Asia Drives for Stability

How Stable Growth Can Offer New Opportunities for Investors

Paul Christopher, CFA
Head Global Market Strategist

Sean Lynch, CFA
Co-Head of Global Equity Strategy
<table>
<thead>
<tr>
<th></th>
<th>China</th>
<th>Japan</th>
<th>South Korea</th>
<th>U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross Domestic Product (GDP)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Per Capita</td>
<td>$8,113</td>
<td>$38,917</td>
<td>$27,538</td>
<td>$57,436</td>
</tr>
<tr>
<td>Growth Rate</td>
<td>6.80%</td>
<td>1.70%</td>
<td>2.40%</td>
<td>1.80%</td>
</tr>
<tr>
<td>Inflation</td>
<td>1.60%</td>
<td>0.70%</td>
<td>2.10%</td>
<td>2.20%</td>
</tr>
<tr>
<td>Unemployment¹</td>
<td>3.95%</td>
<td>2.80%</td>
<td>3.80%</td>
<td>4.20%</td>
</tr>
<tr>
<td>Population²</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10-Year Change</td>
<td>0.50%</td>
<td>-0.10%</td>
<td>0.40%</td>
<td>0.80%</td>
</tr>
<tr>
<td>Over Age 65</td>
<td>10.80%</td>
<td>27.90%</td>
<td>14.10%</td>
<td>15.60%</td>
</tr>
<tr>
<td><strong>Fixed Income³</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10-Year Yield</td>
<td>3.61%</td>
<td>0.06%</td>
<td>2.38%</td>
<td>2.33%</td>
</tr>
<tr>
<td><strong>Equities⁴</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Large-Capitalization Stocks</td>
<td>16.30%</td>
<td>6.30%</td>
<td>18.20%</td>
<td>12.00%</td>
</tr>
<tr>
<td>Price/Earnings (P/E) Ratio</td>
<td>16.4</td>
<td>18.2</td>
<td>15.5</td>
<td>21.6</td>
</tr>
<tr>
<td>Dividend Yield</td>
<td>2.00%</td>
<td>1.90%</td>
<td>1.60%</td>
<td>2.00%</td>
</tr>
<tr>
<td><strong>Currency⁵</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gain/Loss</td>
<td>4.70%</td>
<td>3.60%</td>
<td>5.30%</td>
<td>–</td>
</tr>
</tbody>
</table>


Yields and returns represent past performance. **Past performance is no guarantee of future results.** Yields may be lower or higher than those quoted. Yields will fluctuate as market conditions change.

¹GDP refers to total national output and is measured in U.S. dollars. Per capita GDP for 2016. Growth rate for fourth-quarter 2016 year-over-year average. As of December 31, 2016.

²Inflation is measured by 12-month changes in consumer price indices. As of September 30, 2017.

³As of September 30, 2017.

⁴This is the 10-year annualized population change for all ages. As of December 31, 2015.

⁵China, Japan, and South Korea are represented by 10-year yields on local-currency government bonds; the U.S. is represented by the yield on the 10-year Treasury note. As of September 30, 2017.

⁶Equity performance data are based on the CSI 300 Index for China, Nikkei 225 Index for Japan, KOSPI Index for South Korea, and S&P 500 Index for the U.S. Returns are local currency, year to date. P/E is based on 12-month trailing earnings. Dividend yield is based on the latest 12-month return. As of September 30, 2017.

⁷Gain/loss shows the currency’s 2017 change in value versus the U.S. dollar. As of September 30, 2017.
For decades after the desolation of the last century’s wars, South Korea and China have followed Japan’s export-oriented, fast-growth economic development strategy. All three countries:

• Have leveraged their populations’ large savings to compete closely in manufacturing and technology

• Have faced slowing population growth—or, in Japan’s case, declining population—and rising debt levels

• Have worried about the threatening prospect of an impoverished (but nuclear-armed) North Korea

More clearly than ever, our latest visit to the region showed three dynamic economies but also three neighbors locked in tough mutual competition—while sharing similar demographic and geopolitical challenges.

We found these challenges are driving each country to use its economic and labor resources more carefully to promote more sustainable economic growth rates that better support political stability. Our recent visit clearly showed that this switch in economic strategies presents potential investment opportunities. Yet, investors should be aware of the risks if the policies and attempts to change fail.

