August 19, 2019

Gold—What Is It Telling Us?

John LaForge
Head of Real Asset Strategy

Key takeaways

- *Gold's recent run to six-year highs of about $1,520 has the investment community abuzz. We believe that gold is quite expensive at a level above $1,500.*
- *For gold to move significantly higher (to a price above $1,600), we believe that additional rounds of heightened concerns over interest rates, global economic growth, and trade disputes would have to occur together.*
- *While we expect additional trade dispute escalation, we anticipate stabilizing economic growth in the coming year.*

What it may mean for investors

- *We do believe that gold has a place in a well-diversified portfolio, but we caution investors not to own too much at these levels. Our year-end 2019 target range—and 12-month forward estimate—is $1,400-$1,500.*

Asset Group Overviews

"I can calculate the movements of heavenly bodies but not the madness of people." –Sir Isaac Newton

Market volatility is on the rise—and as history would suggest—investors are flocking to gold. Gold's recent run to six-year highs of about $1,520 has the investment community abuzz. This time last year, gold was trading at approximately $1,200 per ounce. The problem is that some investors do not understand gold, which can be dangerous. Flock to gold at the wrong time, and it can be painful—possibly for years. Most gold buyers between 2010 and 2018 either lost money or made only a little bit by the end of 2018.[1] Timing is key with gold.

We do believe that gold has a place in a well-diversified portfolio most of the time. As investors just witnessed, gold can offer upside and help reduce the downside during volatile times. Predicting these times is next to impossible—so owning some gold can be smart. As for today, we do recommend holding some gold, but we caution investors not to own too much. We believe gold is quite expensive at a price above $1,500. For gold to move significantly higher (to above $1,600), we believe that additional rounds of heightened concerns over interest rates, global economic growth, and trade disputes would have to occur together.

[1] Based on the $1,342 average price of gold from January 1, 2010 to December 30, 2018 and the $1,281 price of gold as of December 31, 2018.

Gold—What Is It Telling Us?

While we do expect additional trade dispute escalation, we anticipate stabilizing economic growth in the coming year. Our year-end 2019 gold target—and 12-month forward estimate—is $1,400-$1,500. Yet, there are cheaper alternatives to buying gold. For more insight on this question, please see "An alternative to pricey gold" in the August 6, 2019, Investment Strategy report titled *"Fed Cuts Rates—Why Now?"*

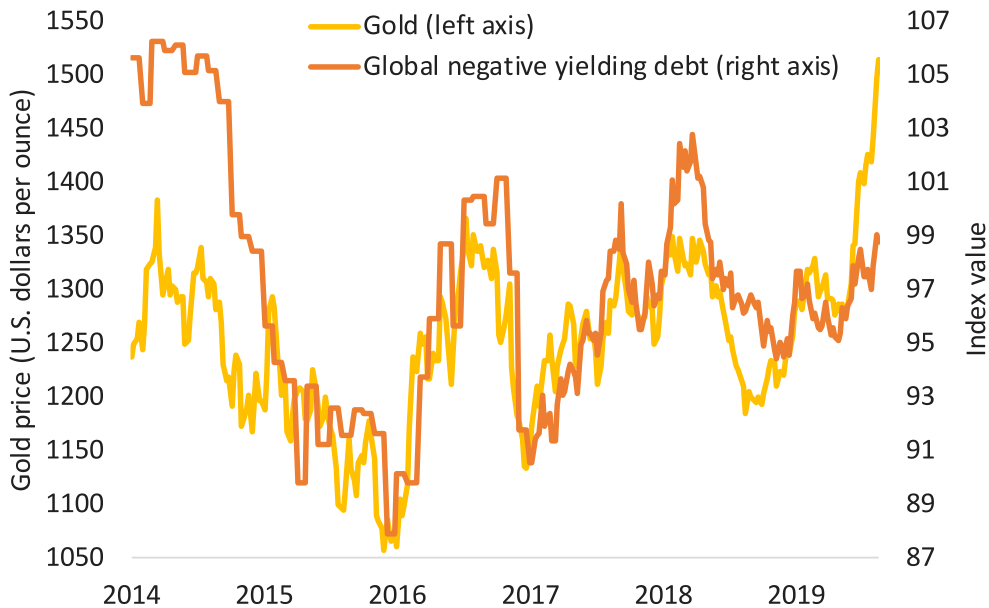
Back to understanding what moves gold—this is never easy, because gold is one funky asset. It is the chameleon of the investment world. Gold's price morphs and changes, depending on a wide range of investment drivers. At any given time, we'll hear a host of reasons why gold is moving and what message it may be giving to market participants. To make gold even more confusing, many of the reasons can be contradictory. Gold is being driven by inflation—no wait, deflation—no wait, fear—no wait, euphoria, sinking interest rates, rising interest rates, the color of the sun (Ok, this last one is pure sarcasm, but we have heard it said).

