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Investment Strategy

WEEKLY GUIDANCE FROM OUR INVESTMENT STRATEGY COMMITTEE

October 9, 2017

Third-Quarter Earnings Preview

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Senior Global Equity Strategist

Key Takeaways

» *The first two quarters of 2017 registered robust earnings growth that was well in excess of expectations. We believe that the probability of a big upside surprise in third-quarter earnings is much lower.*

» *We expect third-quarter S&P 500 Index earnings to grow by five to six percent versus the year-ago period. Outside of the Energy sector, Information Technology also should post good results. Two of the 11 sectors may show year-over-year earnings declines.*

What It May Mean for Investors

» *We continue to favor more cyclical sectors and retain an overweight position for the Industrials, Consumer Discretionary, Financials and Health Care sectors. We believe that it is too early to move toward a more defensive sector weighting in portfolios.*

Earnings growth reported for the S&P 500 Index during the first half of 2017 exceeded our (and the "Street's") estimate by a wide margin—as domestic and international economies outperformed our expectations. As a result, last month, we raised our 2017 earnings estimate to $129 from $127. Yet, with that in mind, we think the probability of a meaningful upside surprise in overall third-quarter earnings results is low.

At the end of this week, the third-quarter earnings reporting season will begin in earnest when a number of large banks release results. The next four weeks will feature a heavy load of third-quarter reports and forward outlooks. We look for third-quarter S&P 500 earnings growth in the five to six percent range. In other words, earnings results are solid—but not impressive. As we have stated in previous reports, we expected that earnings comparisons would start to get tougher in the third quarter. Our full-year 2017 earnings estimate reflects a growth rate of nearly 10 percent. Looking ahead to next year, we see approximately seven-percent growth, supported by a slightly better economic environment both here and abroad.

During this reporting season, the Energy sector likely will post the strongest year-over-year growth rate—as many of the companies in this sector continue to benefit from the rebound in oil prices. Investors may recall that, in early 2016, crude oil traded down to near $26 per barrel, almost half the current level. The outsized Energy-sector earnings gains likely will continue to slow over the next handful of quarters.

Asset Group Overviews

Equities.......................... 3
Fixed Income 4
Real Assets..................... 5
Alternative Investments.................. 6

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Third-Quarter Earnings Preview

The Energy sector makes up approximately six percent of the S&P 500 Index's total market capitalization. As with the first two quarters of this year, these outsized earnings gains have had a noticeably positive effect on overall growth.

Outside of the Energy sector, we expect that the magnitude of third-quarter earnings growth will drop dramatically. Based on our analysis, the Information Technology sector likely will post respectable earnings growth in the 10-percent area. Technology has continued to benefit from high margins, along with the continuing U.S. recovery and improved international economic growth rates. We do not look for those trends to change for (at least) the next few quarters.

The Industrials sector is expected to produce third-quarter earnings gains in the five to six percent range. Most companies in this sector have a significant amount of international exposure. As we mentioned, international economies continue to slowly improve, and they are earlier in the cycle than the U.S. is today. It also is typical for the Industrials sector to benefit from late-cycle capital spending, which we see picking up domestically. Note that this sector has outperformed the S&P 500 Index since July 2015. We look for this trend to continue as we enter 2018. We recommend an overweight position for Industrials.

In summary, the third quarter likely will reflect a slowdown in earnings growth relative to the first half of the year. We expect nine of 11 S&P 500 Index sectors to show positive year-over-year comparisons. We continue to favor more cyclical sectors and remain overweight the Industrials, Consumer Discretionary, Financials and Health Care sectors. We believe that it is too early to move toward a more defensive sector weighting in portfolios, and we remain underweight Consumer Staples, Utilities and Energy.

S&P 500 Index Sectors: Third Quarter Growth Estimate

	Percentage Change Year-over-Year (Estimate)
Energy	116.0%
Information Technology	10.0%
Industrials	5.5%
Consumer Staples	3.8%
Financials	3.1%
Health Care	2.5%
Real Estate	2.0%
Consumer Discretionary	1.8%
Telecommunication Services	0.0%
Materials	-5.0%
Utilities	-5.0%
S&P 500 Index	5.0% to 6.0%

Sources: Wells Fargo Investment Institute, S&P Capital IQ, 10/4/17.

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Sean Lynch, CFA
Co-Head of Global Equity Strategy

Underweight
U.S. Small Cap Equities

Evenweight
U.S. Large Cap Equities

Evenweight
U.S. Mid Cap Equities

Evenweight
Developed Market Ex-U.S. Equities

Evenweight
Emerging Market Equities

International Equities: Different Earnings Cycles and Different Outlooks

International economies and earnings are at a different point in the business cycle than the United States is. We believe that this signals further upside potential for international equity markets.

