal stimulus, the country's economy is expected to slow due to the necessary effort to tighten financial regulations, as well as trade tensions with the U.S. Economic contractions in Argentina and Turkey will also contribute to slower emerging markets growth. However, we still expect to see some of the strongest growth across the globe coming from emerging markets.

Consumer staples in China—unlike in some developed markets—provide a growth opportunity due to the rising middle-class and Chinese consumers shifting to healthier foods. That sector represents an overweight, as do financials that may provide stable and attractive dividends. On the other hand, we're underweight to China's more cyclical materials and energy sectors due to the fact we're seeing what we believe to be better opportunities in higher value-added sectors, such as technology.



Source: International Monetary Fund (IMF) as of May 2019

The importance of the earnings growth factor

For our quantitative strategies, we employ both a pure quantitative as well as what we call a "quantamental" approach. Within a pure quantitative discipline, investors can harvest factors such as growth, value, momentum, and size, depending on the portfolio's objective—as a way to help improve the risk/return profile. In a similar fashion, our quantamental approach uses a multi-factor quantitative model paired with a qualitative validation process. We use this two-fold approach to ensure we've identified undervalued companies with improving earnings fundamentals.

Let's look at earnings growth, as an example. While the near-term outlook for earnings growth has softened, we believe the action of identifying companies that produce positive earnings surprises in the environment can and should be rewarded. Uncovering these surprises is a key part of our process.

Currently, we see the most opportunity within the value factor, because of prolonged underperformance. In a slowing economy, two variables coupled together should benefit investors:

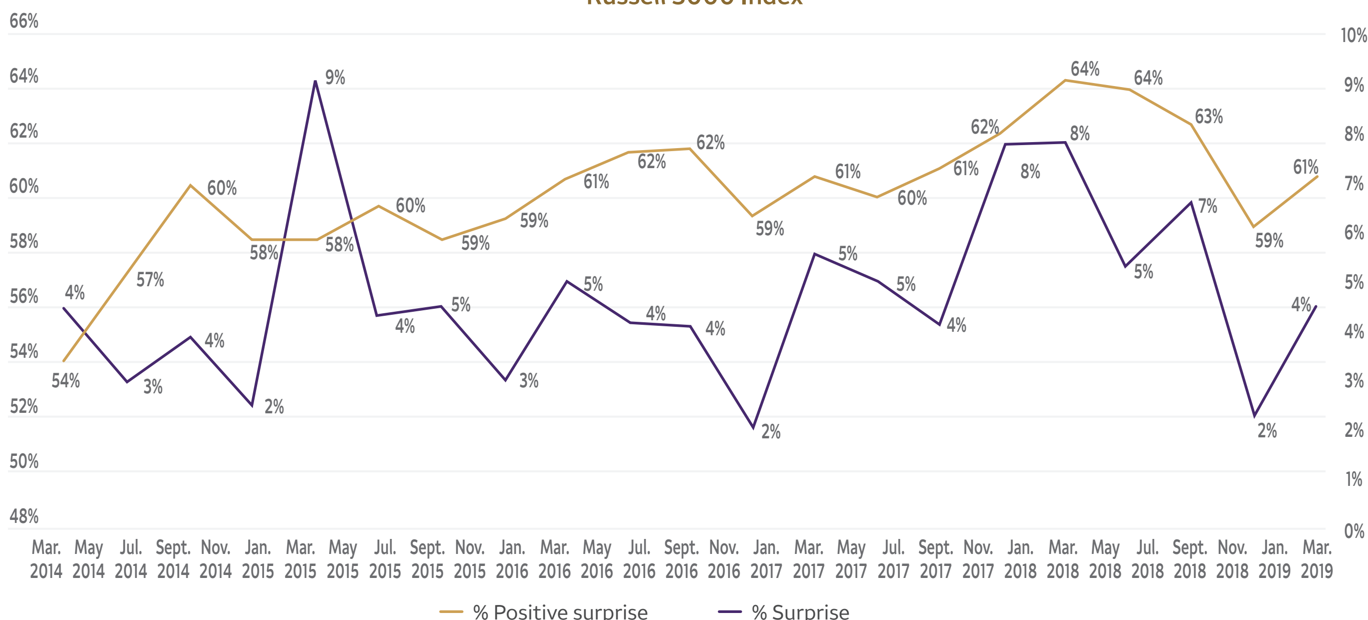
- Positive earnings surprises
- Reversion to the mean, or the idea that asset valuations and prices should return to their long-term averages

In terms of our positioning, we are:

- Overweight to the technology and health care sectors due to consistent earnings growth.
- Underweight to the consumer staples sector given limited earnings growth.

While companies' earnings surprise metrics are down from peak levels, the most recent quarter suggests to us that earnings are remaining healthy relative to analyst expectations. A positive earnings surprise, especially when it's accompanied by improved guidance, has often been an indication of improving fundamentals. This, in turn, has often led to consecutive earnings beats and positive price momentum.

