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Investment Strategy

WEEKLY GUIDANCE FROM OUR INVESTMENT STRATEGY COMMITTEE

April 30, 2018

Midterms and the Markets

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Global Asset Allocation Strategist

Key takeaways

» *U.S. midterm elections will be held this fall, and these elections historically have signaled some clear patterns for equity markets. Midterm election years have had higher volatility in the past, but also have offered some compelling buying opportunities.*

» *We will shed some light on these trends in today's report. (Please also see last week's Market Commentary report titled "Midterm Election Year: What is Normal?" for insights.)*

What it may mean for investors

» *We continue to expect higher U.S. equity markets by year-end 2018. Periods of volatility can offer opportunities to invest in cyclical equity sectors that we favor, and in a variety of global asset classes to broaden portfolio diversification.*

Asset Group Overviews

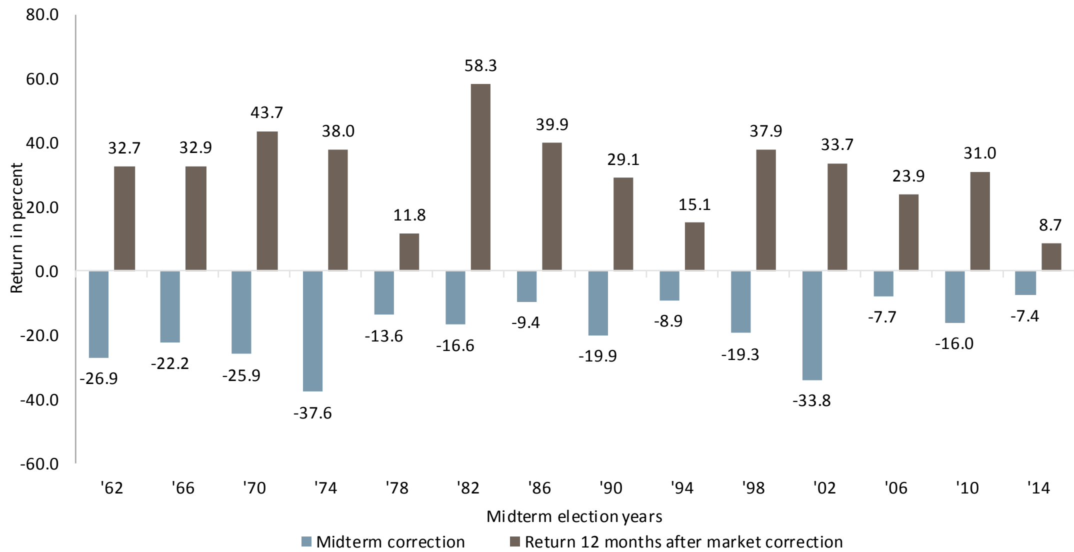
With trade, taxes, and volatility dominating headlines early this year, the looming U.S. midterm elections have received minimal coverage. That is likely to change in the coming months as the elections near and political advertisements begin. Currently, Republicans control the presidency, the Senate, and the House of Representatives (through a majority)—and they have promoted a pro-market agenda of tax reform and deregulation. Yet current polls show a greater likelihood of a Democratic takeover in the House of Representatives following the midterm elections, while they suggest that Republicans likely will maintain a hold on a Senate majority.[1]

Congressional turnover is common in a U.S. president's second year in office—with the party in control losing ground in five of the past six midterm elections. This power shift is often a result of voter frustration with one party's propensity to do "too much" or "too little" to benefit its political agenda. Historically, political uncertainty leading up to midterm elections has led to greater market volatility, and this year has been no exception. In previous midterm election years, the S&P 500 Index has experienced a sell-off early in the year—and on average, ends the first three quarters flat to slightly lower (as of this writing, the S&P 500 Index price is nearly unchanged year to date). Equity markets tend to rally in the fourth quarter of midterm election years as election results become clearer. Since 1962, fourth-quarter returns for the S&P 500 Index during midterm election years have averaged 7.5% (with October being the best month).

[1] The PredictIt site also signals these changes.

