

2019 Outlook

THE END OF EASY

December 2018

A letter to investors from Darrell L. Cronk



"I was taught that the way of progress was neither swift nor easy." Marie Curie

During the past decade, many asset price trends have persisted with limited interruption. Unusually, equity and bond prices rose together, U.S. market performance dominated international markets, and only a few equity sectors led prolonged periods of outperformance. These trends made it relatively easy for investors to position portfolios. We see a number of these long-term trends shifting, marking what we call the end of easy:

- The end of extraordinary stimulus: Certainly, monetary stimulus has been fading for some time, but 2019 should bring a peak in fiscal policy stimulus as well. As financial conditions tighten, markets will need to adjust to a period of reduced stimulus.
- The end of cheap capital: As interest rates rise from generational lows, consumers and businesses will have to rationalize how rising costs of capital affect borrowing and spending decisions.
- The end of outsized job gains: Multidecade tight labor conditions put upward pressure on wages, making it difficult for employers to attract and retain needed talent for growth. This, in turn, should slow job growth.
- The end of positively correlated gains between equity and fixed-income markets: As interest rates rise and volatility picks up, stocks and bonds should return to a more normal historical relationship of divergent returns.
- The end of extremely low volatility across equities, rates, and currencies: One of the hallmarks of this cycle has been the extraordinarily low volatility regimes for most major asset classes. We believe that this began to change in 2018, and we expect this trend to continue throughout 2019.
- The end of U.S. equities continually outperforming international equities: Geopolitical turmoil, a strong U.S. dollar and better overall U.S. growth have created sustained outperformance of U.S. assets over international investments. We believe multidecade valuation gaps could create appealing opportunities for investors.
- The end of equity returns driven by only a few sectors: Outsized investor performance has come from only a few equity sectors through much of this cycle. We see the range of opportunities broadening, resulting in appealing valuations across a number of equity sectors.

To be clear, the end of easy doesn't mean the end of the cycle. The expansion is old but not over. What it does mean, however, is that conditions that have proven reliable for many years are shifting. We believe investors need to adjust portfolio positioning accordingly as we outline in this 2019 Outlook.

On behalf of my Wells Fargo Investment Institute colleagues, I am pleased to recommend timely and actionable investment advice. We hope that this guidance will help you reach your investment goals. Last, but not least, we appreciate the trust you extend to us as our clients, and we wish you investment success in 2019.

A handwritten signature in black ink, appearing to read "Darrell L. Cronk".

Darrell L. Cronk, CFA

President, Wells Fargo Investment Institute

Chief Investment Officer, Wealth and Investment Management

Global economy, *page 4*

- We expect U.S. economic growth to remain positive, albeit at a slower pace. We believe that global growth will remain steady, with some country-level variation.
- We expect U.S. dollar strength to wane in 2019, allowing moderate appreciation of the euro, the yen, and many emerging market currencies.

Global equities, *page 7*

- We favor emerging markets and U.S. large- and mid-cap equities.
- U.S. equity market volatility should increase as economic growth slows and interest rates rise.

Global fixed income, *page 10*

- We look for the Federal Reserve (Fed) to end its current rate-hike cycle by the end of 2019. By contrast, the European Central Bank (ECB) is removing stimulus and is likely to raise interest rates in 2019.
- These monetary policy transitions make capital more costly and could elevate bond market volatility, but have potential to create investor opportunity.

Global real assets, *page 12*

- Commodities should be good performers in 2019, after a dismal 2018.
- Real estate investment trusts (REITs) likely will underperform other real assets in 2019.

Global alternative investments, *page 14*

- As we enter a period of greater asset-class dispersion, stock-price volatility, and credit delinquencies, we favor relative value, equity hedge, macro (discretionary), and event driven (distressed) strategies.
- Multiple sectors and regions are facing structural challenges, which should amplify the benefits to security selection in the equity and fixed-income markets.

Five ways investors can position portfolios for the end of easy, *pages 16 and 17*

1. Position for growth in equity markets.
2. Maintain positions in high-quality fixed income.
3. Diversify into international assets.
4. Lower allocations to the most rate-sensitive assets.
5. Deploy cash as volatility creates opportunities.

Selected year-end 2019 forecasts

See page 18 for our complete economic and market forecasts

2.7%

U.S. GDP growth

2.5%

U.S. inflation
Consumer Price Index

2,860-2,960

S&P 500 Index

3.00%-3.25%

Federal funds rate

3.25%-3.75%

10-year U.S. Treasury note yield

\$60-\$70

West Texas Intermediate crude oil per barrel

Source: Wells Fargo Investment Institute (WFII); November 19, 2018.

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



Peter Donisanu

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Global Fixed Income Strategist

A mixed picture for the global economy

For the first time in years, firms are investing more in their businesses, while household borrowing and spending are growing. Tight labor market conditions (see chart on page 5) finally have ended years of wage stagnation, and employers are finding it difficult to hire qualified workers.

Yet, the pace of the U.S. economy may not be so easy to maintain. Tax reform and federal government spending stimulus should pass their peak in 2019, and rising wages eventually should slow job growth. These factors are likely to moderate what households and fiscal policy contribute to growth. We expect U.S. economic growth to slow slightly to 2.7% in 2019. For the world as a whole, we anticipate that country-level differences will offset and leave the global growth pace steady, compared with 2018.

Outside of the U.S., we anticipate somewhat slower growth in Europe as the U.K. prepares for Brexit and Germany's economy enters the latter stages of its expansion. Uncertainties surrounding tariffs are a concern for China, yet we expect supportive fiscal and monetary policy to help underpin the country's economy. On balance, we believe that emerging market economic growth should accelerate, and growth rates in developed economies outside the U.S. should slow toward their long-term trends.

Stable inflation expectations take hold

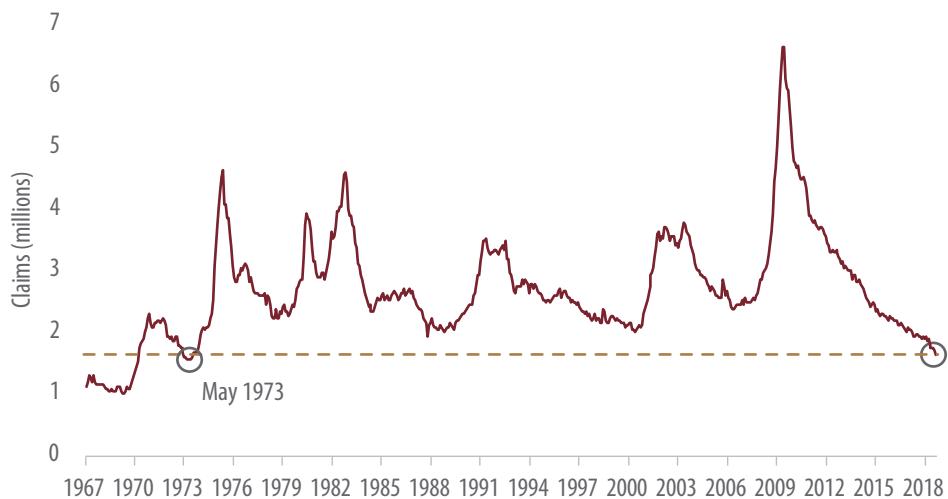
We expect stable U.S. consumer price inflation to support the economy in 2019. For example, average wage growth should still outpace inflation and thereby drive household spending growth. Financial markets expect stable inflation, and we agree. Our 2019 inflation forecast is for 2.5%, little changed from the 2018 pace.