Earnings Surprises
Russell 3000 Index



Source: Factset; as of May 30, 2019, 94% of March 2019 Russell 3000 companies reported

The “real” opportunity in emerging market debt

The slowdown in global growth and muted inflation provide a good backdrop for fixed income investing and yield convergence. Real yields in emerging markets and the U.S. have risen, while in the developed world (ex-US), they have again moved below zero. Under a scenario of weaker global growth, we could expect real yields in emerging markets to decline. We believe there is potential for significant outperformance for emerging markets over the coming months and years.

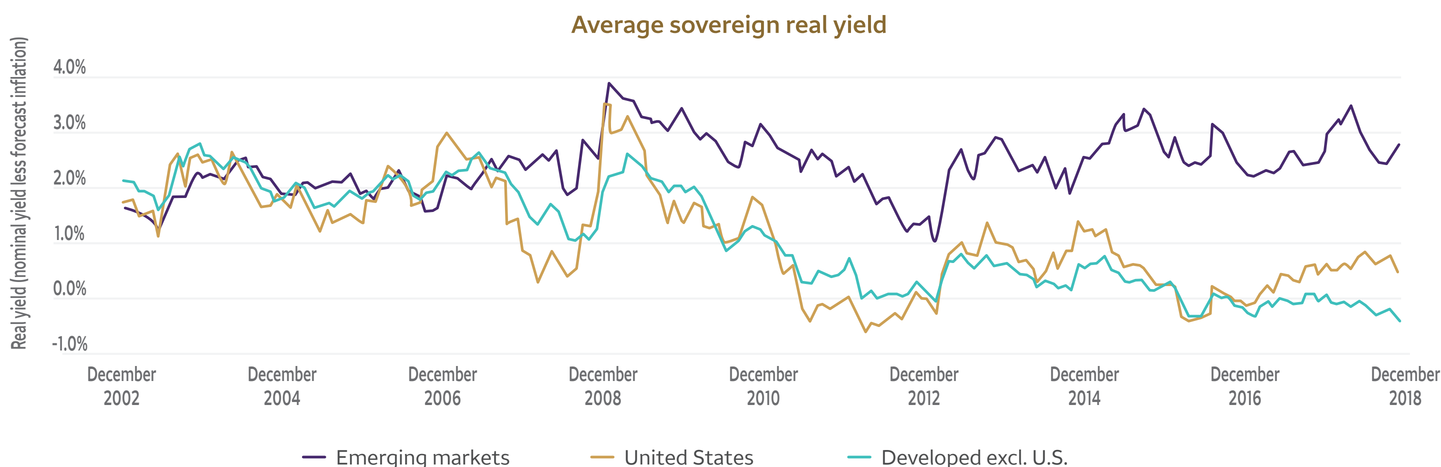
The global economic story remains a narrative about slowing but still positive growth, and muted inflation. That dynamic should provide a good backdrop for bond investment and yield convergence. However, high levels of geopolitical risk are sparking volatility. This raises a key question: Will the current global economic slowdown find a bottom later this year? The answer could affect future central bank policies, as well the U.S. dollar’s path. The length of the slowdown could also determine just how far interest rates could fall and bond prices rise.

Let’s turn our attention to real yields, or yields that are inflation-adjusted.

- Real yields in emerging markets and the U.S. have risen, while those in the developed world (ex-U.S.) have again fallen below zero.
- Emerging market real yields are now at levels comparable to 2007, just before a significant slowdown in global growth.
- If growth continues to weaken—which may have already begun—real yields in emerging markets could decline.
- However, developed market yields are unlikely to fall as hard, because they are already at or near all-time lows.

What might this mean for investors? We see the potential for significant outperformance from emerging market debt over the coming months and years.

Meanwhile, a slew of bond markets remain historically expensive: Japan, the U.K., Austria, Germany, the Netherlands, Finland, the Czech Republic, Denmark, and Switzerland. We are still overweight our preferred developed markets of New Zealand, Australia, and the U.S. We see better value away from the traditional developed markets and favor debt in these regions: Brazil, South Africa, Peru, Mexico, Hungary, Poland, Indonesia, and India.



Source: Consensus. Economics, Bloomberg, 31-May-19. Developed market real yield is a simple average of Germany, Norway, U.K., Switzerland, Australia, New Zealand, Japan, Korea, Singapore and Canada. Emerging markets consist of constituents of the JP Morgan GBI-EM Global Diversified, weighted using index weights. Opinions are subject to change, provided for informational purposes only and should not be relied upon. **Past performance is not indicative of future results.**

Contributors: Andy Hunt | Michael Rodgers | Danny Sarnowski

Fundamentals provide a solid backdrop for investment grade credit

The investment grade credit market in the first half of the year posted one of its best starts since 2012, driven by dovish central banks, strong technical factors, and macroeconomic tailwinds. Even though global growth is slowing, U.S. economic growth and the global labor markets have remained strong. The main sources of volatility are the escalating trade wars and geopolitical risks. Strong fundamentals typically provide a solid backdrop for the investment grade market. We expect long-term rates to stabilize around current levels and that global demand for investment grade bonds should remain strong.