Midterms and the Markets

Chart 1. S&P 500 Index performance during and after midterm election years



Sources: Wells Fargo Investment Institute and Bloomberg, April 25, 2018. The S&P 500 Index is an unmanaged, market capitalization-weighted index unavailable for direct investment. It is considered representative of the U.S. stock market.

As Chart 1 shows, equity-market corrections during midterm election years historically have turned out to be great buying opportunities. Since 1962, the average peak-to-trough S&P 500 Index decline during these years was 19%, although the past three midterm election years averaged closer to a 10% drop (the correction in February 2018 was approximately 10%). In all instances, the index was higher one year after the trough, with an average return of 31%. Furthermore, once the midterm election takes place, the index has been higher one year later every time since 1946. This could be partly due to the markets preferring a greater balance of power or the anticipation of additional fiscal stimulus in a president's third year in office.

Although a Republican majority in Washington, D.C. historically has been accompanied by strong equity-market performance, a potential split in Congress is unlikely to derail the U.S. equity bull market (in our view). The average annualized return for the S&P 500 Index when Republicans were in control was a robust 15.1%. If Democrats win a majority in the House of Representatives this November, history tells us that U.S. equity-market returns have been lower under this scenario, but they still have been double-digit returns (on average).

Average S&P 500 Index returns by political party control: 1933-2016 (President/Senate/House of Representatives)

	RRR	DDR	DRR	RRD	DDD	RDD
S&P 500 Return	15.1%	13.6%	13.0%	10.8%	9.3%	4.9%

Source: Strategas, as of April 20, 2018. Returns are average annual S&P 500 Index returns between 1933 and 2016, and reflect relative political party control.

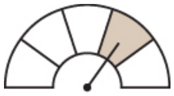
Charts are for illustrative purposes only. There is no certainty that the S&P 500 Index will perform similarly in the 2018 midterm election year as it has in past midterm election cycles or in future midterm elections or produce similar returns as shown above relative to political party control. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Midterms and the Markets

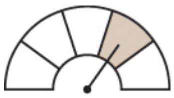
Historical analysis suggests that the midterm election cycle is traditionally a turning point for equity markets, regardless of the shift in power. Not unlike today, volatility often picks up as investors digest shifting political winds that could impact fiscal and monetary policy, the economy, and corporate earnings. We believe that the year-to-date market movement is normal, and we expect equity markets to end 2018 higher than where they are today. If markets continue to experience greater volatility, it likely will present an opportunity to lean into some of the asset classes that we view favorably. In particular, we continue to see strong fundamentals and reasonable valuations in U.S. equities, and we continue to favor cyclically-oriented sectors such as Consumer Discretionary, Financials, and Industrials, along with Health Care.

EQUITIES

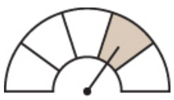
Stuart Freeman, CFA
Co-Head of Global Equity Strategy



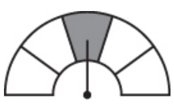
Favorable
U.S. Small Cap Equities



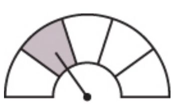
Favorable
U.S. Large Cap Equities



Favorable
U.S. Mid Cap Equities



Neutral
Developed Market
Ex-U.S. Equities



Unfavorable
Emerging Market Equities

First quarter earnings season starts strong

It is early in the first-quarter earnings reporting season, but with 26% of S&P 500 Index companies having reported, it is worth sharing initial notes. Overall, we have projected 16-17% S&P 500 earnings-per-share growth for the first quarter, and roughly 16% for 2018. So far, the first-quarter sector results appear as follows:

	Percent of company earnings outperforming	Percent of company revenues outperforming
Consumer Discretionary	64%	57%
Consumer Staples	90%	70%
Energy	100%	50%
Financials	74%	59%
Health Care	100%	69%
Industrials	85%	89%
Information Technology	93%	86%
Materials	50%	67%
Real Estate	60%	60%
Telecommunications*	100%	100%
Utilities	50%	0%

*Note that only 1 of 3 Telecommunications Services sector companies have reported, and only 7% of Utility sector companies have reported, thus far.
Source: Wells Fargo Investment Institute, S&P Capital IQ, April 25, 2018.