Key Questions Addressed in This Report

• Can aging populations force new economic efficiencies and stable economic growth?

• How might improving corporate governance, competition in innovation, and changing market compositions produce investment opportunities and a new way to think about Japan and the emerging Asian markets?

• What should investors know about the potential market volatility resulting from a nuclear-armed North Korea?
Demographics: Destiny and Driver of Change

Declining populations appear to be East Asia’s destiny. The chart below shows China’s and South Korea’s population growth slowing and Japan’s population already in decline. Some negative economic implications already are apparent. Worker productivity is low as more older, experienced workers are leaving the workforce than new, younger workers are entering it. The growing number of retirees prefers saving and lower spending, which together generally cool economic growth. These developments tend to benefit local currencies versus the dollar as local inflation rates fall.

The growing shortage of skilled workers also exposes structural problems in the labor markets. South Korea and Japan, for example, have long divided workers into so-called regular and nonregular workers. Regular workers are career-track employees who seek promotion and seniority and, ultimately, management experience and top wages. Nonregular workers divide their time between the workplace and home. The regular workers tend to be men, while the nonregular workers have been women and other part-time workers. For decades, this system helped limit the number of career-track workers, increasing their wages and benefits. The system also supported social norms that encouraged women as caregivers. In fact, neither day care facilities nor nursing homes are easily available in Japan. The tax system further encourages the labor force division by assigning tax benefits to families that have a nonregular worker.

All Three Countries Face Population Challenges

China’s and South Korea’s Population Growth Is Slowing; Japan’s Population Is Shrinking

Sources: Bloomberg, Wells Fargo Investment Institute; September 22, 2017
Now that populations are peaking or declining, however, leaders are looking to find new workers from the existing populations. For instance, Japanese leadership is pushing a reform program to raise retirement ages, open many more day care and nursing home facilities, change the tax code to encourage full-time work, and generally invite women and retirees to take career-path jobs.

Another way to add more workers or raise wages is to expand labor and product markets to other countries. China, South Korea, and Japan all have been active in seeking to send jobs to other countries, especially to where wages are lower. China used to be known as a center for inexpensive, mass-produced goods. Yet, in recent years, China has outsourced many of these low-value processes to Southeast Asia—especially Vietnam and Thailand. The chart below shows that all three countries—Japan, in particular—have been increasing their investments in production overseas. Meanwhile, Chinese workers today focus on higher-value processes, such as autos, computers, and electronics.

Investment in Overseas Production Is Increasing Across the Board
Foreign Direct Investment Stocks as a Percent of GDP

Sources: Organisation for Economic Co-operation and Development, Wells Fargo Investment Institute; September 22, 2017
Note: Foreign direct investment is investment in a country by residents in another country for the purpose of building an enterprise or part of an enterprise.
In addition, Japan is seeking broader trade as a way to expand its products’ appeal. For decades, Japan has promoted its exports but limited its agricultural imports as a way to protect its self-sufficiency in food. Strong global competition now limits this strategy’s effectiveness, especially because government subsidies and protection from foreign competitors have cost Japan’s farmers efficiency. Japan is now dropping protections on agricultural products in exchange for broadening markets around the world for its exports. The global trend in trade is toward more liberalized bilateral trade agreements, and Japan recently signed a free trade agreement with the European Union. This is a significant new opening for Japanese exporters.

**Market Implications and Risks**

If successful, China, South Korea, and Japan could broaden their export markets and extend female and older worker participation at home. These reforms could produce more stable, sustainable growth; finally banish deflation; and help service the debt these countries accumulated earlier in the economic development phase.

