Investment Strategy

Weekly Guidance from our Investment Strategy Committee **March 2, 2020**

[1] Forecasts are not guaranteed, and they are based on certain assumptions and on our views of market and economic conditions, which are subject to change.

Alternative Investments Spotlight

Yegin Chen, Ph.D.
Senior Global Alternative Investment Strategist

Coronavirus and our outlook on Asian private equity

We expect the novel coronavirus (COVID-19) to impact many lives, businesses, and markets globally over the next several months. Private equity funds—particularly those investing in Asia—also are likely to be affected in the near term.

Asian private equity funds have invested in many companies that are suffering revenue and profit declines from the coronavirus outbreak. Travel restrictions and quarantines spurred by the outbreak have dampened business activity in numerous regions. Particularly hard-hit have been the businesses focused on travel, restaurants, hospitality, and brick-and-mortar retailing—which have seen their passenger or customer base shrink dramatically. As manufacturers curb factory operations, we expect private equity investments in these sectors likely will experience a short-term decline in accounting value for existing holdings (given "mark to market" practices). On the other hand, private equity holdings that could witness enhanced operating results include e-commerce companies (as citizens unable to travel shop online) and health-care companies.

In addition to general earnings declines, we anticipate that valuation multiples of existing Asian private equity portfolio companies in key sectors also will drop. "Exit market" activity (particularly via initial public offerings) is likely to slow, as public market investors (and others) scale back due to coronavirus-related uncertainty. The public market valuation multiples of companies that are similar to those in private equity portfolios also are expected to decline, at least until uncertainty about the coronavirus is resolved.

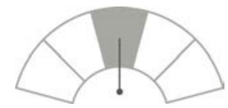
Brighter long-term prospects—particularly in Asian health-care private equity

In the longer term, we expect private equity funds with available capital (dry powder) to enjoy more attractive entry valuations for their transactions. With terms of up to 10 years, these funds' long-term outlooks could help them to weather short-term market volatility and disruptions triggered by the coronavirus outbreak.

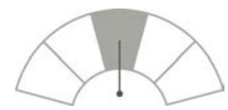
In particular, private equity funds investing in Asian health care should enjoy a richer opportunity set. The coronavirus outbreak has overwhelmed existing health-care infrastructures; private equity funds will continue to play a key role in backing producers of coronavirus health-care products—and services needed to modernize health-care systems.

We expect several health-care sectors targeted by private equity funds to experience greater visibility and long-term prospects, including:

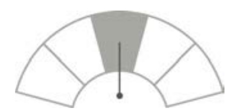
- Medical diagnostics companies, such as one seeking accelerated approval of its molecular coronavirus test from China's Food and Drug Administration



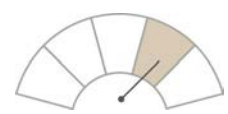
Neutral
Private Equity



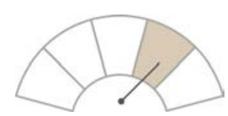
Neutral
Hedge Funds – Macro



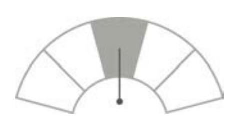
Neutral
Hedge Funds – Event Driven



Favorable
Private Debt



Favorable
Hedge Funds – Equity Hedge



Neutral
Hedge Funds – Relative Value

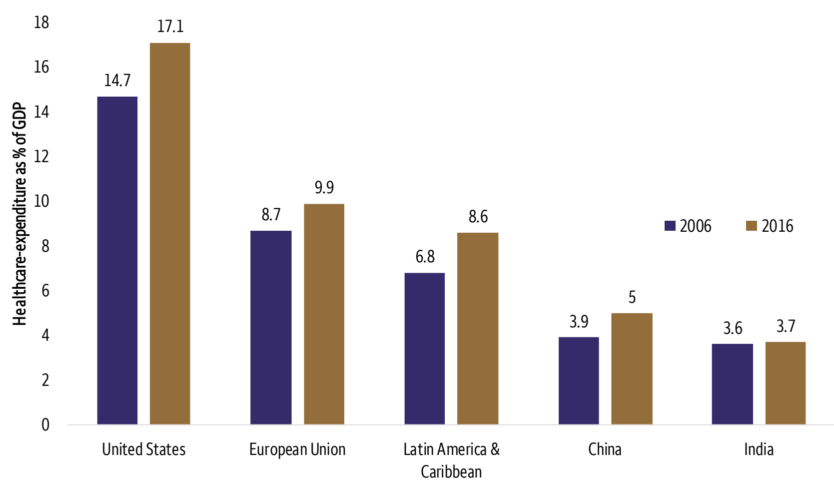
Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not suitable for all investors and are only open to "accredited" or "qualified" investors within the meaning of U.S. securities laws.