Roughly 80% of S&P 500 Index companies have reported better-than-expected earnings to date. As earnings season moves forward, we believe that this outperformance level is likely to move toward the mid-to-high 70% area. The chart below plots the history of outperformance and underperformance (and the long-term medians for each from 1992 to today).

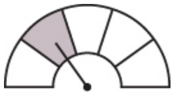
Overall, with 131 S&P 500 Index companies having reported to date, 91 have outperformed on revenues (69%). While this number is likely to soften as reporting season progresses, it is significantly greater than the 35-45% revenue beats we had seen mid-cycle. More recently, the revenue outperformance has been 55%, 52%, 64%, 70%, 67%, and 75% for the third quarter of 2016 through the fourth quarter of 2017, respectively.

We recommend that investors capitalize upon any market weakness to rebalance their portfolios and accumulate positions in quality issues within our favored sectors.

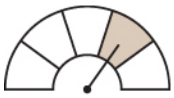
Percentage outperforming on earnings versus percentage underperforming

Sources: Wells Fargo Investment Institute, Bloomberg; April 25, 2018. *For illustrative purposes only. An index is unmanaged and not available for direct investment.* **Past performance is no guarantee of future performance.**

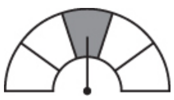
Brian Rehling, CFA
Co-Head of Global Fixed Income Strategy



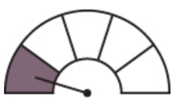
Unfavorable
U.S. Taxable Investment Grade Fixed Income



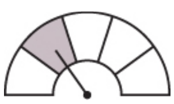
Favorable
U.S. Short Term Taxable Fixed Income



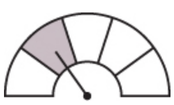
Neutral
U.S. Intermediate Term Taxable Fixed Income



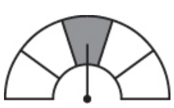
Most Unfavorable
U.S. Long Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

Borrowing costs are increasing

Higher interest rates have been a welcome development for investors who have been forced to deal with exceptionally low-rate choices for short-term investments. While many investors are focused on the impact (and opportunity) surrounding an interest-rate increase, it also is important to consider the effect of this change on borrowing costs. Borrowing costs are tied to interest rates, and they are increasing for many borrowers as the Federal Reserve (Fed) raises rates.

For borrowers, the most immediate impact of higher rates will be on loans tied to short-term or floating-rate debt. We have seen significant increases in short-term rate indices such as the London Interbank Offered Rate (LIBOR). Higher costs and an increase in debt payments for outstanding balances are the new realities for borrowers with debts that adjust based on an underlying short-term reference rate (LIBOR and the prime rates are examples).

For borrowers with short-term or floating-rate debt, we believe that now is the time to analyze your balance sheet and determine whether your current liability structure is appropriate for your situation.

Higher rates also are likely to impact fixed-rate debt costs for those looking to borrow. Fixed-rate mortgages closely track longer-term interest rates, such as 10-year Treasury yields. Over the past 7 years, rates for 30 year fixed-rate mortgages often have been at or below the 4% level. While we don't expect a dramatic increase in longer-term rates, rates are moving higher. Last week, the Bankrate.com U.S. Home Mortgage 30-year fixed rate national average stood at 4.50%. Given our expectation for slowly increasing longer-term rates, we expect these rates to continue climbing over time.

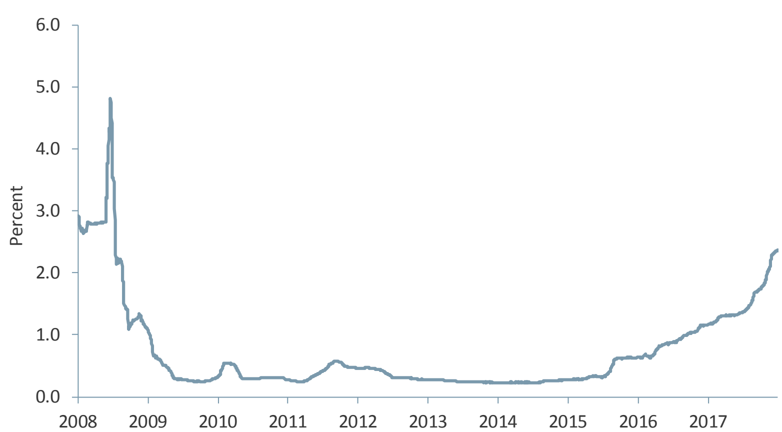
Key takeaways

» We look for interest rates to continue climbing.