Investors like to pay attention to what gold may be saying, because it has history. It literally has survived time. And at times, it can tell us things about markets like no other asset. Yet, there can be a downside. Gold has been around so long—and has reacted to so many economic and geopolitical events—that sometimes it is claimed to be the "all-knowing signal" to help investors better understand our economic and geopolitical ills. We say, be careful here. Gold can be a good investment signal at times, but it has not been perfect, and it is not always understood correctly. So what is gold telling us today? The short answer is that there is lots of economic uncertainty. The more precise answer, in our view, is that gold's rally reflects mounting investor fears over: 1) collapsing global interest rates, 2) swelling amounts of global negative yielding debt, 3) inverting yield curves and central banks that are "behind" the curves, 4) heightened equity volatility, 5) slowing global growth, 6) volatile currency exchange values, and 7) escalating global trade disputes.

Of all of the fears listed above, gold appears to be reacting most to negative-yielding debt and inverting yield curves. Chart 1 shows the tight connection between the price of gold and global negative yielding debt. The reason is that gold can become a good alternative to bonds when their yields are negative. As an example, the 10-year German Bund yielded -69 basis points (-0.69%) last week.[2] Investors now pay to invest in German government debt. On the other hand, gold is not tied to a particular government. Investors do have to pay to hold gold (storing costs, etc.), but since gold is not tied to a particular government, this eliminates the risk that a government may act irresponsibly.

[2] One hundred basis points equal 1.00%.

Chart 1. Gold versus global negative yielding debt

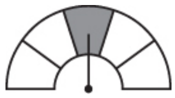


Sources: Bloomberg, Wells Fargo Investment Institute. Weekly data: January 3, 2014-August 16, 2019. Global negative yielding debt is represented by the Bloomberg Barclays Global Aggregate Negative Yielding Debt Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

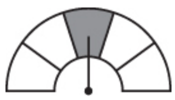
The bottom line is that we believe gold's 2019 rally tells us that investors remain fearful of: 1) collapsing global interest rates, 2) swelling amounts of global negative-yielding debt, 3) inverting yield curves and central banks that are "behind" the curves, 4) heightened equity volatility, 5) slowing global growth, 6) volatile currency exchange values, and 7) escalating global trade disputes. Yet, gold has become expensive. For gold to move significantly higher (to a level above $1,600), we believe that additional rounds of heightened concerns about interest rates, global economic growth, and trade disputes would have to occur together. While we do expect additional trade dispute escalation, we anticipate stabilizing economic growth in the coming year. Owning some gold in a diversified portfolio can be a good thing—we just don't recommend owning too much at these levels.