In Europe and Japan, inflation should recover enough to prompt central bankers to remove more monetary policy support. For emerging markets, we expect steady inflation at rates below 15-year averages. Low and steady inflation should leave emerging market policymakers room to cut interest rates to support economic growth.

Aging recoveries can turn bumpy

In recent years, steady job and wage gains, low interest rates, benign inflation and large cash stockpiles have fueled optimism and steady spending. As a result, economic volatility fell to a near record-low in 2018. Yet, these conditions typically do not last late into an economic recovery. Households and businesses eventually begin to hit credit limits and start to use their cash. Economic growth typically varies from quarter to quarter, but confidence and spending could fluctuate even more than usual in 2019, in response to rising interest rates and external factors such as perceived political risks. In turn, greater volatility in economic activity also raises the possibility—even the likelihood—of greater financial market volatility, which is part of what we mean by the end of easy.

Tight U.S. labor market shows lowest unemployment claims since May 1973



Sources: Wells Fargo Investment Institute and Bloomberg, October 31, 2018. Monthly data from January 31, 1967, to October 31, 2018.

Note: The dashed horizontal line shows the October 2018 level of 1.63 million unemployment claims.

Investor watch

- We believe U.S. economic growth will moderate and that inflation will remain stable. In our view, the likelihood of recession rises beyond 2019.
- We expect global growth to continue with emerging market activity outpacing that of developed markets. We also expect inflation to remain contained around the globe.
- Greater swings in economic activity, coupled with the risks related to Fed or trade policy missteps, raise the likelihood of higher financial market volatility.

Investor watch

- We expect the euro and the yen to appreciate as the end of the Fed's rate-hike cycle comes into view.
- Emerging market currencies now look undervalued and could recover as inflows resume into emerging markets.

A look at currencies—the end of the dollar as king

We expect U.S. dollar strength to wane in 2019, allowing moderate appreciation of the euro and yen as well as recovery for many emerging market currencies. Our macroeconomic projections indicate that U.S. economic outperformance will not be as prominent in 2019 as it was in 2018. More important, we believe that the monetary policy and interest rate divergence that supported the dollar will turn to convergence, resulting in waning dollar strength. Fed rate increases may end by late 2019, while developed market central banks, such as the ECB and the Bank of Japan (BOJ), begin to remove their extraordinary stimulus measures of recent years. The chart below suggests that the dollar may be set to depreciate below its average of recent years (February 16, 2011 through November 19, 2018). However, should U.S. economic outperformance expand, or if the Fed should signal rising interest rates beyond 2019, then the dollar's strength might persist for longer than we anticipate.

Despite risks from trade conflicts and political transitions in certain countries, we believe that an environment of continued global growth will support emerging market currencies. In our opinion, external vulnerabilities and policy missteps as seen in Turkey and Argentina are the exception rather than the rule, and we do not think that the currency volatility of 2018 will continue. Rather, as the dollar peaks against developed market currencies, we believe that many emerging currencies will be seen as undervalued relative to their long-term fundamentals, leading to renewed inflows that should allow them to stabilize and recover against the dollar.

U.S. dollar exchange rates may be set to depreciate again

The chart below shows a composite index of U.S. dollar exchange rates against other G7 currencies, along with subperiod averages over select periods.



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data from December 2, 2011 to November 19, 2018. *For illustrative purposes only.* The dollar index is a trade-weighted basket of dollar exchange rates against the euro, Japanese yen, British pound, Canadian dollar, Swedish krona, and Swiss franc. Higher values denote dollar appreciation, lower values reflect depreciation. The two horizontal lines show the averages over two periods, December 2, 2011 to August 15, 2014, and February 16, 2015 to November 19, 2018.

Increasing volatility, but ultimately a positive year

We expect greater volatility, but record-high 2019 earnings should create a favorable environment

The end of easy means, in part, that more historically normal volatility has returned to financial markets that experienced very limited disruptions during 2016 and 2017. That trend is changing as rising interest rates make credit more expensive and the sudden shifts in the geopolitical environment spark surprises. Economic volatility, mentioned above, typically also fuels wider equity market price swings.

However, we believe that investors should not fear the changing trend, so long as low inflation and solid earnings-per-share (EPS) growth continue. To this point, even if EPS rises more slowly late in a cycle, it can still reach higher levels that, in turn, drive higher equity prices. As shown in the chart below, the S&P 500 Index typically rises in proportion to its EPS growth.



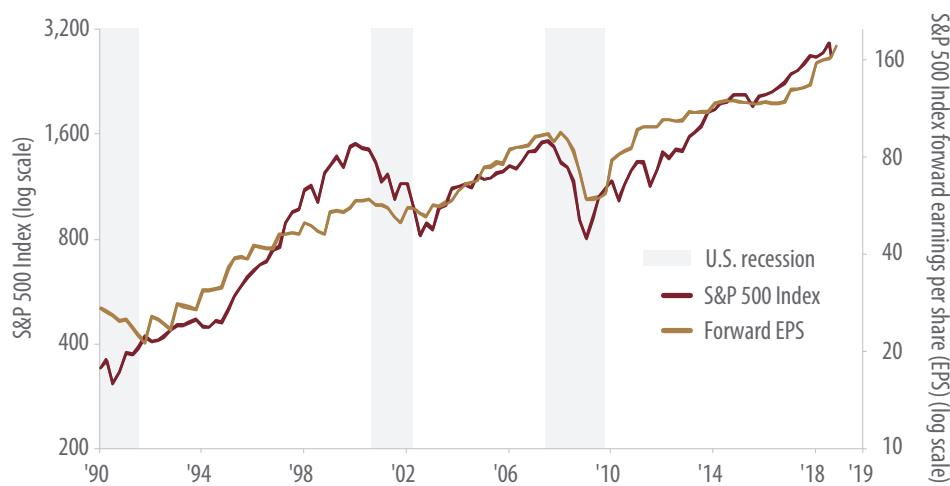
Audrey Kaplan
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Record-high expected EPS through 2019 should support current market valuation

Our S&P 500 Index and 12-month-ahead EPS forecast through year-end 2019



Sources: FactSet and Wells Fargo Investment Institute (WFI), as of October 31, 2018. Quarterly historical data; forward EPS shows estimates of EPS over the coming 12 months. The point for December 2018 indicates the EPS expected for year-end 2019. Logarithmic scaling is used so that two equal percent changes have the same vertical distance on each scale.

Earning per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock and often serves as an indicator of a company's profitability. The S&P 500 Index is an unmanaged index generally considered representative of the U.S. stock market.