- Biopharmaceutical drug companies researching new vaccines and repurposing existing therapies, including one that filed for emergency Chinese regulatory approval of its coronavirus treatment
- Medical service providers, including a hospital chain with several locations across India.

The COVID-19 outbreak highlights a general situation across Asia—that rapid economic growth over recent decades has not yet produced world class health-care systems. In particular, while China and India have large populations and economies, their health-care sectors still have significant room for growth and development in the decades ahead.

As Chart 1 indicates, China and India still spend a comparatively small 3-5% of their gross domestic product (GDP) on health-care products and services. This figure pales in comparison with the 9-17% of GDP that other regions spend on health care. However, as China and India become more prosperous, we expect the percentage of GDP that these countries spend on health care to continue increasing as their leaders and populations have greater incentive (and means) to maintain health and wellness.

Chart 1. Asian health-care spending has been growing and has ample upside potential



Source: World Bank, February 2020. 2016 data is the most recent available for health-care spending as a percentage of GDP in these markets.

U.S. investors currently have limited access to the long-term Asian health-care opportunity via the public markets. We suggest that U.S. investors consider private equity funds to access the opportunity, particularly those sponsored by U.S. private equity firms with experienced, local investment teams in Asia.

Investment implications

As a result of the coronavirus outbreak, Asian private equity funds are expected to post short-term declines in accounting valuations for many existing fund assets. However, we believe that these assets are likely to maintain their long-term value.

We anticipate that, in the longer term, private equity funds investing in Asia—particularly in health care—will witness an expanded opportunity set. These funds target portfolio companies that are expected to benefit from changed spending and health-care priorities after the outbreak, and they have backed companies that are providing needed biopharmaceutical treatments, diagnostic products, and medical services.

Many U.S. investors can access the secular Asian health-care opportunity through private equity funds that are based in the U.S. with on-the-ground teams in Asia.

Equities

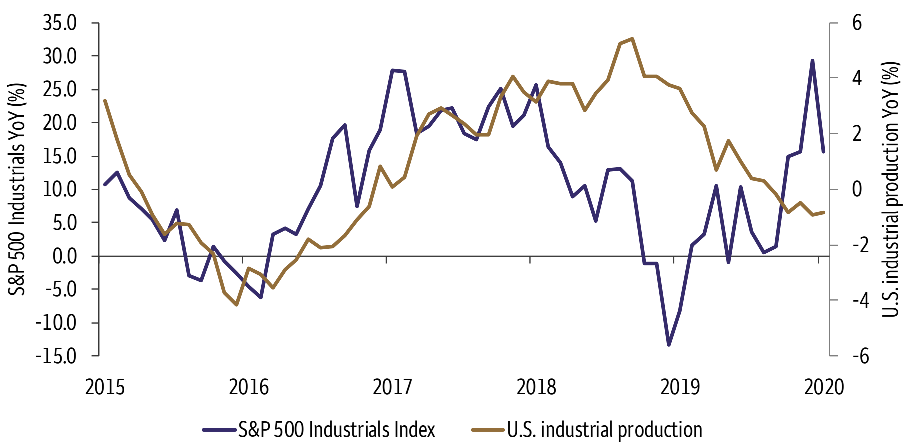
Lowering our Industrials sector guidance

Rising coronavirus uncertainties led to investor anxiety last week as the S&P 500 Index fell back to 2018 levels. Industrials, which are arguably one of most sensitive sectors to overseas growth, were not shielded from the drop. This S&P 500 sector has fallen by more than 9% since the sell-off began on February 19.[2]

The already struggling Industrials sector has been besieged by tariffs and the grounding of a well-known U.S. airplane manufacturer. Furthermore, industrial production, which tends to correlate with the Industrials sector's performance, points to further weakness as firms contend with the slowing global economy. The coronavirus adds to this strain after government-mandated quarantines in China forced factories to shut down. Reduced production likely will weigh on earnings growth in the first half of 2020. Consensus earnings expectations for this sector are for an 11.6% and 3.7% decline, respectively, in the first and second quarters of 2020.[3]

For these reasons, we have reduced our guidance on Industrials from neutral to unfavorable. We believe that investors should raise the quality of their equity holdings, and reallocate capital to sectors such as Communication Services (which we recently raised to favorable from neutral). We also have a positive view of the Information Technology, Consumer Discretionary, and Financials sectors, which have reflected high "quality" metrics in our analysis. For more details, please request a copy of our February 28, Institute Alert titled "Adjusting Our Targets, Guidance, and Equity Allocation."