EQUITIES

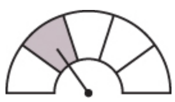
Scott Wren
Senior Global Equity Strategist



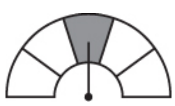
Neutral
U.S. Large Cap Equities



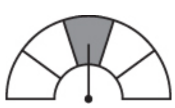
Neutral
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Neutral
Developed Market
Ex-U.S. Equities



Neutral
Emerging Market Equities

Second quarter emerging market earnings update—lackluster performance

With just over 36% of companies in the MSCI Emerging Markets Index having reported second quarter earnings results, we thought it would be a good time to share an update on the progress thus far. Emerging market (EM) reporting schedules always trail the bulk of S&P 500 company results. Thus far, the EM reporting season has been disappointing.

Coming into second-quarter reporting season, our work suggested year-over-year earnings growth would be slightly positive. The "Street" was more optimistic than we were, looking for an EM year-over-year earnings gain of just over 8%. But with 434 of 1,194 companies in the MSCI Emerging Markets Index reporting, second-quarter earnings have risen by approximately 0.2% (see table below). Sector results have varied significantly. Note that we are looking for full-year 2019 EM earnings growth of 2.1%.

We expect consumer-driven sectors, such as Consumer Discretionary, Real Estate, Consumer Staples, Health Care, and Financials to produce healthy earnings growth in most EM countries. In China, the largest weight in the MSCI Emerging Markets Index, the consumer has continued to push the economy and earnings forward. From a sector perspective, Information Technology has disappointed in many EM economies that are technology export-dependent—as trade frictions have reduced business capital ("capex") spending by a noticeable amount. Countries that are large technology exporters, such as South Korea and Taiwan, are seeing year-over-year earnings comparisons tumble by 30% to 60% or more.

Trade frictions have accelerated in recent weeks, and they represent a meaningful risk to our EM equity outlook.

Key takeaways

» With just over 36% of companies reporting, EM equity markets have had disappointing earnings results overall (+0.2% year-over-year). Results have varied significantly by sector.

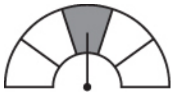
» Rising trade frictions represent a meaningful risk to our EM equity outlook.

Emerging market second-quarter earnings results through August 13

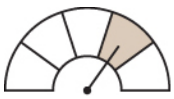
Sector/Index	Year-over-year % growth*
Consumer Discretionary	58.6%
Utilities	50.1%
Real Estate	40.1%
Industrials	19.6%
Consumer Staples	18.7%
Health Care	8.9%
Financials	8.2%
MSCI Emerging Markets Index	***0.2%***
Communication Services	-7.9%
Energy	-15.7%
Materials	-22.2%
Information Technology	-38.2%

Sources: FactSet, Wells Fargo Investment Institute, August 14, 2019. *In order of performance from strongest to weakest. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

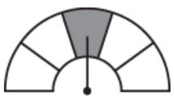
Luis Alvarado
Investment Strategy Analyst



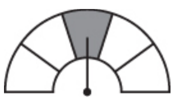
Neutral
U.S. Taxable Investment Grade Fixed Income



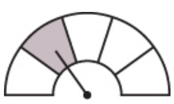
Favorable
U.S. Short-Term Taxable Fixed Income



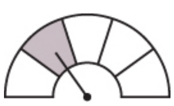
Neutral
U.S. Intermediate Term Taxable Fixed Income



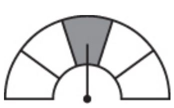
Neutral
U.S. Long-Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

An inverting Treasury yield curve

Yields on U.S. Treasury securities have returned to market focus as yields on longer-maturity issues have fallen abruptly in recent weeks—causing the yield curve to invert further. Yet, Treasury yields remain attractive relative to the negative developed market sovereign bond yields overseas (particularly in Europe). As trade uncertainties remain high and global slowdown fears mount, investors have moved assets into longer-dated U.S. Treasury securities as a perceived "safe haven" investment, in an effort to mitigate any "risky asset" fallout.