Broadening export markets to tap low-wage labor supplies could also benefit the markets of Southeast Asia. Countries like Indonesia and Malaysia have large populations whose incomes have been limited by dependence on commodity exports. As these economies diversify their industrial capabilities, they should

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**High National Savings Rates Relative to U.S. Rate Leave Less for Spending**

Gross National Savings as a Percent of GDP

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>30%</td>
<td>45%</td>
<td>40%</td>
<td>35%</td>
<td>30%</td>
</tr>
<tr>
<td>Japan</td>
<td>40%</td>
<td>50%</td>
<td>45%</td>
<td>40%</td>
<td>35%</td>
</tr>
<tr>
<td>South Korea</td>
<td>50%</td>
<td>55%</td>
<td>50%</td>
<td>45%</td>
<td>40%</td>
</tr>
<tr>
<td>U.S.</td>
<td>25%</td>
<td>30%</td>
<td>25%</td>
<td>20%</td>
<td>15%</td>
</tr>
</tbody>
</table>

*Sources: Bloomberg, Wells Fargo Investment Institute; September 22, 2017*
increase the value of their output and markets and reduce their market exposure to wide swings in commodity prices. Their currencies may also gain strength and be less variable—which should generally benefit investments based in other currencies.

So far, the reform progress has been slow, and the main risk is that the labor market reforms and trade negotiations will lose momentum, leaving consumer spending and economic growth to languish. South Korea and Japan have created plans to end the split between career and part-time workers, but the reforms tend to pause whenever global growth slows and policymakers grow cautious. We believe all three countries need stronger social security systems, day care, and nursing care in order to redirect excessive savings into spending (see chart on page 6).

Despite the risk to steady progress, we ultimately expect positive results from reform. We foresee that countries will avoid isolation risk by expanding trade with other Asian trading partners if new U.S. policies limit trade with Asia. Demographic pressure also should compel further changes. With Japan's population already falling, some analysts we met predicted a Japanese labor shortage of nearly 6 million workers by 2025 (unless it expands its markets and labor force).

**KEY TAKEAWAYS**

- Peaking or falling populations should push new policies to reallocate labor resources and raise spending.
- These policies currently are advancing slowly but should gain speed and effect as population declines create more pressure for change.
- A U.S. detour into trade protectionism could limit spending in Japan, China, and South Korea but also should accelerate bilateral trade agreements that could diversify these countries' economic growth drivers.
- Higher spending should reduce saving surpluses and lift inflation to historically average levels.
Can Valuations Play Catch-Up?

As the chart below and the table on page 9 show, equity valuations for China, South Korea, and Japan generally have trailed the comparable U.S. measures in the past five years. We believe these valuation discounts are a result of unfavorable long-term structural problems and concentrated market composition (that is, the relative importance of the companies in a local equity market). A second factor has been the degree of mistrust in corporate governance. The times are clearly changing with both of these factors. Innovation is a third factor that could affect both earnings and investors’ perceptions of value.

Equity Valuations Have Lagged the U.S.
P/E Ratios in South Korean, Chinese, and U.S. Equity Markets

Market Composition

One key axiom for investing is to know how and where you are invested. An investment in South Korea is as much a play on global semiconductor demand as it is on the country’s economy. One global technology leader makes up nearly 30 percent of the South Korean KOSPI 200 Index. Technology collectively has risen in importance across emerging markets and is the single largest sector by market capitalization in the KOSPI and Japanese TOPIX indices. Technology now accounts for approximately 27 percent of the MSCI Emerging Markets Index compared with 14 percent just five years ago, as shown in the table on page 10. We believe investors will pay higher valuations for Asian and emerging markets.
equities in the coming years as the technology sector, with its historically steady (and less variable) growth, replaces the more volatile commodity and materials sectors as the largest sector across these markets.