Emerging Markets (EM): The consensus forecast for the MSCI Emerging Markets Index calls for three consecutive years of earnings growth (2016-2018). This has not happened since the 2005-2007 period. This steady earnings improvement is being driven by accelerating economic growth and the important contributions of the technology and consumer sectors. Following the 2008-2009 global financial crisis, EM countries provided excessive stimulus to their economies. The resulting 2011-2015 bear market came about as commodities declined and conditions were tightened. We expect steadier EM growth going forward.

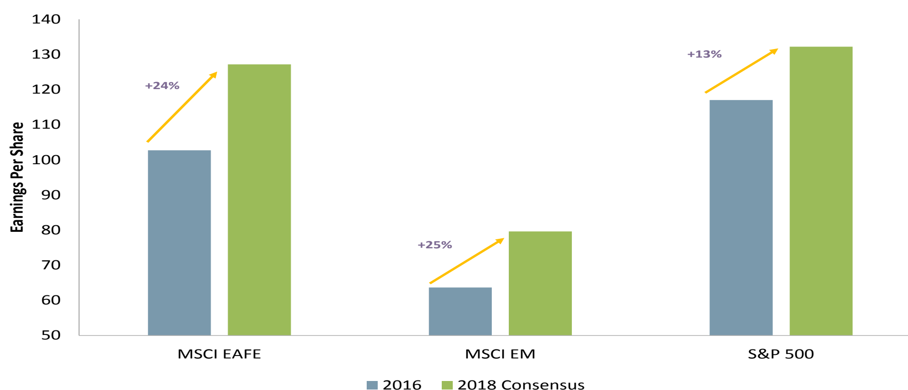
Developed Markets: There are concerns that a strengthening euro will begin to pressure earnings. Based on its recent study, Wells Fargo Investment Institute has concluded that there is likely to be limited corporate-earnings impact for Eurozone firms from a strengthening euro. Developed equity markets are dominated by large multinational corporations that are adept at managing currency volatility. An additional concern is whether a strengthening euro will impact valuations. We believe that the euro strength confirms the region's improving fundamentals and should not be viewed as a threat to derail recent equity gains.

In both emerging and international developed markets, the earnings rebound since the 2008-2009 global financial crisis happened much later than it did in the United States. Consequently, central banks in these markets are likely to remain more accommodative than the Federal Reserve (Fed). Further, we expect business and consumer confidence to continue rising. We believe that these developments will be conducive to steady earnings improvement.

Key Takeaways

- The MSCI Emerging Markets Index is expected to see its third straight year of earnings growth in 2018. This hasn't happened since the 2005-2007 period.
- We believe that recent euro strength confirms the Eurozone's improving fundamentals; we do not believe that it threatens to derail recent equity gains.

Earnings Growth: International Equity Markets versus S&P 500 Index



Sources: Wells Fargo Investment Institute, Bloomberg; 10/4/17. An index is unmanaged and not available for direct investment.
Past performance is no guarantee of future results.

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Brian Rehling, CFA
Co-Head of Global Fixed Income Strategy

Underweight
High Yield Taxable Fixed Income

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

Evenweight
U.S. Short Term Taxable Fixed Income

Evenweight
U.S. Long Term Taxable Fixed Income

Evenweight
Emerging Market Fixed Income

Overweight
U.S. Taxable Investment Grade Fixed Income

Overweight
U.S. Intermediate Term Taxable Fixed Income

Fed Hikes Don't Have To Hurt

The odds of a December rate hike rose following the most recent Federal Open Market Committee (FOMC) meeting—as the Fed appears determined to continue tightening monetary policy despite relatively benign inflation data. We expect the Fed to increase the fed funds rate in December and to hike rates two more times next year.

Tighter Fed policy may sound scary to some fixed income investors. After all, there is an inverse relationship between bond prices and rates—as rates move higher, bond prices fall. It is important to remember that the Fed only has the ability to explicitly control and set short-term interest rate policy. Although the Fed has manipulated longer-term rates through its quantitative-easing purchases; ultimately, supply, demand and market forces set the level of long-term rates. We do not anticipate that these market forces will change significantly in the coming months, despite the Fed's plans to slowly reduce its balance-sheet size.

We expect inflation to remain well contained in the coming quarters. As a result, we believe that the impact of any fed funds rate increase on longer-term U.S. bond yields should be modest.