The Treasury yield decline has drawn investor focus back to yield-curve inversion as a leading indicator of a potential recession or economic slowdown. In the past, we have written about this topic in detail.[3] The 10-year Treasury yield versus 3-month yield indicator has been triggered—as it has been negative since May 23 and inverted by more than 25 basis points since August 5. Other key Treasury yield indicators (10 year minus 1 year and 10 year minus 2-year yields) have also inverted (the latter on an intraday basis last Wednesday).

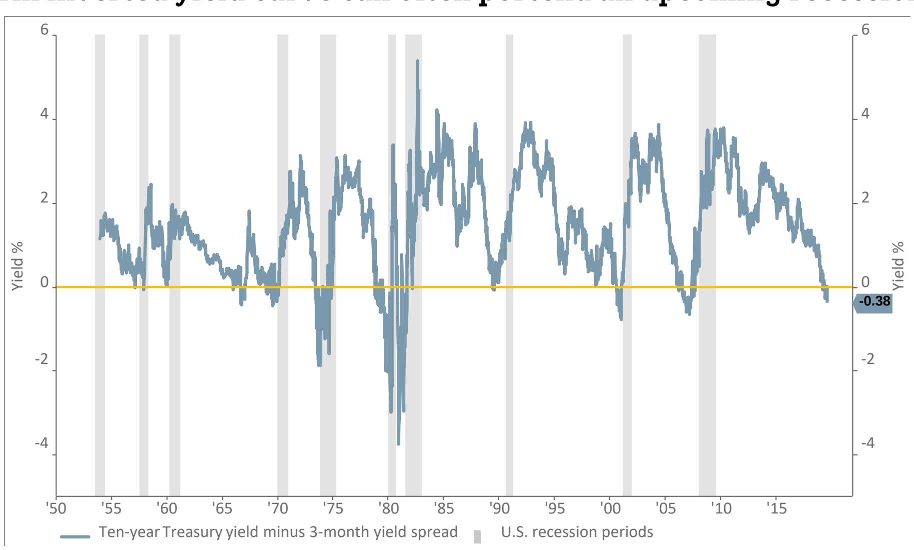
While the yield curve is foreshadowing a challenging future growth story, we would need to see a more generalized restriction in financial conditions and deterioration in economic fundamentals to become more concerned about a recession in the next 12 months. However, the odds of an economic downturn are increasing. We are currently monitoring these indicators and evaluating any potential investment impact.

Key takeaways

» Yields on longer-maturity Treasury securities have fallen abruptly over the past two weeks as investors have sought to mitigate any market fallout from risky assets.

» While the 10 year minus 3-month Treasury yield inversion indicator has been triggered, we believe that the story remains incomplete. We will monitor economic data for any potential trouble ahead.

An inverted yield curve can often portend an upcoming recession

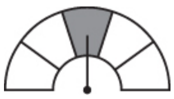


Sources: FactSet, Wells Fargo Investment Institute, August 12, 2019. Daily U.S. Treasury yield data from January 4, 1954 to August 12, 2019. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. **Past performance is no guarantee of future results.**

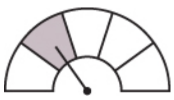
[3] Wells Fargo Investment Institute, "The Predictive Power of the Yield Curve", April 3, 2019.

Austin Pickle, CFA
Investment Strategy Analyst

"It is our responsibilities, not ourselves, that we should take seriously."
--Peter Ustinov



Neutral
Commodities



Unfavorable
Private Real Estate

Bond and equity markets are signaling concern. What say commodities?

Growth concerns and recession fears have spiked recently. We can see evidence of this market anxiety in several ways. The two most visible are: 1) the inverted U.S. Treasury yield curve, and 2) heightened equity market volatility. The commodity world has its own growth jitters indicator: the copper-to-gold ratio. As you may expect, it is painting a not-so-rosy picture right now. Let's take a look.