Comparative Equity Index Fundamentals and Performance Measures

<table>
<thead>
<tr>
<th>Index</th>
<th>Five-Year Average P/E</th>
<th>Consensus Next-12-Months (NTM) P/E Estimate</th>
<th>Five-Year Average Return on Equity (ROE)</th>
<th>Consensus NTM ROE Estimate</th>
<th>Five-Year Average Dividend Yield</th>
<th>Consensus NTM Dividend Yield Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>18.3</td>
<td>19.2</td>
<td>13.7%</td>
<td>16.4%</td>
<td>2.1%</td>
<td>2.0%</td>
</tr>
<tr>
<td>MSCI Japan</td>
<td>17.2</td>
<td>14.4</td>
<td>7.9%</td>
<td>6.0%</td>
<td>2.0%</td>
<td>2.1%</td>
</tr>
<tr>
<td>MSCI China</td>
<td>11.2</td>
<td>14.7</td>
<td>14.6%</td>
<td>12.7%</td>
<td>2.9%</td>
<td>2.0%</td>
</tr>
<tr>
<td>MSCI Korea</td>
<td>11.4</td>
<td>9.7</td>
<td>9.3%</td>
<td>12.6%</td>
<td>1.3%</td>
<td>1.7%</td>
</tr>
<tr>
<td>MSCI Taiwan</td>
<td>15.5</td>
<td>14.3</td>
<td>12.1%</td>
<td>14.9%</td>
<td>3.4%</td>
<td>4.0%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Index</th>
<th>Year to Date</th>
<th>One Year</th>
<th>Three Year</th>
<th>Five Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>NIKKEI 225</td>
<td>8.2%</td>
<td>25.9%</td>
<td>9.9%</td>
<td>20.2%</td>
</tr>
<tr>
<td>TOPIX (Tokyo)</td>
<td>12.3%</td>
<td>29.1%</td>
<td>10.3%</td>
<td>20.2%</td>
</tr>
<tr>
<td>KOSPI 200</td>
<td>22.0%</td>
<td>25.3%</td>
<td>9.1%</td>
<td>5.4%</td>
</tr>
<tr>
<td>Shenzhen SE A Share</td>
<td>1.8%</td>
<td>0.5%</td>
<td>15.1%</td>
<td>19.4%</td>
</tr>
<tr>
<td>Taiwan TAIEX</td>
<td>16.5%</td>
<td>17.6%</td>
<td>9.2%</td>
<td>9.8%</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>14.2%</td>
<td>18.6%</td>
<td>10.8%</td>
<td>14.2%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Index</th>
<th>Last-12-Months Earnings per Share (EPS)</th>
<th>WFII EPS Estimate 2017</th>
<th>Bloomberg EPS Growth Estimate 2017</th>
<th>Consensus EPS Estimate 2018</th>
<th>WFII EPS Estimate 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>$116.82</td>
<td>$129.00</td>
<td>13.1%</td>
<td>$145.99</td>
<td>$138.00</td>
</tr>
<tr>
<td>MSCI EAFE</td>
<td>$99.49</td>
<td>$121.00</td>
<td>28.0%</td>
<td>$136.32</td>
<td>$127.00</td>
</tr>
<tr>
<td>MSCI Emerging Markets</td>
<td>$68.50</td>
<td>$76.00</td>
<td>16.2%</td>
<td>$93.39</td>
<td>$84.00</td>
</tr>
</tbody>
</table>

Sources: Bloomberg, Wells Fargo Investment Institute; September 30, 2017

Returns and yields are based on local currency, not the U.S. dollar. Yields and returns represent past performance. Past performance is no guarantee of future results. Yields fluctuate as market conditions change. An index is unmanaged and not available for direct investment. Consensus estimates are actual, average earnings-per-share estimates from individual analysts. Estimates and forecasts are based on certain assumptions and views of market and economic conditions and are subject to change.

Corporate Governance

The second factor that could affect investor confidence is changing corporate governance. Japan enacted its first corporate governance code in 2015, and the Global Pension Investment Fund of Japan, the world’s largest, explicitly stresses key aspects of the governance code in its investment policies. The reforms aim to include outside directors, improve dividend policy, and prioritize profitability. Implementation will take time and may vary by firm, but our visit showed that outside directors are becoming more common. Investors also are realizing that market outperformers in Japan often have independent directors and fragmented shareholders.
### Technology Now Leads the Pack in Emerging Markets

Sector Size as a Percent of Total Index Based on Market Capitalization

<table>
<thead>
<tr>
<th>MSCI Emerging Markets Sector</th>
<th>1997</th>
<th>2012</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technology</td>
<td>0.6%</td>
<td>14.0%</td>
<td>26.9%</td>
</tr>
<tr>
<td>Financials</td>
<td>26.3%</td>
<td>23.2%</td>
<td>23.9%</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>13.3%</td>
<td>7.9%</td>
<td>10.2%</td>
</tr>
<tr>
<td>Materials</td>
<td>6.8%</td>
<td>13.1%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Energy</td>
<td>0.6%</td>
<td>12.4%</td>
<td>6.6%</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>9.0%</td>
<td>8.3%</td>
<td>6.6%</td>
</tr>
<tr>
<td>Industrials</td>
<td>17.2%</td>
<td>6.5%</td>
<td>5.5%</td>
</tr>
<tr>
<td>Telecommunication Services</td>
<td>14.9%</td>
<td>8.2%</td>
<td>5.2%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>–</td>
<td>1.8%</td>
<td>2.8%</td>
</tr>
<tr>
<td>Utilities</td>
<td>11.5%</td>
<td>3.6%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Health Care</td>
<td>–</td>
<td>1.1%</td>
<td>2.2%</td>
</tr>
</tbody>
</table>