We remain overweight the financial sector as credit metrics continue to improve and event risk remains low. Driven by our goal of generating excess returns, while providing a well-underwritten yield advantage, we're focusing on the following themes:

- Post-event issuances
- Secondary market issues
- Fundamentally improving names
- Attractive opportunities in the new issue market

Even though the BBB-rated bond universe has grown significantly across currencies since 2011, we do not view this growth as an imminent risk. The reason: Companies have big incentives to defend their investment grade ratings, and have begun reducing their leverage earlier in the cycle than usual.

At current valuations, we generally favor an up-in-quality bias as market volatility increases. We believe Structured Products is an attractive sector, offering the potential for an enhanced yield profile, higher quality, and diversification benefits. Security selection and risk management will be paramount to generating solid risk-adjusted returns.

Global investment grade credit markets have experienced one of the strongest starts since 2012, largely because of strong fundamentals. We expect long-term rates to stabilize around current levels and global demand for investment grade credit to remain supportive. We remain overweight the financial sector and generally favor an up-in-quality bias at current valuations. The BBB-rated bond universe has grown significantly since 2011; however, we do not view BBBs as an imminent risk. We believe Structured Products is an attractive sector offering the potential for an enhanced yield profile, higher quality, and diversification benefits.

Credit spreads tightened on central bank pivot and improved macro conditions

Source: Bloomberg Barclays. 100 basis points equal 1.00%.

Contributors: Andy Hunt | Helen Roberts | Michael Rodgers

Resilient in the U.S., attractive in Europe

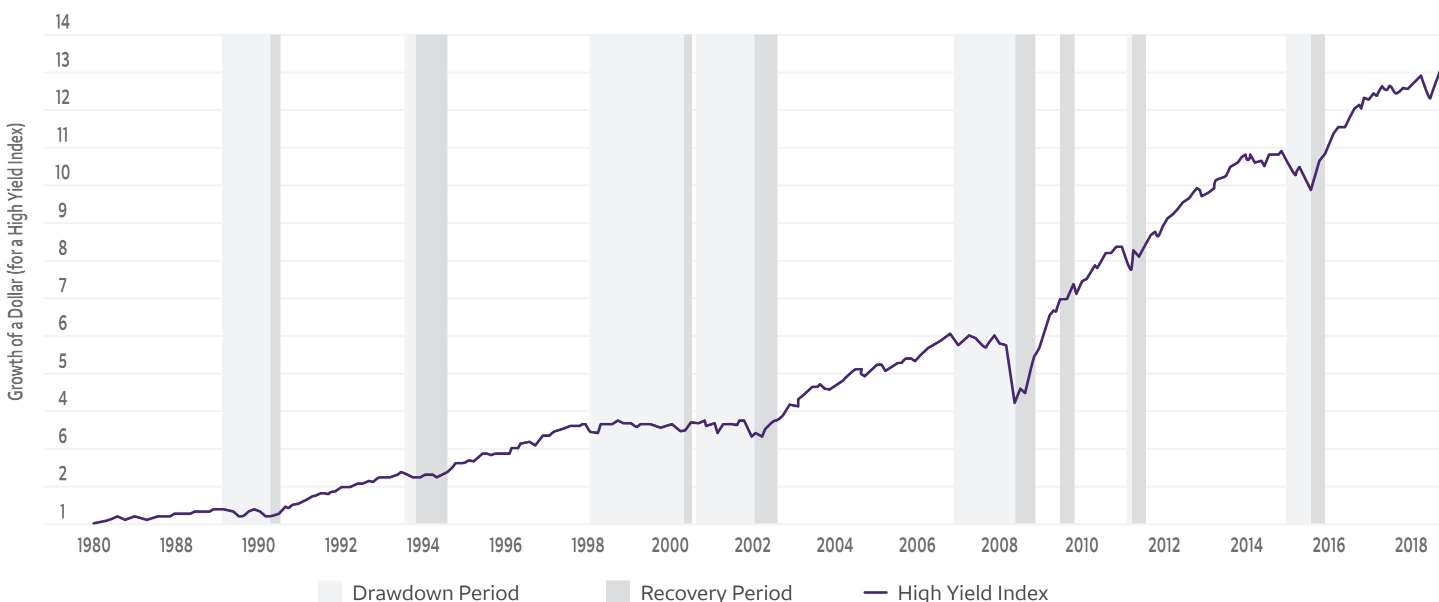
High yield bonds have enjoyed one of their strongest starts to a year on record. We believe U.S. high yield has some characteristics that should justify maintaining exposure during all environments. One key element is the resilience of U.S. high yield bonds, which tend to recover quickly from losses. We're more neutral on European high yield bonds but have a positive view of European loans as default rates remain low.