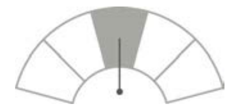
U.S. industrial production points to weakness in the Industrials sector



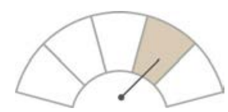
Sources: Bloomberg, Wells Fargo Investment Institute. Data is as of February 26, 2020. Industrial production data is as of January 31, 2020. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Ken Johnson, CFA
Investment Strategy Analyst

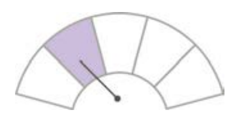
Krishna Gandikota
Investment Strategy Analyst



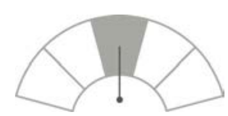
Neutral
U.S. Large Cap Equities



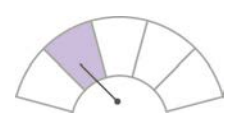
Favorable
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Neutral
Developed Market Ex-U.S. Equities



Unfavorable
Emerging Market Equities

[2] As of February 26, 2020.
[3] Source: Bloomberg, February 26, 2020.

Fixed Income

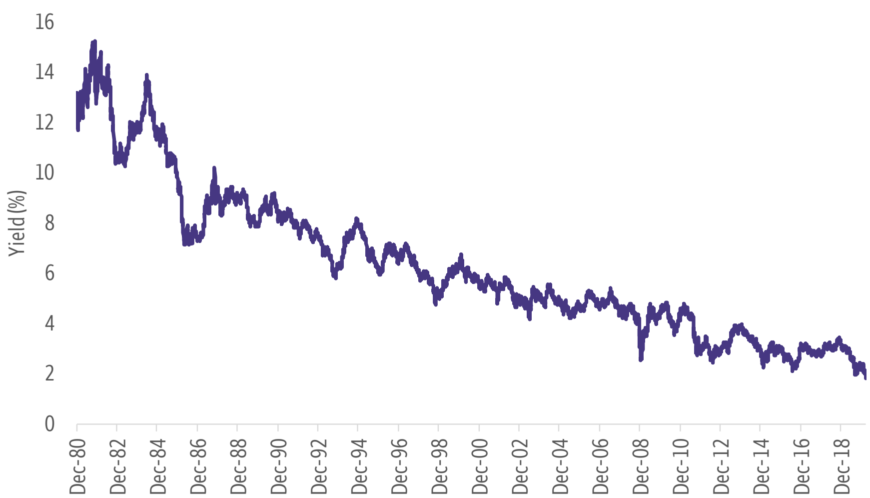
Historic lows

Longer-term Treasury yields recently reached all-time lows on fears that the coronavirus will continue to spread across the globe and impact economic activity. In response to the emergence of the coronavirus, we recently decreased our year-end 2020 interest-rate targets across the yield curve. We now expect a federal funds rate cut this year. Our new year-end federal funds rate target range is 1.25-1.50%. We also reduced our 10-year and 30-year Treasury yield targets by 25 and 50 basis points, respectively.[4] Our year-end 2020 target range for the 10-year Treasury yield now stands at 1.25-1.75%, while our 30-year Treasury yield target range is now 1.50-2.00%.[5]

At the start of this year, we did not foresee an emerging virus that would threaten global economic growth and add further support to Treasury market valuations. If virus concerns deepen or other events unexpectedly occur that dampen consumer and business confidence, we likely would see U.S. interest rates continue to decrease from current levels. While we have seen historic lows in longer-term Treasury yields, the potential for interest rates to move lower still remains.

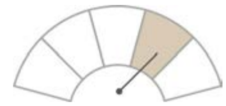
We continue to stress that investors focus on quality, given the increased market uncertainty. In addition, we remain comfortable with our favorable duration stance in portfolios.[6] High quality, longer-duration securities (such as high quality intermediate and longer-term bonds) historically have proven to be a positive attribute to portfolios in periods of market uncertainty.

Thirty year Treasury yield reaches historic lows

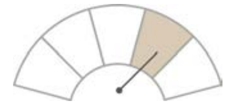


Source: Bloomberg, February 26, 2020.