Short-term fixed income investments have minimal rate sensitivity relative to their longer-maturity counterparts. In fact, higher short-term rates could be a positive development for many investors, as returns on cash alternatives (and other short-term investments) could offer better yield opportunities than they do today. If long-term rates were to unexpectedly rise, we likely would increase allocations to long-term fixed income—as we believe that any rate increase further out on the yield curve would be temporary—at least until we see a change in the trend of inflation expectations.

Key Takeaways

- We recommend that investors maintain a neutral duration profile within fixed income allocations.
- Short-term and long-term interest rates do not always move together.
- We recommend that investors refrain from selling fixed income allocations due to Fed rate-hike concerns. Longer-term bonds have been among the better-performing fixed income classes this year.

Inflation Expectations Do Not Suggest Higher Long-Term Rates

Sources: Bloomberg, Federal Reserve, 10/3/17. This series is a measure of expected inflation (on average) over the five-year period that begins five years from today.

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Austin Pickle, CFA
Investment Strategy Analyst

Underweight
Commodities

Evenweight
Private Real Estate

Overweight
Public Real Estate

"The only real mistake is the one from which we learn nothing."
--John Powell

Real Assets: Two Steps Forward—Two Steps Back

Today, we will review the key drivers of year-to-date (YTD) performance in the real assets class and outline our expectations for the fourth quarter.

Real estate investment trusts (REITs) have enjoyed supportive fundamentals in 2017, but highly publicized retail bankruptcies and fears of rising interest rates have soured investors' mood on the asset class. Continued economic growth, benign interest-rate moves, and a more positive news cycle should propel REITs into the end of the year.

Individual commodity performance has varied widely YTD, and the broad commodity index has lagged. We expect the commodity bear super-cycle to be the main driver of returns for years to come—as excess global supply is worked off. Additionally, muted inflation, a stronger dollar, and modest economic growth should limit commodity gains in the fourth quarter.

The price of West Texas Intermediate (WTI) crude oil has declined YTD, despite its third-quarter surge. OPEC (Organization of the Petroleum Exporting Countries) cut oil production—hoping to reduce inventory levels and drive oil prices higher. But shale-oil production resiliency and the ability of oil producers to boost output as prices rise has kept inventory levels robust and capped oil-price moves. Currently, the price of WTI crude oil sits above our year-end 2017 forecast range of $40-$50 per barrel, but we expect added supply to soon hit the market and pressure prices back into our year-end range later this quarter.

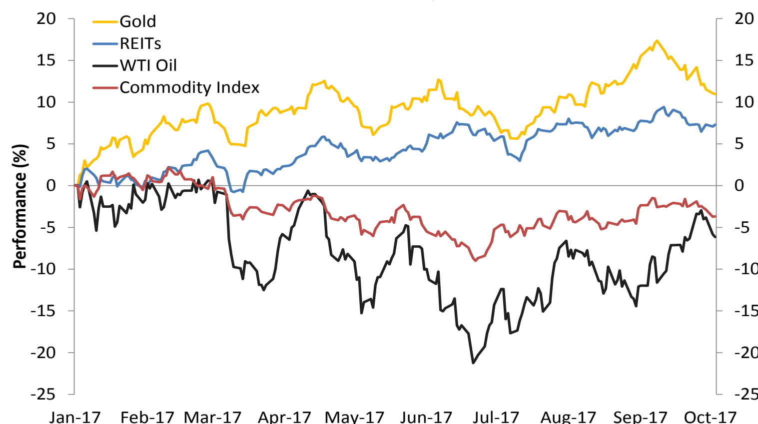
Gold has benefited from the U.S. dollar's fall, along with geopolitical tensions. For the remainder of this year, we believe that gold is likely to mirror the dollar and "follow fear." Wells Fargo Investment Institute expects the dollar to strengthen this quarter, and we hope that geopolitical tensions will ease. As a result, gold should find its way back to our year-end target range of $1,150-$1,250 per ounce.

Key Takeaways

» Gold and REITs have handily outperformed oil and commodities YTD.

» Entering the fourth quarter, we remain overweight REITs and underweight commodities, while our year-end targets for gold and WTI oil remain at $1,150-$1,250 and $40-$50, respectively.