High yield bonds enjoyed one of their strongest starts to a year on record. While our outlook for future returns is modest, we believe the U.S. high yield market will benefit from the support of a strong U.S. economy, healthy corporate profits, and minimal defaults. We also believe high yield has some characteristics that should justify maintaining some portfolio exposure during all environments. Few asset classes tend to generate an income stream as steady and high as what high-yield offers. And our research suggests that the starting yield is a very strong predictor of an investor's outcome. High yield has also proven to be a resilient asset class, as it tends to recover relatively quickly from losses. Since 1986, we've seen seven periods during which the high-yield market declined by more than 5%; on average, high yield recouped all of those losses within five months.

For European high-yield bonds, we expect the market to continue benefitting from an accommodative monetary policy from the European Central Bank, as well as a supportive economic backdrop. However, we remain neutral on European high yield bonds, expecting modest spread-widening to be offset by the attractive carry on offer.

Our outlook for European loans is positive, because default rates remain low and demand remains supported by issuance of collateralized loan obligations. We are selectively adding to exposures while keeping an eye on two variables: any further deterioration of loan documentation, or any potential increase in deal leverage.

U.S. High Yield bonds have recouped losses quickly



Source: ICE BofAML , U.S. High Yield Master II Index (H0A0), As of April 30, 2019. Based on month-end index levels.

Contributors: Andy Hunt | Helen Roberts | Michael Rodgers | Danny Sarnowski

Strong demand drives municipal values higher

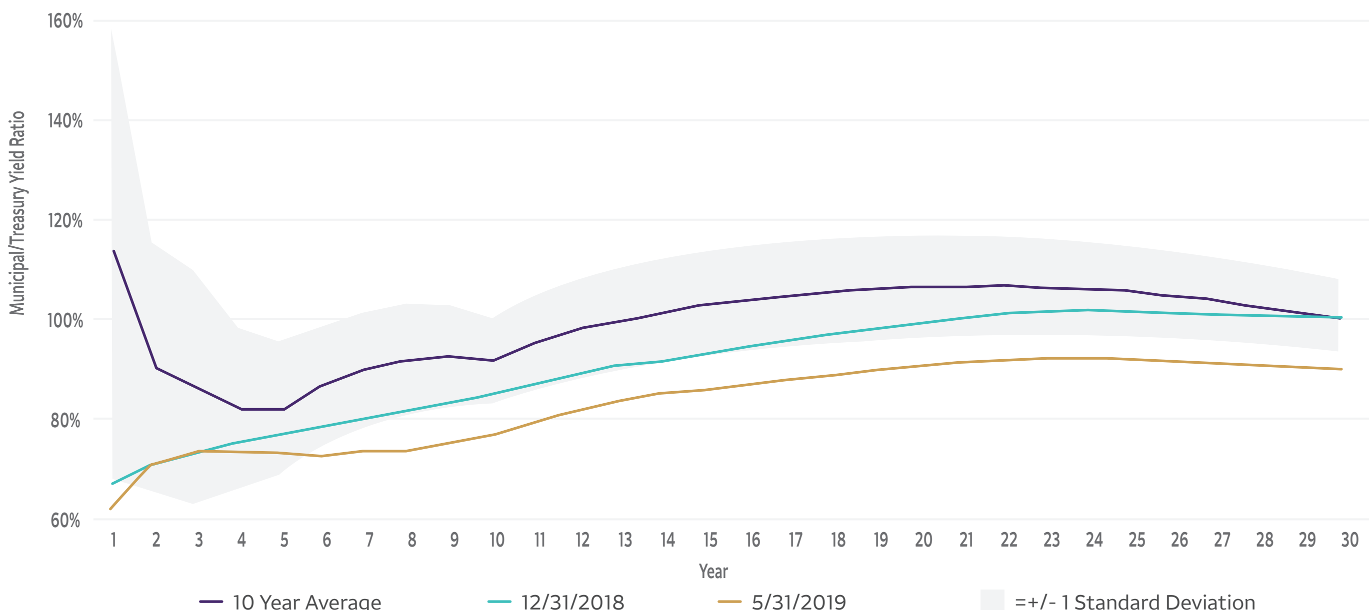
Investors filed their taxes this year for the first time under the new tax legislation passed by Congress in 2017, And based on their actions, it was clear investors filed with greater awareness of the new rules' full impact. Case in point: Limits on state and local tax deductions led to a surge in demand for the tax-exempt income that municipal bonds offer. Inflows into municipal bond mutual funds through April 2019 have already exceeded the full-year total of any year since 2012.