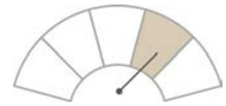
Brian Rehling, CFA
Head of Global Fixed Income Strategy



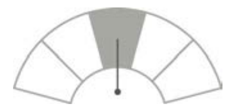
Favorable
U.S. Taxable Investment Grade Fixed Income



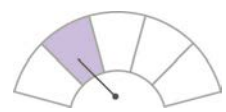
Favorable
U.S. Short-Term Taxable Fixed Income



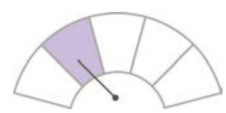
Favorable
U.S. Intermediate Term Taxable Fixed Income



Neutral
U.S. Long-Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



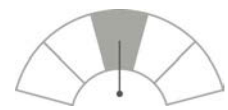
Unfavorable
Developed Market Ex.-U.S. Fixed Income

Neutral
Emerging Market Fixed Income

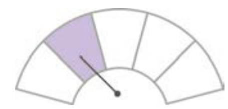
[4] One hundred basis points equal 1.00%.
[5] Forecasts are not guaranteed, and they are based on certain assumptions and on our views of market and economic conditions, which are subject to change.
[6] Duration is a measure of interest-rate sensitivity.

Real Assets

John LaForge
Head of Real Asset Strategy



Neutral
Commodities



Unfavorable
Private Real Estate

"Risk comes from not knowing what you are doing." —Warren Buffett

Gold on the run

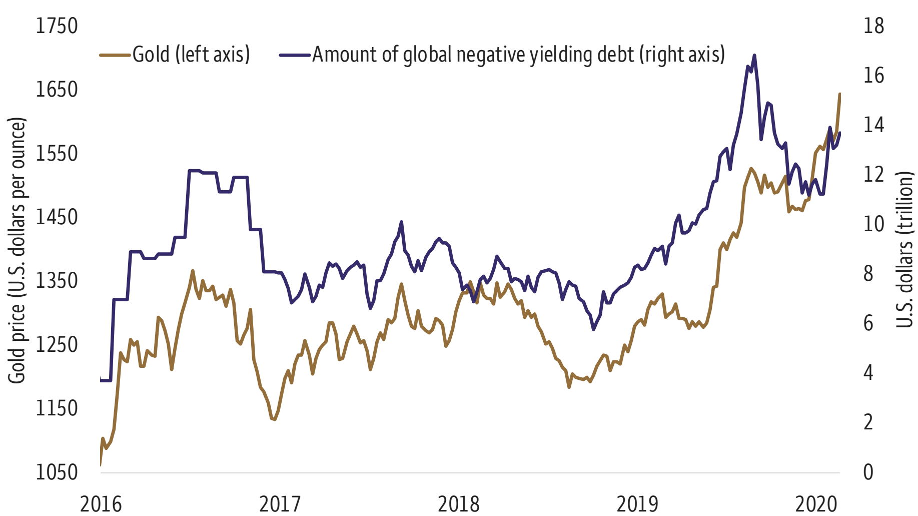
Gold continues to creep higher, and we are becoming increasingly confident that it has room to keep creeping higher. This has been our thinking for some time now. We increased our gold targets twice in 2019, and we did again last week. Our new year-end 2020 target range is $1,650-$1,750. Gold's macro and technical backdrops point to higher gold prices.[7]

Gold is up 8% so far in 2020, on top of the 20% gain last year.. With that said, we do believe that gold will hold its new $1,600s price levels—and eventually push higher.

From a "macro" perspective, gold has a host of economic and market factors working in its favor. Most recently, gold's rise has been fueled by the increased volatility and uncertainty that has followed the coronavirus' spread. Gold's prime macro driver, though, continues to be the direction and level of global interest rates, and their persistent flirtation with negative levels. The chart shows the price of gold (gold line) plotted next to the total amount of negative-yielding debt globally. The evidence suggests gold is being used by investors as a hedge against the unknown impacts of persistently low long-term rates.

The bottom line is that we continue to like gold as part of a well-diversified portfolio, particularly in light of persistently low, and falling, global rates.

Gold versus global negative yielding debt



Sources: Bloomberg, Wells Fargo Investment Institute. Weekly data: January 1, 2016-February 21, 2020. Global negative yielding debt is represented by the Bloomberg Barclays Global Aggregate Negative Yielding Debt Index (market value in U.S. dollars). **Past performance is no guarantee of future results.**

[7] Forecasts are not guaranteed, and they are based on certain assumptions and on our views of market and economic conditions, which are subject to change.

Risk Considerations

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

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. **Communication Services** companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. 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 **Financial** services companies will subject a investment to adverse economic or regulatory occurrences affecting the sector. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio's performance. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market.

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

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

Definitions

An index is unmanaged and not available for direct investment.

The Bloomberg Barclays Global Aggregate Negative Yielding Debt Index (market value in USD) measures the stock of debt with yields below zero issued by governments, companies and mortgage providers around the world which are members of the Bloomberg Barclays Global Aggregate Bond Index

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.

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