Real Assets: Year-to-Date 2017 Performance



Sources: Wells Fargo Investment Institute, Bloomberg; 10/5/17. REITs are represented by the total return of the FTSE EPRA/NAREIT Developed Index. Commodities are represented by the total return of the Bloomberg Commodity Index (BCOM). Bloomberg Commodity Index represents futures contracts on 22 physical commodities. No related group of commodities (e.g., energy, precious metals, livestock and grains) may constitute more than 33 percent of the index as of the annual re-weightings of the components. No single commodity may constitute less than two percent of the index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Justin Lenarcic
Global Alternative Investment Strategist

Evenweight
Private Equity

Evenweight
Private Debt

Evenweight
Hedge Funds-Macro

Evenweight
Hedge Funds-Event Driven

Overweight
Hedge Funds-Relative Value

Overweight
Hedge Funds-Equity Hedge

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

The Phases of Late-Cycle Security Selection

We often point to the first quarter of 2016 as an inflection point, or perhaps the first "phase" of an improved opportunity set for active management. After early 2016, the decrease in security, sector, and geographic correlations allowed fundamentally based managers to begin capturing more of the market's upside than they had in previous years. The rather abrupt change in the rolling two-year *up capture ratio* shown in the chart below illustrates the significance of this new landscape. The up capture ratio helps investors understand how well the strategy performed when the market was up. (In the chart below, the "market" is measured by the MSCI World Index.) In February 2016, Equity Hedge managers (on average) were only capturing 37 percent of the up market; now, they are capturing approximately 58 percent.

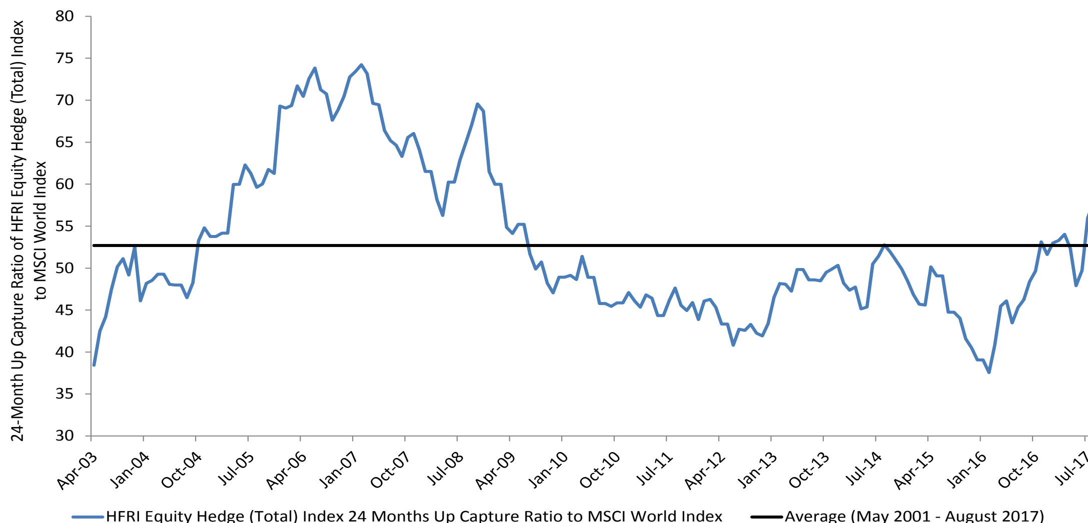
We believe that the ability of Equity Hedge managers to improve their up capture ratios is the first phase of a new regime characterized by active-management outperformance. The second phase likely will be a decrease in the *down capture ratio* in periods of choppy and/or down markets as managers are able to generate positive returns from short equity positions. As the cycle matures, we expect correlations to continue to decrease, along with an increase in the dispersion of returns. These developments should benefit managers that are skilled in the selection of long positions, but also those with a skill set in shorting equities.

Key Takeaways

» In our view, the environment for security selection continues to strengthen, with the first phase being the improvement in the up capture ratio that began last year.

» The latter stages of an economic and market cycle often provide an attractive environment for hedge funds, particularly those using Equity Hedge strategies.

Phase One of Active Management: Better Up Capture



Sources: HFR, Bloomberg, 10/17. Indices are for illustrative purposes only. They represent general market results and do not reflect actual portfolio returns. An index is unmanaged and not available for direct investment. The up-market capture ratio is used to evaluate how well an investment performed relative to an index during periods when that index has risen. **Past performance is no guarantee of future results.**

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Risks Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

Bloomberg Commodity Index is calculated on an excess return basis and reflects commodity futures price movements.

FTSE EPRA/NAREIT Developed Index is designed to track the performance of listed real-estate companies and REITs in developed countries worldwide.

HFRI Equity Hedge (Total) Index maintains positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios.

MSCI EAFE (DM) and **Emerging Markets (EM) Indices** are equity indices which capture large and mid-cap representation across 21 developed market (DM) countries and 23 emerging market (EM) countries around the world.

MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of 23 developed market countries.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

An index is unmanaged and not available for direct investment.

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