However, a disconnect is happening: Muni bond funds' record inflows have so far been met with a subdued level of new issuance.

This mismatch between demand and supply pushed up muni bond valuations and helped the broad muni bond index return nearly 6% over the past six months, as measured by the Bloomberg Barclays Municipal Bond Index. The relative value of muni bonds to U.S. Treasuries—expressed as the municipal/ Treasury yield ratio—fell dramatically, with the 10-year portion of the relative yield curve at its lowest level since 2001. The current degree of market exuberance implies that valuations may remain strong, although issuance could rise to meet the demand, and bring ratios back in line with historic norms.

The insatiable demand for tax-exempt income pushed up prices across the municipal credit spectrum, with lower-rated bonds outperforming higher-rated securities in the first half of the year. With credit spreads tight, the marginal compensation for taking additional credit risk is lower.

Municipal bond valuations rose strongly in the first half of 2019, producing positive total returns. Municipal/Treasury yield ratios have fallen across the curve since year-end 2018, to the point that portions of the relative yield curve are more than a standard deviation below their 10-year averages.



Source: Wells Fargo Asset Management. MMD. Thomson Reuters. As of May 31, 2019

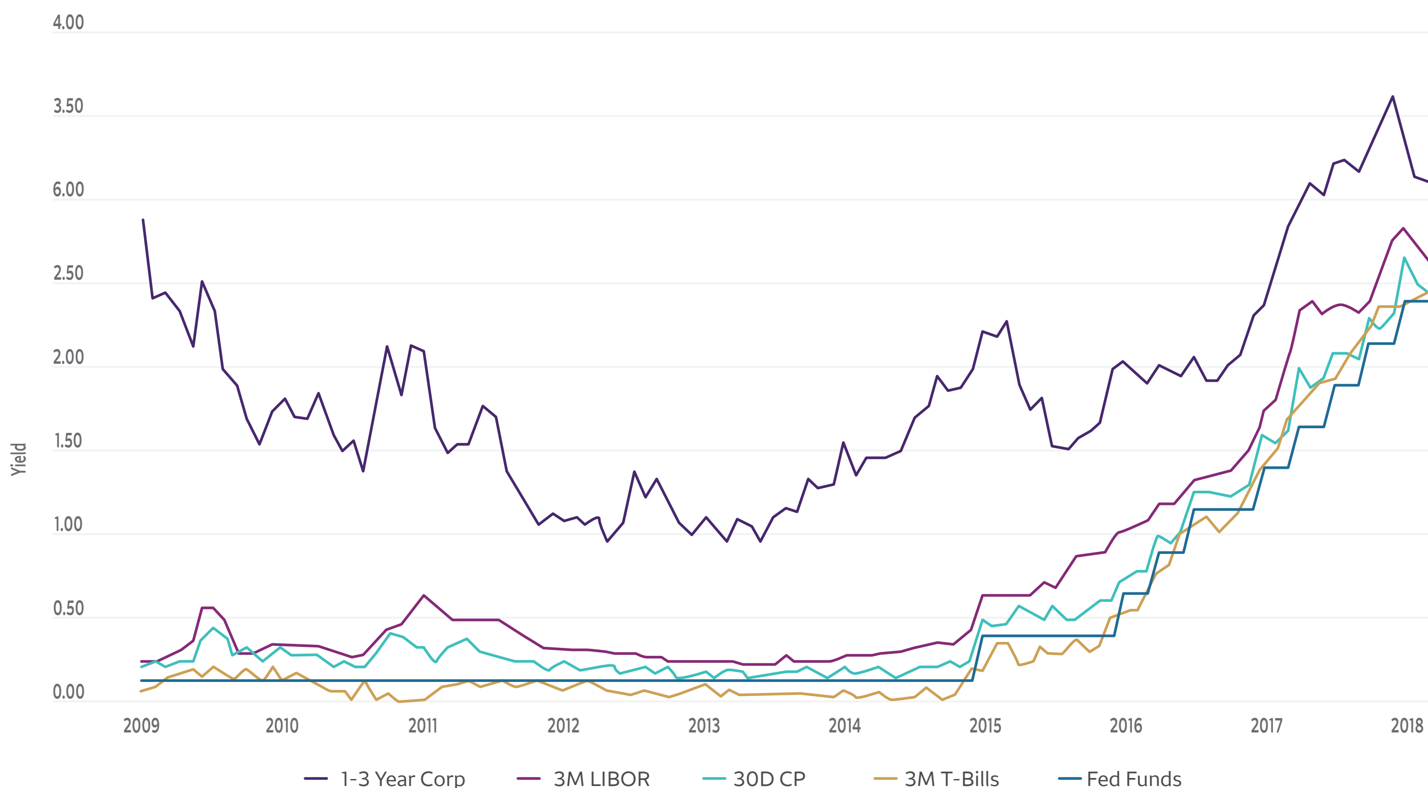
A potential opportunity—a rising tide lifts all boats

Compelling opportunities exist across a variety of short-term fixed income instruments. Money market instruments like commercial paper and Treasury bills have experienced notable yield increases, due to the Fed's pursuit of policy normalization. Investors who have the ability to extend duration on their core cash position will have the potential to capture enhanced returns with what we believe to be limited risk.