Copper, known as "Dr. Copper" in certain social circles, can be a useful tool to help gauge the health of the economy. When the economy is booming, many industries expand, and construction and manufacturing typically thrive. As a result, the demand for copper rises, causing its price to increase (and vice versa). Gold, on the other hand, is a perceived "safe haven" investment. When fears run rampant, the price of gold typically increases. The copper-to-gold ratio (the price of copper divided by the price of gold) can act as an early warning signal for the economy (notice how the ratio tends to track The Conference Board's Leading Economic Index in the chart below). When this ratio decreases, it essentially means that growth optimism is fading too. And the copper-to-gold ratio has decreased fairly precipitously since its April 2019 peak. In fact, the commodity market has not been so pessimistic since the 2016 global growth scare.

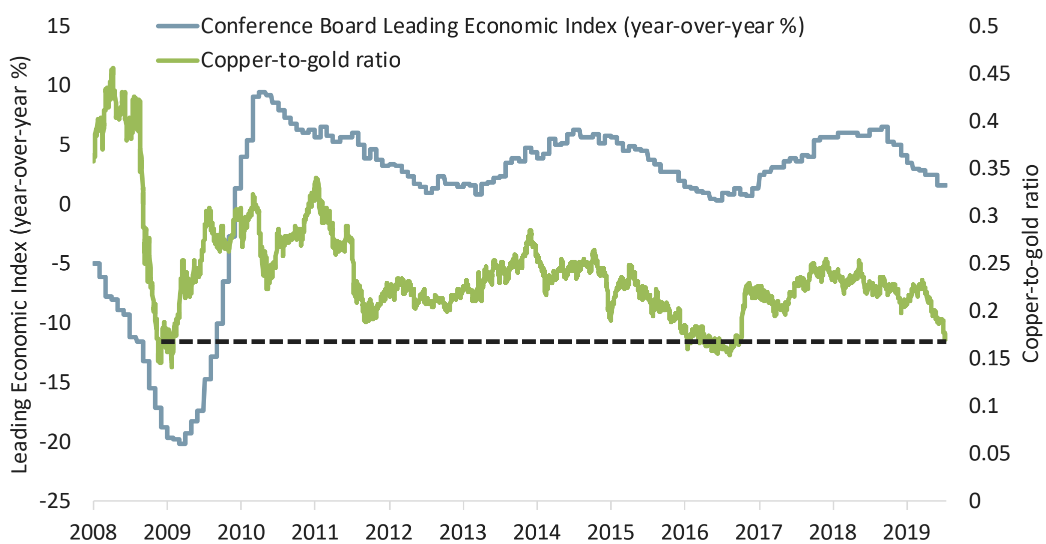
Bond and equity markets are not the only ones showing some concern.

Key takeaways

» Inverted bond yields and equity volatility are not the only signs of market angst.

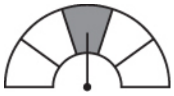
» The commodity market is exhibiting signs of concern as well—as the copper-to-gold ratio is at its second lowest reading since the financial crisis.

Copper-to-gold ratio and the economy

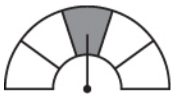


Sources: Bloomberg, The Conference Board, Wells Fargo Investment Institute. Daily data: January 31, 2008-August 14, 2019. The Leading Economic Index is a monthly index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

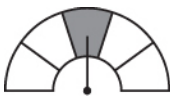
Ryan McWalter, CAIA
Global Alternative Investment Strategist



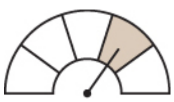
Neutral
Private Equity



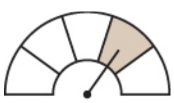
Neutral
Hedge Funds-Macro



Neutral
Hedge Funds-Event Driven



Favorable
Hedge Funds-Relative Value



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.

Stock correlations and the Equity Hedge strategy

Equity markets have performed well for much of the post-crisis era at a time of expansionary monetary policy. Stock dispersion also has been low as S&P 500 correlations have been above the historical average.[4] Yet, these correlations have declined in recent years (see chart).