Ken Johnson, CFA
Investment Strategy Analyst

Top asset classes for 2019

- U.S. Large Cap
- U.S. Mid Cap
- Emerging Markets

Top equity sectors for 2019

- Consumer Discretionary
- Financials
- Health Care
- Industrials
- Information Technology

Favored international region

- Developed Market Pacific

The main risks to our outlook include escalating geopolitical risks, unexpectedly higher inflation, and overly restrictive monetary policy. Markets also may fear that dollar-denominated loans could become too expensive for emerging economies. These risks seem less likely or more distant than our base case but are worth watching.

U.S. EPS and equity prices both have room to rise

The end of easy for businesses means that wages, materials, and the cost of capital have risen, while peak tax-reform stimulus is likely to pass in 2019. Household and business spending should keep profit margins at sustainable levels. EPS for the large-cap benchmark index, the S&P 500 Index, should have additional support from repatriated overseas profits. Some of this cash is likely to be used in share buybacks to reduce outstanding share counts, which increases EPS. Russell Midcap® Index EPS may not grow quite as fast because these companies do not participate in equity buybacks (share repurchases) nearly as much as large caps do.

Various cross currents should create steady valuations for large- and mid-cap valuations from 2018 to 2019. We expect a U.S.-China trade deal to support valuations, but higher interest rates and slower EPS growth should restrain the upturn in sentiment. We expect these positive and negative factors to roughly balance and leave valuations little changed in 2019. Overall, we expect low double-digit price returns for large-cap equities and high single-digit returns for mid caps.

We favor several large-cap sectors. Valuation is a main reason that we find the Health Care, Financials, and Information Technology sectors attractive. We also favor the Consumer Discretionary and Industrials sectors, which should benefit from the solid pace of consumer spending, an improved rate of business spending, and steady economic growth overseas.

Small-cap equities look neutral

For small caps, tax reform fueled record 2018 small-cap, four-quarter EPS growth to an unusually strong pace above 50%. Small companies tend to have higher tax rates and lower margins than larger companies. Therefore, tax reform disproportionately has benefited smaller companies. The tax benefit should support small-cap EPS growth again in 2019, though probably at a slower 23.9% pace as the tax boost fades at midyear.

Declining valuations are likely to neutralize some of the expected earnings gain. Investors are likely to decline to pay up as the tax benefit diminishes. Also, small-cap companies have more debt relative to large-cap companies and are therefore comparatively more sensitive to rising borrowing costs. Finally, we believe small-cap companies are expensive relative to earnings growth expectations and potential expansion prospects. The combination of growing EPS but declining valuations should produce mid single-digit returns. We expect higher returns in other equities, which motivates our neutral guidance on small-cap equities.

International opportunities could play a larger role in 2019

We believe improving fundamentals into 2019 suggest an opportunity in emerging markets. Key supports include double-digit expected EPS growth and an expectation of moderating U.S. dollar appreciation. We expect an eventual U.S./China trade deal, and believe policymakers in emerging economies will continue to use fiscal stimulus to counter trade fears and support credit growth. On balance, we expect 10.6% EPS growth in 2019. Along with this favorable earnings backdrop, the MSCI Emerging Markets Index valuation discount to the S&P 500 Index is the widest we have seen since 2003. We are most favorable on emerging market equities, because our assumptions about earnings and valuation imply a near 15% increase in the MSCI Emerging Markets Price Index.¹

The developed markets outside the U.S. should remain challenged by slow economic growth and political uncertainties. One positive is that Japanese companies should continue to benefit from their U.S. subsidiaries' access to U.S. tax cuts. Europe may struggle for longer, however. Many companies are operating at peak capacity and are reluctant to expand their businesses, as the continent will continue to wrestle with stimulating growth in 2019. We expect that the slow international economic expansion will continue but will limit earnings growth to mid single digits. We anticipate mid single-digit returns on developed market equities outside the U.S., and we are neutral because we see better opportunities in the U.S. and emerging markets.

That said, we'll continue to examine developed international markets as a potential opportunity. There are wide valuation differences between developed international and other global markets that could create new opportunities if growth increases again. Valuations are also cheap on a historical basis in these developed international markets. However, the growth rates of earnings indicate that the time to buy has not yet arrived.

¹A price index is not a total return index and does not include the reinvestment of dividends. Index returns do not represent investment returns or the results of actual trading. An index is unmanaged and not available for direct investment. There are special risks associated with investing in foreign markets, especially emerging markets. Please see Risk Considerations at the end of this report for a description of these risks.

Investor watch

- *We believe the equity markets have room to rise in 2019 due mostly to record-high EPS expected in the coming year.*
- *We are most favorable on the Financials and Industrials sectors. We also find attractive opportunities in Consumer Discretionary, Information Technology, and Health Care.*
- *International equities, and especially emerging market equities, look most attractive based on growth and valuation. They also should benefit from marginal U.S. dollar weakness, rising corporate capital expenditures, and growing global industrial production.*

Monetary policy endings and beginnings

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When monitoring yield-curve inversion, we recommend that investors focus on the 10-year minus the 1-year Treasury yield. If this indicator turns negative for at least four weeks or inverts by more than 25 basis points (100 basis points equal 1.00%), we would see that as the bond market sending a cautionary signal.

Central banks transition away from cheap capital

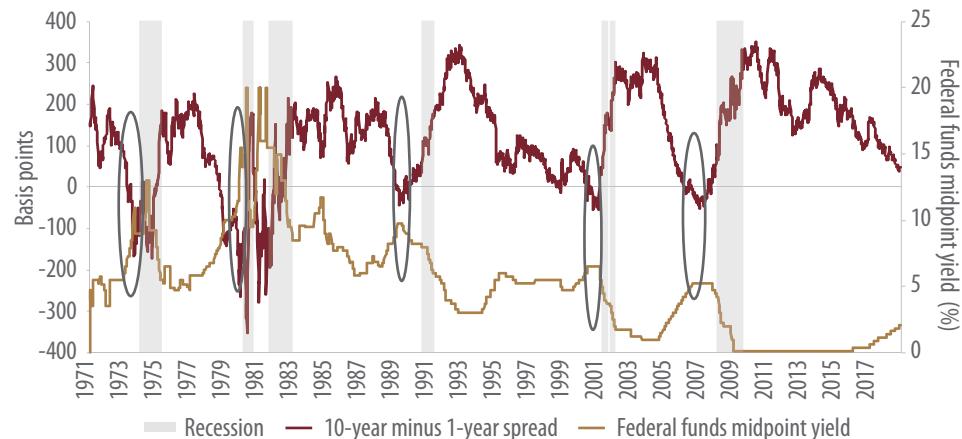
We expect the next year to be one of transition for global central banks. The Fed has hiked rates eight times since it began raising rates in 2015. We look for the Fed to end its current rate-hike cycle by the end of 2019. By contrast, the ECB is just beginning to remove its economic stimulus. For most of 2018, the U.S. bond market exhibited extremely low volatility. However, the risks of monetary transitions—which include potential policy missteps or poor central bank communication and associated market uncertainty—create the potential for elevated bond market volatility and investor opportunity. These monetary policy endings and beginnings highlight our 2019 bond market outlook.