We believe short duration fixed income is at its most investable level in nearly a decade. The Federal Reserve (Fed) recently announced that it will now be "patient" regarding further monetary policy, after hiking short-term rates over 2% during the current cycle. In turn, the Fed is giving us the prospect of relatively quiet fixed income markets, by effectively taking the fear of rising rates off the table. Most market observers agree this is an indication the Fed is at (or near) the end of the current tightening cycle, and may begin cutting rates.

The current yield curve provides an opportunity to lock in peak yields over a longer time horizon. Economic and credit fundamentals offer a more supportive backdrop to higher short-term rates than they did over the past several years. Investors who have the ability to extend duration on their core cash position will have the potential to capture enhanced returns with what we believe to be limited risk. Now may be an opportune time to invest in short duration fixed income.

Highest yields in nearly a decade



Source: Bloomberg. 1-3 Year Corp: The Barclays U.S. 1-3 Year Corporate Bond, 3M LIBOR: ICE BofAML 3-Month LIBOR Constant Maturity Index, 30D CP: U.S. Commercial Paper Placed Top 30 Day Discount, 3M T-Bills: Generic United States 3-Month Government Bill, Fed Funds: Federal Funds Target Rate Mid-Point of Range. **Past performance is not indicative of future results.**

Contributors: Andy Hunt | Michael Rodgers | Danny Sarnowski

In search of balance

So far, 2019 has been an unsettling year for many investors. Globally, risky assets rallied with a dovish pivot by central bankers and an apparent thaw in the trade tiff between the U.S. and China. Suddenly, BAM!—volatility from a tweet about trade talks. Times like this require a rethink about risk management.

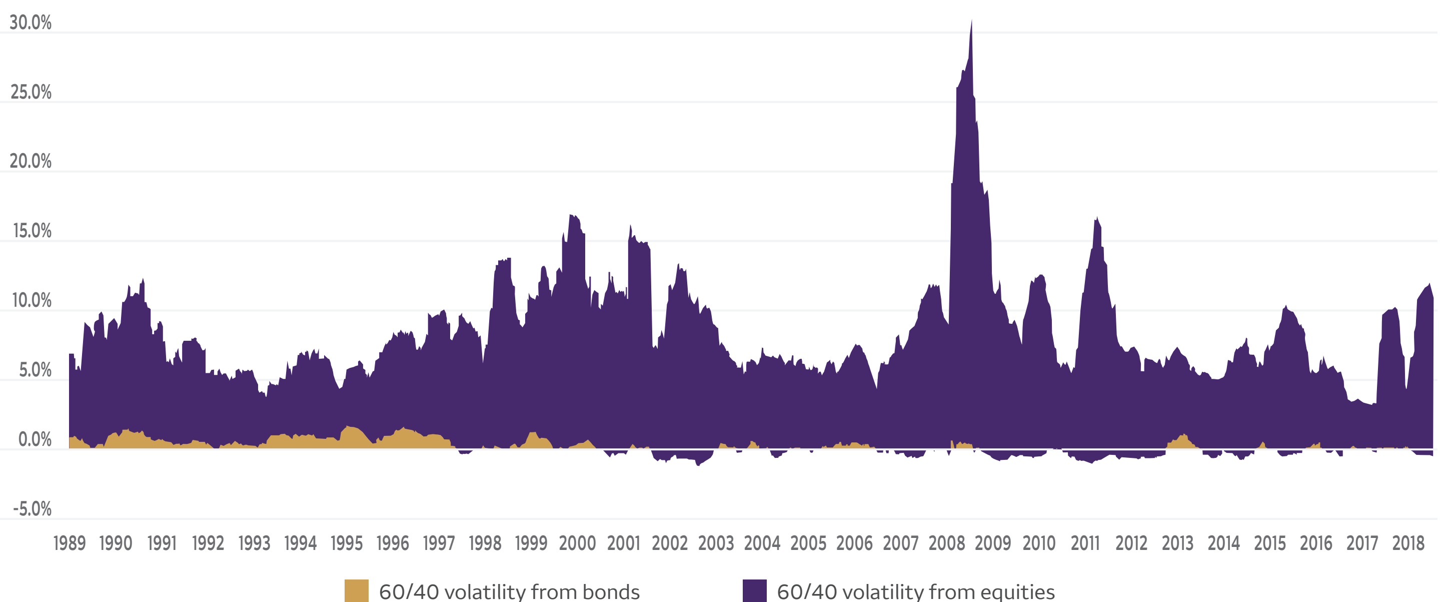
The traditional approach to managing a portfolio involves targeting certain capital allocations, perhaps favoring one asset class over another, depending on the outlook. A focus on capital allocation can still give rise to a rather bumpy ride. And bumpiness can induce bad behavior among investors, if they suddenly lose faith in their strategic allocation, which is designed to get them to their long-term goals.