» For those with debt tied to short-term or floating rates, we believe that now is the time to analyze your balance sheet to determine whether your debt structure is appropriate for your situation.

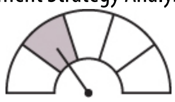
» Additional fed funds rate increases likely will have the greatest impact on borrowers with loans tied to short-term or floating-rate debt. Modestly higher borrowing costs for fixed-rate debt also are likely.

U.S. Three-Month LIBOR

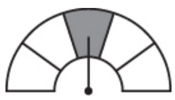


Source: Bloomberg; April 25, 2018.

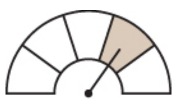
Austin Pickle, CFA
Investment Strategy Analyst



Unfavorable
Commodities



Neutral
Private Real Estate



Favorable
Public Real Estate

"Prosperity is a great teacher; adversity a greater."
--*William Hazlitt*

Tensions, tariffs, and sanctions—Oh my!

Tensions, tariffs, and sanctions have brought steel, aluminum, and soybeans into the national narrative, along with the regular attention hog—oil.

Aluminum prices shook off the proposed 10% tariff on aluminum imports that the U.S. administration announced in March. Yet they surged nearly 30% on April news of U.S. sanctions against one of the world's largest aluminum suppliers, Rusal. Aluminum prices have dropped 13% from that peak as the U.S. extended the deadline for sanction compliance until October (versus June) and provided criteria for the U.S. to consider lifting the sanctions.

Unlike aluminum, steel was not able to shake off news of a proposed U.S. import tariff, and prices spiked. China, in a retaliatory move, indicated that it would respond with several tariffs on U.S. imports, including soybeans (China is the largest consumer of U.S. soybeans).

And Middle East tensions and talks of reimposing sanctions on Iran have helped oil prices to reach levels not seen in years.

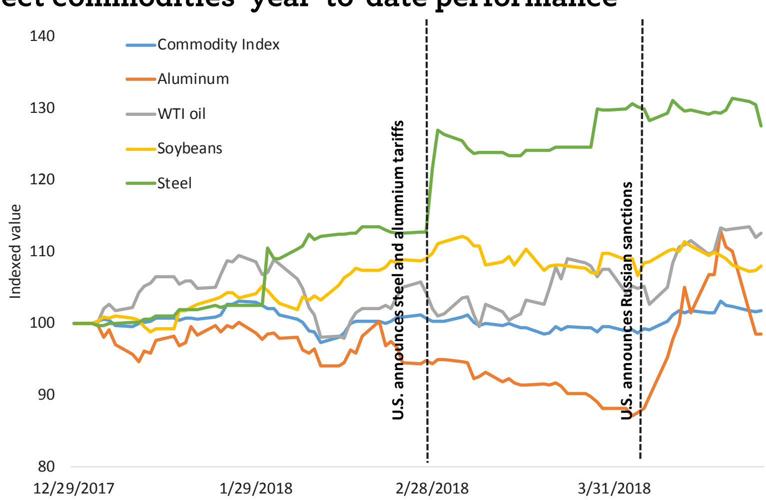
These actions can have a sizeable impact on prices of individual commodities. Yet, the impact on the overall commodity space is typically more limited. This can be seen in the chart below, which shows the year-to-date performance of aluminum, steel, soybeans, oil, and commodities overall. Notice the volatility in these individual commodities and how the Bloomberg Commodity Index has been flat (blue line). Unless trade wars, sanctions, and tensions escalate to the point that economic growth is threatened, the impact to the commodity complex as a whole likely will be limited.

Key takeaways

» Tariffs, sanctions, and Middle East tensions have driven recent commodity headlines and have had significant impacts on steel, aluminum, soybean, and oil prices and performance.

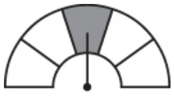
» Unless these developments escalate to the point of impacting global growth, we do not expect a sizeable impact to the commodity complex as a whole.