We see three Fed rate hikes in 2019

We expect the Fed to hike rates three times in 2019, bringing the federal funds rate to a range of 3.00% to 3.25%. We also see the Fed slowing or ending its balance sheet reduction in 2019 or early 2020. A key concern is that the Fed might become too aggressive raising interest rates. A Fed policy misstep—even if it occurs in slow motion—is an increasing risk, in our opinion.

As the Fed increases short-term rates, we look for longer-term rates to drift higher. We expect the 10-year Treasury yield to end the year between 3.25% and 3.75%. Likewise, we see the 30-year Treasury ending the year within the same 3.25% to 3.75% range.

Yield-curve inversions and the conclusion of rate-hike cycles tend to occur in advance of recessions



Sources: Bloomberg and Wells Fargo Investment Institute. Weekly data from January 8, 1971 to November 16, 2018. *For illustrative purposes only.* An inverted yield curve occurs when the yields on bonds with shorter durations are higher than the yields on bonds with longer durations. The difference between the 10-year and 1-year Treasury yield measures the spread between short- and long-term interest rates. Please see Notes at the end of this report for other information on the chart data.

A flattening U.S. yield curve

The U.S. yield curve has been flattening (the difference between short-term and long-term bond yields is decreasing) for more than seven years, but investors only recently started to worry about the message it was sending. In our opinion, investors should not become overly concerned because a flat yield-curve environment can support risk assets. For now, the yield curve remains positively sloped, and our interest rate outlook suggests that a positive, albeit flattening, curve will continue throughout 2019. Yield-curve inversion—a typical late-cycle phenomenon in which short-term rates move higher than long-term rates—is an important but not definitive signal that suggests a recession may be near. Yield-curve inversion is an increasing risk but one that we do not expect to soon materialize.

Global monetary policy

Elsewhere around the globe, monetary tightening is just getting started. Global rates have trended well behind U.S. rate moves and remain at extraordinarily low levels. In 2019, we expect the ECB to end new bond purchases, and to start raising rates slowly and gradually in the latter part of the year. Meanwhile, we look for the BOJ to allow greater latitude in its 10-year yield target—which is now effectively zero +/- 10 basis points.

These new beginnings may be complicated by a change in leadership at the ECB; President Mario Draghi's term expires in October 2019. Uncertainty over ECB leadership just as the long process of rate normalization begins could result in increased bond market volatility.

Risk grows for high-yield debt

It is difficult to find any valuation metric that would classify high-yield debt as inexpensive; quite the contrary, most valuation measures show that high-yield debt is quite expensive. With credit spreads at historically tight levels, the opportunity for meaningful upside performance remains low. We remind investors that significant and unexpected credit events can occur with little warning. We continue to recommend that investors consider moving up in credit quality given the asymmetric risk/return profile currently inherent in lower-rated credits.

We believe municipal credits should experience continued relative strength throughout 2019, as constrained supply and increased investor demand in higher-tax states should lead to tighter yield ratios versus taxable counterparts. Additionally, stronger economic growth has provided municipalities with greater financial flexibility to address longer-term issues, such as those associated with pension benefits.

Investor watch

- *We look for the Fed to end its rate-hike cycle in 2019, but there is a risk that the Fed might take it too far.*
- *Investors, in our opinion, should position fixed-income portfolios defensively: taking credit quality higher and staying below benchmarks for duration and maturity.*
- *We also favor the emerging market asset class (dollar-denominated sovereign debt) for attractive income opportunities. We expect annualized returns to remain around the 5% to 6% range.*

Top asset classes for 2019

- U.S. Short Term Taxable Fixed Income
- Emerging Market Debt

Top sectors for 2019

- Preferred Securities
- Municipal bond sector
 - Taxable Municipal Essential Service Revenue Prerefunded*

Global real assets 2019—not like 2018



John LaForge
Head of Real Asset Strategy



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A new year, a new look

For 2019, we're expecting a shake-up in real asset performance compared with 2018. Commodities should be good performers after a volatile 2018. REITs could underperform other real assets in 2019, which would be a big change compared with the past few years. Master limited partnerships (MLPs) have the potential to be solid performers in 2019 after a string of down years. The chart on page 13 highlights individual 2017-18 returns by commodities (gold line), REITs (gray line), and MLPs (red line) versus the real asset group overall.

We believe that commodities are likely to rebound

Commodities underperformed other real assets for most of 2018 (declining gold line on the chart). We viewed this level of underperformance as unwarranted given our outlook on the dollar, trade disputes, and global economic growth (including the impact of fresh Chinese economic growth incentives). We therefore took the opportunity to upgrade the asset class to favorable in September 2018. For 2019, we anticipate that commodity prices will continue to rebound. Metals were hit the hardest in 2018 and are likely candidates for a strong bounce in 2019, especially precious metals.

Top asset class for 2019

- Commodities

Crude oil too low to start 2019

For the first time in years, we are entering a new year bullish on crude oil. We believe that \$50-\$60 per barrel reflects the underlying supply-demand fundamentals for U.S. West Texas Intermediate (WTI)² crude oil. We add a \$10 per barrel expected premium for geopolitical concerns and for potential oil production cuts by the Organization of the Petroleum Exporting Countries (OPEC). Our 2019 WTI target range is thus \$60-\$70 per barrel (\$65-\$75 for Brent crude oil).

Gold has modest upside potential

Our year-end target range for gold is \$1,250 to \$1,350 per troy ounce, which means that we're expecting modest upside. Global gold production growth has declined somewhat in recent years, which could provide the trigger for an upside move. Gold also could benefit from a falling U.S. dollar and rising commodity prices, both of which are our expectations in 2019. To be clear, though, we do not expect a gold rally to extend beyond \$1,350, as gold remains stuck inside of a long-term trading range, in our view.

²WTI is a grade of crude oil used as a benchmark in oil pricing.