Rather than focusing on balancing capital allocations, we think focusing on balancing risks may increase the probability of portfolio success. For the Multi-Asset Solutions team, our big act of balancing macroeconomic risks involves the following actions:

- Moderating our allocations to growth-related assets like equities and credit spreads
- Managing duration risks through favoring shorter-term government bonds over longer-term government bonds
- Mitigating the risks of mild inflation by allocating towards more inflation-sensitive assets

Fixed capital allocations can help give rise to variable portfolio volatility. Risk targeting can help give a smoother ride, but requires prudently navigating the risks around growth, rates, and inflation. The biggest big-picture risks are moderating allocations to growth; that interest rates seem inclined to rise, but not significantly; and that inflation has softened, but may make another turn.

Volatility contribution to a 60% equities/40% bonds portfolio



Source: Wells Fargo Asset Management; calculation based on S&P 500 Index for equities and the Bloomberg Barclays U.S. Aggregate Bond Index.

Nico Marais, CFA
CEO of Wells Fargo Asset Management

“*When it comes to serving our clients, we believe culture is essential.* Empathy drives our actions: We visualize our clients’ desired outcomes by placing ourselves in their shoes. When our clients succeed, then we’ll know we’ve done our jobs.*

We believe we are here to help our clients solve their investment problems. Their challenges are ours. To do that, we need to deliver investment results that meet or exceed client expectations in a transparent way. These insights give you a taste of what we’re doing to help increase the probability that our clients will achieve their goals.”

Conclusion

Our capabilities span the gamut from money market investments to emerging markets. Our approaches to investing range from bottom-up security selection to tactical asset allocation. The diverse teams of Wells Fargo Asset Management and their diversity of views give our clients access to a full scope of talents and tools for solving investment problems. Each of our teams uses their distinctive approaches to investing to support their portfolio positioning. But we also draw strength from an exchange of ideas. Calling upon that culture of collaboration, this investment insights paper is meant to give you a glimpse of the issues that are top-of-mind across our teams, asset classes, and regions. To help our clients improve the probability of portfolio success, we’re taking a three-pronged approach:

1. We’re focusing on balancing the *risks that matter.*

Given a moderate growth outlook and the prospects of inflation remaining subdued, we center our attention on dealing with duration risk. Interest rates may stay historically low, but we believe they are likely to rise during the second half of the year.

2. We’re exploiting volatility as an opportunity.

Some of our strategies employ downside risk hedging to help reshape the distribution of portfolio outcomes. We also see a symmetric opportunity with volatility, as it provides us with chances to be opportunistic buyers, as well as opportunistic sellers. This is especially the case across asset classes—high-quality bonds may look categorically rich, while emerging market equities may look categorically cheap.

3. We’re adding some alpha to our portfolios.

A simple, passive, “get your beta on” approach may have performed well during the double-bull-run of equities and bonds. But if the bull is getting winded, a shift from “just beta” to “beta plus alpha” may make sense.

We hope this report gave you a better understanding of our market outlook and where we’ve been finding opportunities. Our goal is to manage our portfolios so that we meet or exceed client expectations for risk, while also striving for results that will help them achieve their goals. If you don’t yet work with us, thank you for your consideration. And if you’re a client of ours, thank you for your trust, which we strive to earn and keep every day.

Contributors

F. Jon Baranko
WFAM Deputy Chief Investment Officer

Jeffrey Doinoff, CFA
WFAM Senior Equity Portfolio Strategist

Peter Donisanu
WFII Investment Strategy Analyst

Craig Holke
WFII Investment Strategy Analyst

Andy Hunt, CFA, FIA
Co-Head of WFAM Global Fixed Income/Head of LDI and Global Credit

Brian Jacobsen, Ph.D., CFA, CFP®
Senior Investment Strategist, WFAM Multi-Asset Solutions

John Krueger, CFA
Head of WFAM Platform Equity & Portfolio Specialists

Ann Miletti
Head of WFAM Fundamental Equity

Dan Morris, AIA
Head of WFAM Multi-Asset Solutions

Helen Roberts
Sr. Portfolio Specialist, WFAM Global Fixed Income

Michael Rodgers
Sr. Portfolio Specialist, WFAM Global Fixed Income

Danny Sarnowski
Portfolio Specialist, WFAM Global Fixed Income

Peter Wilson
WFII Global Fixed Income Strategist

About Wells Fargo Asset Management

At Wells Fargo Asset Management, we put the client at the center of everything we do. Our commitment: Help clients achieve what matters most to them on their path to financial well-being. We do this by channeling the collective wisdom of our specialized investment teams (backed by over 500 investment professionals) into solutions designed to help meet clients' goals.