Select commodities' year-to-date performance

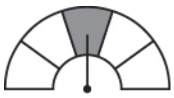


Sources: Wells Fargo Investment Institute, Bloomberg. Daily data: December 29, 2017 - April 25, 2018. Commodity index is represented by the Bloomberg Commodity Index (BCOM). Steel is represented by hot rolled steel. Indexed to 100 as of December 29, 2017. *For illustrative purposes only*. The Bloomberg Commodity Index is calculated on an excess return basis and reflects commodity futures price movements. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

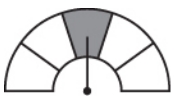
Justin Lenarcic
Global Alternative Investment Strategist



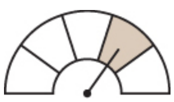
Neutral
Private Equity



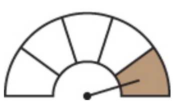
Neutral
Hedge Funds-Macro



Neutral
Hedge Funds-Event Driven



Favorable
Hedge Funds-Relative Value



Most Favorable
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.

Rising interest rates often are a tailwind for hedge funds

The impact of rising rates on the U.S. economy—and on equity and credit markets—has been a key investor concern. Much energy is being spent deciphering whether the recent increase in Treasury yields stems from a strengthening economy, concerns that inflation is accelerating, or other factors. Regardless of the cause, investors are considering how sensitive their fixed-income portfolios are to rising rates. They also are looking for ways to reduce duration.[2]

Hedge funds historically have done very well in a rising-rate environment. In fact, the chart below shows that the average return of the HFRI Fund Weighted Composite Index was nearly 19% over the nine rising-rate periods since 1990. This compares to slightly more than 1% for the Bloomberg Barclays U.S. Aggregate Bond Index.

Part of the reason for this outperformance is that hedge funds generally have very low duration and often reduce their interest rate exposure through swaps or other derivatives. Therefore, they do not feel the direct impact of higher yields in the same manner as traditional fixed-income investments would. Furthermore, many credit-based hedge funds focus on floating-rate securities such as residential and commercial mortgage-backed securities. Finally, higher interest rates can affect corporate balance sheets, which can potentially benefit strategies such as Long/Short Equity and Long/Short Credit that are predicated on distinguishing between financially strong and over-leveraged companies.

Key takeaways

» Hedge funds have historically performed well in rising interest rate environments.

» Interest rate sensitivity often is reduced through hedging, or through security selection where the focus may be on floating-rate securities (such as Structured Credit).

Hedge funds historically have performed well when yields increase

Start of rising rate period	End of rising rate period	Number of days	Change in U.S. 10-year Treasury yield (basis points)	HFRI Fund Weighted Composite Index	Bloomberg Barclays U.S. Aggregate Bond Index
Sep-93	Nov-94	455	2.46	13.6%	-3.3%
Dec-95	Jun-96	210	1.01	15.6%	0.0%
Sep-98	Jan-00	517	1.60	43.6%	1.6%
Jun-03	May-06	1094	1.71	41.3%	6.1%
Dec-08	Apr-10	515	0.92	24.5%	12.4%
Oct-10	Feb-11	150	0.92	7.1%	-0.9%
Jul-12	Dec-13	547	1.44	14.1%	-0.6%
Jul-16	Mar-17	273	0.94	6.8%	-1.9%
Sep-17	Apr-18	236	0.85	3.4%	-2.4%
Average		***444***	***1.32***	***18.9%***	***1.2%***

Sources: Wells Fargo Investment Institute, Wells Fargo Investment Institute, Hedge Fund Research, Inc. April 2018. 100 basis points equal 1%. *For illustrative purposes only.* HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager funds that report to HFR Database. The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based index that measures the fixed-rate taxable bond market. There is no certainty that hedge funds will perform in a similar manner as that shown in the table above in the current or in future rising rate environments. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

[2] Duration measures a bond's price sensitivity to interest rate changes.

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. **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. 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 impact consumer sentiment. Investing in **financial** services companies 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 & 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 excesses industry capacity, and a sustained rise in the dollar relative to other currencies.

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.

An index is unmanaged and not available for direct investment.

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