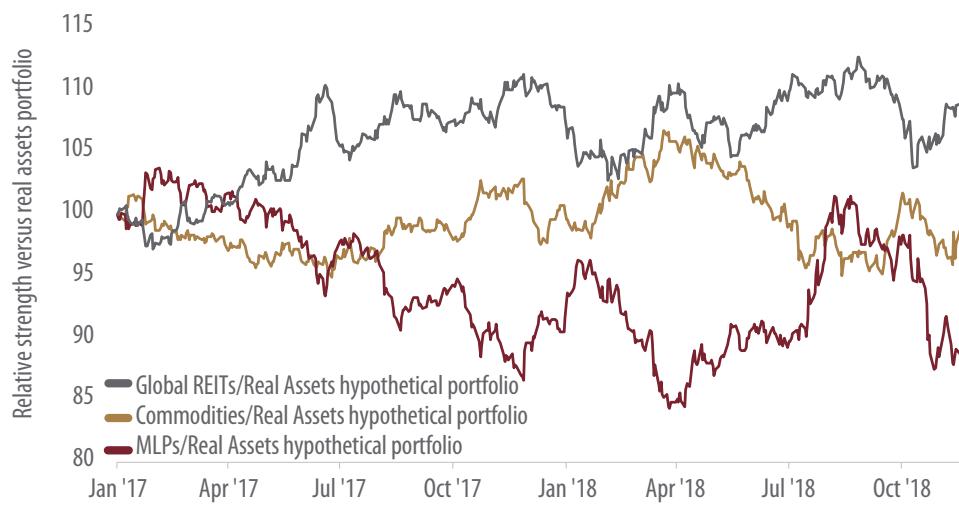
REITs face headwinds

REITs (the gray line in the chart below) have outperformed over the past few years but are facing two strong headwinds—an aging economic cycle and rising long-term interest rates—which have historically slowed their performance. Some REIT fundamentals are beginning to show the signs of a maturing economic cycle, such as slowing net operating income growth, peaking occupancy rates, declining demand for commercial real estate loans, and increasing sensitivity of REIT prices to higher interest rates. Our target for global REITs (as measured by the FTSE EPRA/NAREIT Developed Index) calls for mid-single-digit gains. With that being said, we suspect that REITs may underperform other real assets and equities in 2019.

MLPs have the potential to outperform other real assets

MLPs showed some good relative price action in the back half of 2018. With oil prices poised to bounce in 2019, we suspect that investors will favor MLPs. Additionally, fundamentals are improving, and prices looks cheap relative to comparable assets. We favor midstream MLPs that are large, broadly diversified, and well capitalized.

Commodities and MLPs have the potential to rebound after a volatile 2018, but REITs face headwinds



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data, January 1, 2017 to November 19, 2018.

For illustrative purposes only. Performance results for the Real Assets portfolio are hypothetical. Index returns do not represent investment returns or the results of actual trading nor are they forecasts of expected gains or losses a fund might experience. Index returns reflect general market results, assume the reinvestment of dividends and other distributions and do not reflect deduction for fees, expenses or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. **Hypothetical and past performance do not guarantee future results.** Please see Notes at the end of this report for the definitions of the indices and Real Assets hypothetical portfolio, and descriptions of the asset-class risks.

Investor watch

- *Commodities should be good performers in 2019 after a volatile 2018. Gold, we suspect, will rally along with most other commodities. For crude oil, we believe that year-end 2019 target ranges of \$60 to \$70 for WTI, and \$65 to \$75 for Brent, better reflect the global supply/demand balance and political factors.*
- *REITs probably will be the worst-performing real asset in 2019, which would be a reversal from the past few years.*
- *MLPs, after a string of down years, have the potential to deliver solid performance in 2019.*

Does a lost decade turn into a golden age?



Adam Taback

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Alternative investments are not suitable for all investors and only open to "accredited investors" or "qualified investors" within the meaning of the U.S. securities laws. They are speculative, highly illiquid, and designed for long-term investment and not as trading vehicles.

The benefits of divergent returns

Modestly higher interest rates and somewhat slower U.S. economic and corporate earnings growth should magnify the differences between fundamentally strong and weak companies. As the rising tide of a historically long bull market no longer *lifts all boats*, we anticipate that the benefits of alternative investments will be more prominent.

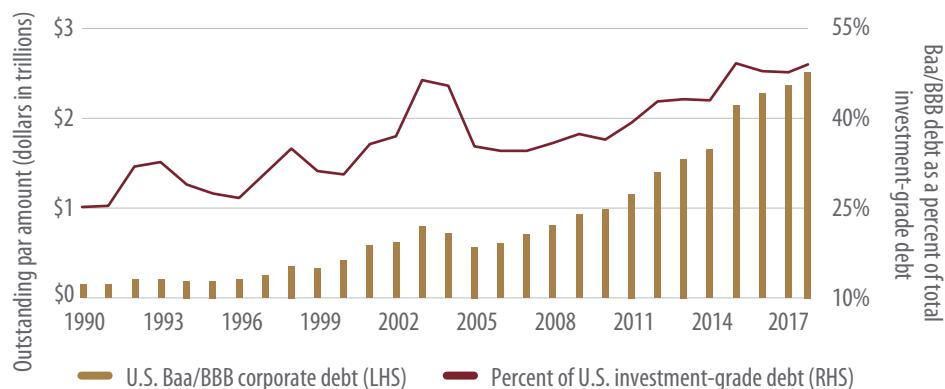
Relative value strategies that focus on long/short credit are among the 2019 opportunities we expect. We also favor event-driven and private debt strategies that focus on stressed and distressed debt, as well as on special situations. Equity security selection also will become increasingly important, and we favor the equity hedge strategy. However, this strategy could face challenges if equity correlations spike, as they did in February and October 2018. Finally, higher interest rate volatility should benefit discretionary macro portfolios.

The corporate credit sector offers opportunities

As seen in the chart below, at the end of September 2018, more than 49% of the Bloomberg Barclays U.S. Aggregate Bond Index was rated Baa/BBB. The notably large proportion of these bonds (at the bottom rung of the investment-grade quality ladder) implies a potential for large-scale downgrades if fundamentals deteriorate. Capitalizing on these potential fallen

We see the potential for large-scale corporate bond downgrades

There is a growing percentage of bonds at the bottom rung of the investment-grade quality ladder, which could be worrisome if fundamentals deteriorate.



Sources: Bloomberg and Wells Fargo Institute. Yearly data from December 31, 1990 through September 28, 2018.

For illustrative purposes only. Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. An index is unmanaged and not available for direct investment. Ratings assess default and credit risk and are not a forecast or guarantee of investment results. Please see Notes at the end of this report for other important information on credit ratings.

angels—companies that experience ratings downgrades that move their debt from investment grade to high yield—is but one of several reasons we are increasingly optimistic about long/short credit and event driven strategies.

We expect a modest decline in corporate deal volume. Waning confidence among chief executive officers could pose a slight headwind to merger arbitrage and activist strategies. However, we see lower deal volume having less of an impact on strategies focused on distressed debt. Default rates are near historical lows so far, but opportunities are developing for smaller distressed debt managers, especially those with a global focus.

Private debt could benefit from the maturing economic cycle

We continue to favor private debt strategies, which are expected to deliver cash yields and total returns at a premium to those available in the public or broadly syndicated debt markets. Publicly traded high-yield credit could suffer bouts of illiquidity as the economic cycle matures, but private debt strategies typically can withstand periods of illiquidity and actually capitalize upon them. In our opinion, tighter lending conditions and deteriorating sentiment from corporate credit investors create opportunities to originate direct loans to smaller companies that have historically faced challenges securing loans from commercial banks. We also see particular opportunity in distressed and special situation strategies that invest in companies in complex situations; examples include financing acquisitions or balance sheet restructuring, particularly in Europe or in niche areas such as energy and other capital-intensive industries.