We place a relentless focus on pursuing consistent and positive risk-adjusted returns, with the support of our independent risk management teams. Together, we strive to help our clients build portfolios aimed at generating successful outcomes and defending them against uncertainty.

We want to help our clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us:

- To reach our **U.S.-based institutional professionals,** contact your existing client relations director, or contact us at **WFAMInstitutional@wellsfargo.com.**
- To reach our **U.S.-based intermediary sales professionals,** contact your dedicated regional director, or call us at **1-888-877-9275.**
- To reach our **U.S.-based retirement professionals,** contact Nathaniel Miles, head of Defined Contribution at Wells Fargo Asset Management, at **nathaniel.s.miles@wellsfargo.com.**
- To discuss **environmental, social, and governance (ESG) investing solutions,** contact Hannah Skeates, global head of ESG at Wells Fargo Asset Management, at **hannah.skeates@wellsfargo.com.**

The views expressed and any forward-looking statements are as of May 28, 2019, and are those of Wells Fargo Asset Management. The information and statistics in this report have been obtained from sources we believe to be reliable but are not guaranteed by us to be accurate or complete. Any and all earnings, projections, and estimates assume certain conditions and industry developments, which are subject to change. The opinions stated are those of the authors and are not intended to be used as investment advice. Discussions of individual securities or the markets generally are not intended as individual recommendations. The views and any forward-looking statements are subject to change at any time in response to changing circumstances in the market and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally, or any mutual fund. Wells Fargo disclaims any obligation to publicly update or revise any views expressed or forward-looking statements.

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.

The **Bloomberg Barclays Global Aggregate Corporate Index** is a flagship measure of global investment grade, fixed-rate corporate debt. This multi-currency benchmark includes bonds from developed and emerging markets issuers within the industrial, utility and financial sectors.

The **Bloomberg Barclays Global Aggregate ex-USD Index (unhedged)** is an unmanaged index that provides a broad-based measure of the global investment-grade fixed-income markets excluding the U.S.-dollar-denominated debt market. You cannot invest directly in an index.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment-grade, U.S.-dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities. You cannot invest directly in an index.

The **Barclays U.S. 1-3 Year Corporate Bond Index** is designed to measure the performance of the short term U.S. corporate bond market. The Index includes publicly issued U.S. dollar denominated corporate issues that have a remaining maturity of greater than or equal to 1 year and less than 3 years, are rated investment grade (must be Baa3/BBB- or higher using the middle rating of Moody's Investor Service, Inc., Standard & Poor's, and Fitch Rating), and have $250 million or more of outstanding face value. You cannot invest directly in an index

The **ICE BofAML 3-Month LIBOR Constant Maturity Index** is based on the assumed purchase of a synthetic instrument having three months to maturity and with a coupon equal to the closing quote for three-month LIBOR. That issue is sold the following day (priced at a yield equal to the current-day closing three-month LIBOR) and is rolled into a new three-month instrument. The index, therefore, will always have a constant maturity equal to exactly three months. You cannot invest directly in an index. Copyright 2019. ICE Data Indices, LLC. All rights reserved.

The **ICE BofAML U.S. High Yield Index** is a market-capitalization-weighted index of domestic and Yankee high-yield bonds. The index tracks the performance of high-yield securities traded in the U.S. bond market. You cannot invest directly in an index. Copyright 2019. ICE Data Indices, LLC. All rights reserved.

The **ICE BofAML U.S. High Yield Master II Index (H0A0)** measures the performance of below investment grade $US-denominated corporate bonds publicly issued in the US market. The index(es) are unmanaged; include net reinvested dividends; do not reflect fees or expenses; and are not available for direct investment.

The **Russell 2000® Index** measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. You cannot invest directly in an index.

The **Russell 3000® Index** measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. You cannot invest directly in an index.

The **Russell Midcap® Index** measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index. You cannot invest directly in an index.

The **S&P 500 Index** consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value. You cannot invest directly in an index.

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

The **Morgan Stanley Capital International (MSCI)** Europe, Australasia, Far East (EAFE) Free Index is a free-float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The MSCI EAFE Free Index consists of the following 21 developed markets country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. You cannot invest directly in an index.

WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

Wells Fargo Asset Management (WFAM) is the trade name for certain investment advisory/management firms owned by Wells Fargo & Company. These firms include but are not limited to Wells Capital Management Incorporated and Wells Fargo Funds Management, LLC. Certain products managed by WFAM entities are distributed by Wells Fargo Funds Distributor, LLC (a broker-dealer and Member FINRA).

INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE

© 2019 Wells Fargo & Company. All rights reserved. FN-402844 IHA-6528408

FAWP027 06-19