History has shown that the lower S&P 500 correlations are, the stronger returns for the Equity Hedge strategy often are (this has been the case since the financial crisis, from April 2009 through July 2019). Over this period, when these correlations were below (or equal to) the historical average of 0.55, the average monthly return for the HFRI Equity Hedge Index was 1.3%. Conversely, when S&P 500 correlations have been above the historical average, the average monthly return for this index has been -0.2%.

While the Equity Hedge strategy has been susceptible to volatility spikes, crowded positions, and factor reversals, low U.S. large-cap correlations historically have supported positive Equity Hedge returns. Lower stock correlations can enhance the opportunity set for managers to add value from both long and short positions.

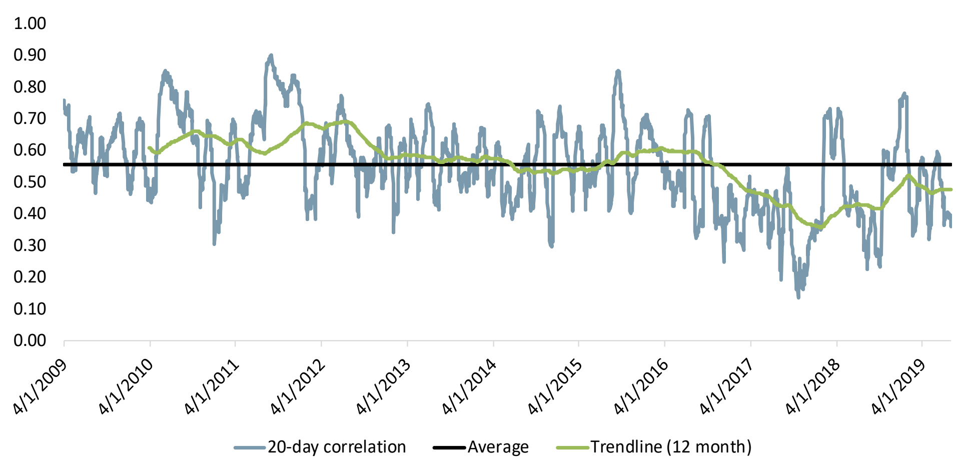
As we enter the latter stages of the market cycle, S&P 500 correlations remain below the historical average of 0.55 (standing at 0.40 on July 31). U.S. equity correlations may continue to decline as stocks recently have been reacting to earnings and other fundamentals. In such an environment, the Equity Hedge strategy can be a valuable complement to equity allocations—with the potential to participate in further market upside while also providing the potential to reduce downside participation.

Key takeaways

» Lower S&P 500 correlations (below the historical average) have led to solid returns for the Equity Hedge strategy.

» We remain favorable on Equity Hedge as we believe that the stock selection environment will provide strategy tailwinds, due to lower correlations and stocks reacting to fundamentals.

S&P 500 correlations are below the historical average



Source: Strategas Securities LLC, August 13, 2019. Chart shows data from April 1, 2019 through July 31, 2019. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

[4] Correlation measures how two asset classes or investments move in relation to each other.

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.

Investments in **gold and gold-related investments** tend to be more volatile than investments in traditional equity or debt securities. Such investments increase their vulnerability to international economic, monetary and political developments. They are also exposed to the risk of severe price fluctuations in the price of gold bullion.

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

The Bloomberg Barclays Global Aggregate Negative Yielding Debt Index is an index that includes only securities returning a negative yield within the universe of the Bloomberg Barclays Global Aggregate Index.

The **Conference Board Leading Economic Index** is an index that is compiled by the Conference Board, a private-sector consulting firm. The index is a composite of economic measurements as was designed in an effort to track and forecast changing patterns in the economy.

HFRI Equity Hedge Index: Investment Managers who maintain 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. EH managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short. The HFRI Equity Hedge Index is a composite of the hedge funds that employ the alternative strategies and who report their performance figure to HFRI. The number of hedge funds reporting may vary between each reporting period.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI.

S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

An index is unmanaged and not available for direct investment.

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