We are neutral on private equity and unfavorable on private real estate

Current valuations are key to our neutral view on private equity and unfavorable view on private real estate. Private equity purchase multiples are at or above historical levels, and large manager cash holdings could raise multiples in 2019. For private real estate, a lesson of the long U.S. expansion is that real estate supply and demand conditions eventually deteriorate, often as interest rates rise, and negatively affect U.S. property capitalization (cap) rates and property values. More attractive investing opportunities might be found in Europe and Asia than in the U.S.

Main risks to our outlook

The main risks to our outlook include unexpected accelerations in economic growth or inflation, and events that raise correlations or collapse return dispersion.

Investor watch

- *The lengthening economic cycle should increase stock price volatility and dispersion, along with credit payment delinquencies. We favor the equity hedge, relative value, macro (discretionary), and event driven (distressed) strategies.*
- *Private debt strategies could benefit from tighter credit conditions and fading credit investor sentiment. We are neutral on private equity but view higher interest rates as negative for private real estate.*

Top hedge fund strategies for 2019

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

Top private capital strategies for 2019

- Private Debt—Distressed

Alternative investments are not suitable for all investors and are only open to "accredited investors" or "qualified investors" within the meaning of the U.S. securities laws. They are speculative, highly illiquid, and designed for long-term investment and not as trading vehicles.



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1 Position for growth in equity markets

We continue to prefer equities over other asset groups and anticipate broader opportunities globally and among the U.S. equity sectors. In global markets, emerging market equities could become the best-performing asset class. In U.S. equity markets, we rank opportunities in U.S. large- and mid-cap equities above those for small-cap equities. Among the U.S. equity sectors, leadership has been narrow, but we anticipate wider leadership in 2019. Ongoing economic growth and attractive valuations should provide investors with a larger set of opportunities.

2 Maintain positions in high-quality fixed income

Equity and fixed-income returns have tended to move together through most of the cycle but are now starting to diverge. Consequently, holding an adequate percentage in high-quality fixed income can act as a portfolio stabilizer when equity markets decline. Also, fixed-income securities typically still pay income even if their prices decline.

Nevertheless, as the economic expansion matures, we believe it is important to be more selective about fixed-income holdings. We suggest reducing exposure to those securities that are most sensitive to interest rate increases, including long-duration fixed-income securities and developed market debt. High-yield bonds are also unattractive at current prices. We continue to favor shorter-maturity positions in both taxable and municipal markets while rates are rising; we may suggest that investors lengthen maturities during the second half of 2019 if rates move near the midpoint of our target ranges. We also favor emerging market debt and preferred securities for their relatively attractive income potential. Among municipal bonds, we favor stronger essential service revenue bonds, but high-yield bonds appear less attractive.

3 Diversify into international assets³

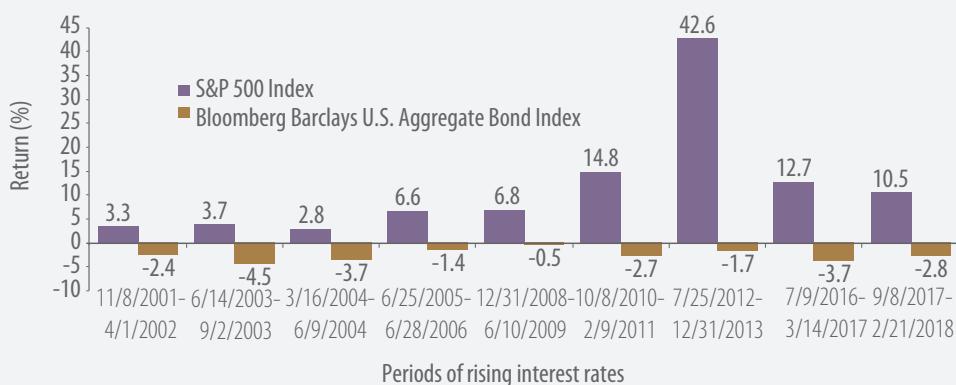
A strong dollar and weak sentiment dented international equity and fixed-income returns in 2018. In the coming year, we believe the dollar will stabilize and even weaken somewhat, providing a potential boost to international assets. Positive trade developments also should cheer investors and reinforce stronger sentiment toward international markets. Intermediate-term indicators such as price/cash flow and price/earnings ratios are registering attractive valuation levels, and international markets should benefit from steady global growth in the coming year.

³ Diversification does not guarantee investment returns or eliminate risk of loss.

4 Lower allocations to the most rate-sensitive assets

History shows that even late in a cycle, when interest rates are rising, equities can still post strong performance (see the chart below). Even so, rate-sensitive asset classes and sectors—such as REITs and most fixed-income securities—may continue to be pressured by rising interest rates. Higher-dividend equity sectors, such as Utilities and Materials, and some value-oriented equities also may face headwinds from rising rates.

Historically, U.S. equities have outperformed bonds while rates are rising



Sources: Morningstar Direct and Wells Fargo Investment Institute, November 19, 2018. *For illustrative purposes only.* The S&P 500 Index is a market-capitalization-weighted index considered representative of the U.S. equity market. The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based measure of the investment-grade, U.S.-dollar-denominated, fixed-rate taxable bond market. *Index returns are not fund returns.* An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** There is no guarantee any asset class will perform in a similar manner in the future or in other rising rate environments even if it has done so historically. Both stocks and bonds involve risk, and their returns and risk levels can vary depending on prevailing market and economic conditions. Bond prices fluctuate inversely to changes in interest rates.

5 Deploy cash as volatility creates opportunities

Greater financial market volatility in 2019 should reinforce the conclusion that the time has passed for unprecedented low volatility and above-average asset returns across equities, fixed income, and currencies. In our opinion, this is especially true in fixed income, where yields are rising. But we believe that the end of easy is not the end of the cycle or the equity bull market. We favor deploying cash selectively as volatility can create new potential opportunities in commodities and some equity markets. Investors who are more risk averse could consider allocating cash incrementally.

Economic and market forecasts

Global economy	2019 (estimate)	2018 (year to date)	2017 (actual)
U.S. GDP growth	2.7%	3.5% ¹	2.2%
U.S. inflation	2.5%	2.5% ⁴	2.1%
U.S. unemployment rate	3.4%	3.7% ⁴	4.1%
Global GDP growth	3.7%	3.7% ²	3.7%
Developed market GDP growth	2.2%	2.3% ²	2.3%
Developed market inflation	2.0%	2.4% ¹	1.7%
Emerging market GDP growth	4.8%	4.7% ²	4.7%
Emerging market inflation	4.3%	3.8% ³	5.2%
Eurozone GDP growth	1.9%	1.7% ¹	2.7%
Eurozone inflation	1.7%	2.2% ⁴	1.4%
Dollar/euro exchange rate	\$1.17–\$1.25	\$1.15	\$1.20
Yen/dollar exchange rate	¥102–¥112	¥113	¥113
Global equities			
S&P 500 Index	2,860–2,960	2,691	2,674
Earnings per share	\$177	\$161	\$134
Russell Midcap® Index	2,090–2,190	2,013	2,078
Earnings per share	\$126	\$115	\$95
Russell Small Cap Index	1,525–1,625	1,497	1,536
Earnings per share	\$83	\$67	\$45
MSCI EAFE Index	1,850–1,950	1,813	2,051
Earnings per share	\$155	\$144	\$132
MSCI Emerging Markets Index	1,080–1,180	988	1,158
Earnings per share	\$104	\$94	\$81
Global fixed income			
10-year U.S. Treasury yield	3.25%–3.75%	3.06%	2.40%
30-year U.S. Treasury yield	3.25%–3.75%	3.32%	2.70%
Federal funds rate	3.00%–3.25%	2.25%	1.50%
Global real assets			
West Texas Intermediate crude oil price (barrel)	\$60–\$70	\$57	\$60
Brent crude oil price (barrel)	\$65–\$75	\$66	\$67
Gold price (troy ounce)	\$1,250–\$1,350	\$1,224	\$1,309

Sources: FactSet, Bloomberg, International Monetary Fund, and Wells Fargo Investment Institute. Market pricing as of November 19, 2018. 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.

1. As of September 30, 2018

3. As of May 31, 2018

2. As of December 31, 2017

4. As of October 31, 2018

We expect stable U.S. consumer price inflation to support the economy in 2019.

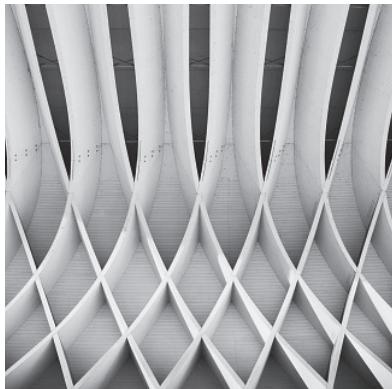
We expect the U.S. dollar to weaken.

We favor U.S. large- and mid-cap equities over small-cap equities.

We expect three Fed rate hikes in 2019.

We favor commodities to rebound in 2019.

China's Place in the World



Key questions we will answer in 2019

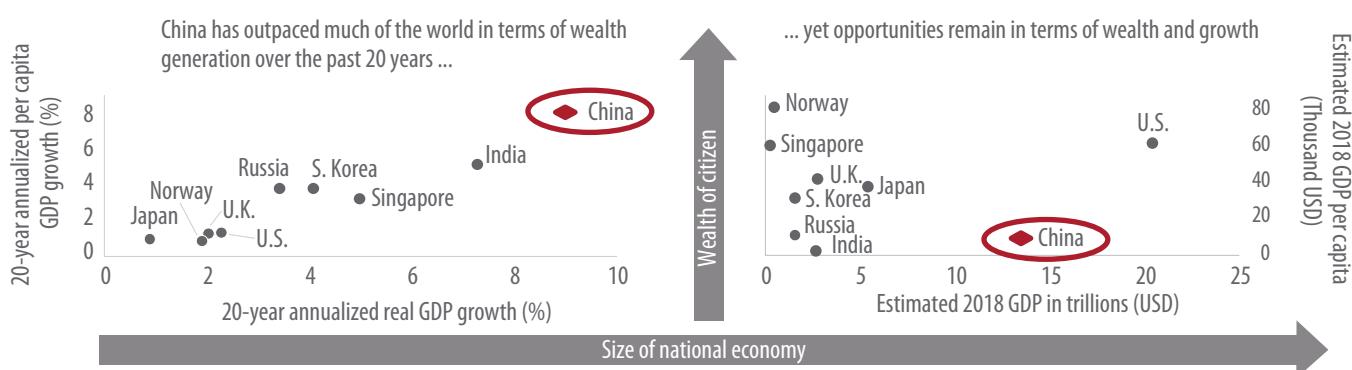
- What is China's economic strategy?
- Could China's rise displace the dominance of the U.S. dollar, capital markets, and economy?
- What opportunities could China's economic ascent provide to investors?

The U.S.-China trade dispute in 2018 highlighted China's rising global prominence and prompted questions about the country's motivations and ability to displace U.S. global leadership. China has said it wants to achieve economic progress in order to build a prosperous society in all respects, and as a result, is pursuing policies that could help advance its economy and global influence. We will examine how China's policies also are prompting questions and concerns from the West about just how much influence China wants to wield.

China's economic reforms already have earned its currency's inclusion in the International Monetary Fund's basket of reserve currencies, and international benchmark indices are including China's stock and bond markets. For perspective, we believe that the U.S. is likely to continue to dominate the most important global financial institutions such as the World Bank. In addition, China's currency is not yet globally traded, and reaching that milestone could take many years.

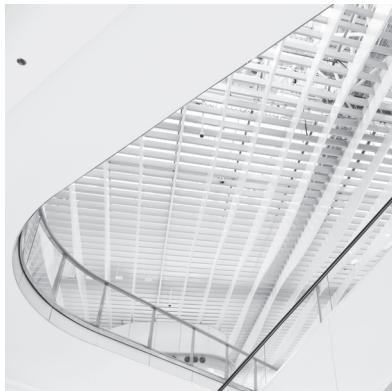
What does this mean for investors? We believe that newfound access to Chinese capital markets could provide investors with more direct access to long-term growth opportunities as China's economy evolves. We will explore the potential investment opportunities of China's economic development as well as Beijing's growing adherence to the rule of law and the global governance systems developed by the West.

China still has a long way to go to catch up to the U.S. in per capita wealth



Sources: International Monetary Fund World Economic Outlook, October 2018 release, and Wells Fargo Investment Institute

The New Approach to Retirement



Key questions we will answer in 2019

- How are Baby Boomers approaching retirement differently than past generations?
- In what unique way are many Gen Xers planning for retirement?
- What sets Millennials apart from prior generations in their approach to retirement?

Retirement in the 21st century is a far cry from the prevailing pattern in the mid-20th century. Traditionally, retirement meant leaving behind a 9-to-5 job and perhaps spending time with family, volunteering for worthy causes, or traveling. But that may be changing. Today, as Baby Boomers approach retirement age at an accelerating rate, many wonder if they can ever afford to fully retire. According to AARP, Inc., 40% of Baby Boomers plan to work part time in retirement.⁴ For some, a job may be necessary to supplement Social Security. For others, working part time offers the opportunity to do something meaningful, stay active and intellectually engaged, and postpone dipping into their retirement assets. Many future retirees can expect to live a long life, but without careful planning, they may run the risk of outliving their savings.

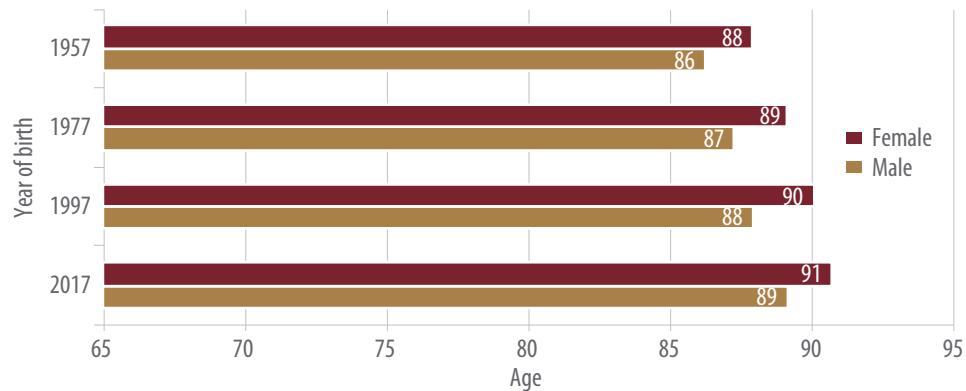
Today, planning for retirement often is up to the individual. Future retirees also will need to grow their assets, especially because health care expenses continue to rise faster than inflation. Looking ahead, part-time employment likely will play a larger role in helping individuals meet income needs in retirement.

For those who truly want to leave their work life behind at retirement, we believe that beginning to save for retirement early and choosing an appropriate investment strategy—which may include a sizable allocation to equities—has the potential to make the task of achieving that goal more attainable.

⁴Source: AARP Bulletin, January/February 2017

Investors should prepare for longer life spans

Retirees may need to generate additional income as they live longer



Source: Social Security Administration Retirement & Survivors Benefits: Life Expectancy Calculator, www.ssa.gov/OACT/population/longevity.html; November 14, 2018. Chart shows lifespan by gender, based upon year of birth.

How Economic Recoveries End

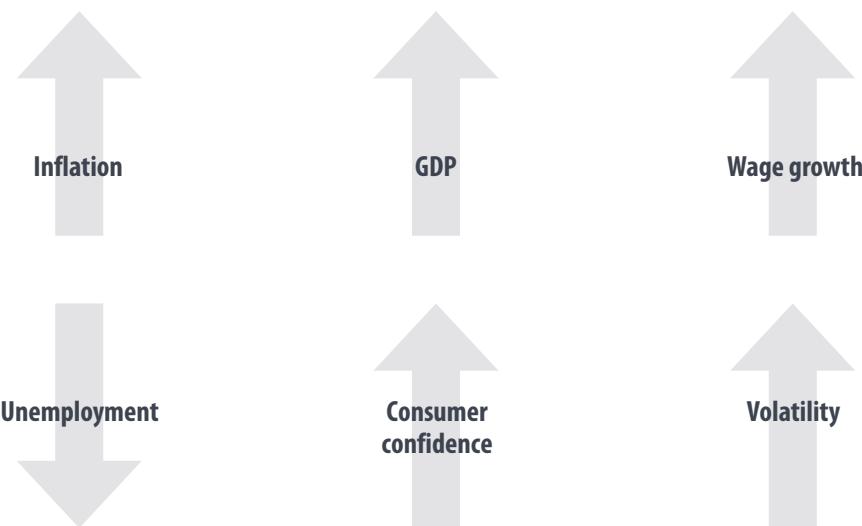
Historically, recessions vary in duration, depth, and magnitude. Since 1929, the U.S. has experienced 14 recessions, lasting from 6 to 43 months, with a median length of 10.5 months. The 2008–2009 Great Recession comprised six quarters of negative GDP growth and left an indelible mark on investors. Between January 2008 and June 2009, U.S. real GDP dropped 4.1% and 7.4 million jobs were lost. Amid the lengthy expansion, we will explore what investors may expect in the next recession, and we will study potential triggers for the next recession.

Although no two recessions are alike, we typically observe some common characteristics, especially excesses in the economy that can trigger recessions. As the recovery continues, we are watching for signs that suggest that the odds of a recession are building.

Finally, we ask how investors may prepare for the next recession. Because recessions are a normal part of the economic cycle, investors should expect to experience them periodically and plan for them accordingly. In the longer term, this is crucial because a fear-based reaction to a downturn can derail achieving financial goals. Investment strategies based on risk and reward—knowing where and when to take on additional risks at certain points in the cycle—can help enhance overall performance and mitigate portfolio volatility.

Our current view on where the economy is headed

Below are our forecasts on the direction of some key economic factors



Source: Wells Fargo Investment Institute, November 19, 2018. Forecasts and targets are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.



Key questions we will answer in 2019

- What might the next recession look like?
- What could trigger the next recession?
- How can investors prepare their portfolios for a recession?

Notes

Fixed-income yield curve chart, page 10

The Ten-Year Treasury Constant Maturity and the One-Year Treasury Constant Maturity Indexes are published by the Federal Reserve Board and are based on the average yield of a range of Treasury securities, all adjusted to the equivalent of a ten-year maturity and the equivalent of a one-year maturity. Yields on Treasury securities at constant maturity are determined by the U.S. Treasury from the daily yield curve.

Real assets chart, page 13

MLPs are represented by the Alerian MLP Index; commodities are represented by the Bloomberg Commodity Index; global REITs are represented by the FTSE EPRA/NAREIT Developed Market Index. The Real Assets hypothetical portfolio is an equal-weighted index of the Alerian MLP Index, the Bloomberg Commodity Index, and FTSE EPRA/NAREIT Developed REIT Index.

Corporate bond chart, page 14

A credit rating is an assessment of the issuer's ability to meet its obligations. It is not a recommendation to buy, sell, or hold securities nor is it an indication of a security's market risk, its liquidity, or its secondary market price. Ratings are assigned by rating agencies such as Standard and Poor's (ratings from 'AA' to 'CCC') and Moody's Investors Service (ratings from 'Aa' to 'Caa') at the time of their analysis and are subject to change based on economic, issuer, or other factors. BBB/Baa is a medium-grade rating, which means the company is subject to moderate credit risk and may have speculative characteristics.

Index definitions

Alerian MLP Index is a float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization, and is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).

Bloomberg Commodity Index is a broadly diversified index comprised of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity.

FTSE EPRA/NAREIT Developed Market Index is designed to track the performance of listed real estate companies and REITS worldwide.

MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure equity market performance across 21 developed market countries excluding the U.S. and Canada.

MSCI Emerging Markets Index is a free float-adjusted market capitalization-weighted index designed to measure equity market performance of 24 emerging market countries.

Russell Midcap® Index is a subset of the Russell 1000® Index and measures the performance of the mid-cap segment of the U.S. equity universe. It includes approximately 800 of the smallest companies in the Russell 1000 Index.

Russell Small Cap (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.

Risk considerations

All investing involves risks, including the possible loss of principal. There can be no assurance that any investment strategy will be successful and meet its investment objectives. Investments fluctuate with changes in market and economic conditions and in different environments due to numerous factors, some of which may be unpredictable. Asset allocation and diversification do not guarantee investment returns or eliminate risk of loss. Each asset class has its own risk and return characteristics, which should be evaluated carefully before making any investment decision. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. 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.

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 prefunded 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. 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. **Materials** industries can be significantly affected by the volatility of commodity prices, the exchange rate between foreign currency and the dollar, export/import concerns, worldwide competition, procurement and manufacturing and cost containment issues. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. **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.

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.

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.

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, including investments in gold and other precious metals, 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.

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



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