Sources: Bloomberg, Wells Fargo Investment Institute; September 22, 2017

China and South Korea also are working to improve corporate governance. The inclusion of China’s MSCI A-shares into the broad MSCI Emerging Markets Index benchmark illustrates China’s growing importance to global financial markets. However, index providers like MSCI have called for Beijing to accelerate reforms for open markets and governance standards among Chinese companies. In South Korea, Lee Jae-yong, the grandson of the founder of Samsung and heir to the top position, recently was sentenced to five years in prison for trying to bribe former Korean President Park Geun-hye. President Park was impeached for corruption, and newly elected Korean President Moon Jae-in’s policies may look to promote transparency—especially among South Korea’s large conglomerates, known as the chaebols. Family-dominated boards are still a problem in South Korea, and as in China and Japan, the reforms are likely to move slowly.

### Technology, Innovation, and Intellectual Property Rights

China has moved up the value chain with respect to technology since our earlier visits during the past five years and is no longer a mere assembly platform for components made in Taipei or Seoul. Our latest visit revealed that China is taking major steps to innovate in digital technology, and we expect mega-cap technology companies to help drive this innovation. The work of assembling components already has begun moving to lower-wage countries (see chart on page 5), notably in Southeast Asia. Another change is that China is acting to enforce intellectual property rights.
In other parts of East Asia, the focus is on artificial intelligence, cybersecurity, and a move from machine learning toward deep learning in which computers study data patterns. The data come from satellite imagery, footfall traffic, social media tracking, and credit and debit card tracking, for instance. The other aspect of technology that will have material impacts on this region is autonomous driving. Japan, South Korea, and China rank among the top five countries in automobile production and are at the forefront of competition using this technology.

**Market Implications and Risks**

We believe the changing market composition, improved corporate governance, and innovation will attract more investors to the Chinese, South Korean, and Japanese equity markets—and that these markets will reflect higher valuations as investors seek to exploit these advantages.

Improving communication and transparency between shareholders and managers likely will expand investor comfort with these markets. Better corporate governance also should encourage firms to compete more on profit and dividends and thereby boost investor willingness to pay for these companies. Moreover, diversifying these economies beyond commodities and simple manufactures should support rising valuations. Finally, reducing the dependence on volatile commodity prices likely will reduce financial asset market volatility in these countries. As economic diversity, value added, and corporate transparency improve, we also anticipate that bond and currency markets will draw more investors.

The main risk to this more attractive combination of factors is that the corporate governance reforms could lose momentum under political pressure, especially if the economies slow and compel leaders to generate “growth at all costs” again. So far, the number of reformed boards of directors is relatively small. In Japan, only 31 percent of firms have nomination committees, for example.

**KEY TAKEAWAYS**

- Emerging equity market composition is shifting toward a broader array of industries that feature technology and electronics and de-emphasize commodities and materials.
- Over the course of our visits to China during the past five years, the shift from assembly and molded plastic to computers and other high-value electronics is impressive and gives the Chinese market more breadth.
- Innovation and the shift in market composition should support higher valuations and likely will reduce market swings as volatile commodity industry constituents have a lower market share.
- The main risk is that corporate governance reforms may lose momentum if slow economic growth and political pressure again prioritize growth at all costs.
The North Korean Nuclear Threat

We spoke with many analysts and economists, some government officials, and one former ambassador to the United States. The wide consensus among these observers was that North Korea's most likely immediate purpose is to quickly establish a credible nuclear threat to bring the U.S. to negotiate a peace treaty for the Korean conflict that includes withdrawal of U.S. forces from the peninsula. North Korea's economy is primitive, and much of its military technology dates back to the 1940s. The views we heard emphasized that North Korea fears for its survival and feels threatened by the U.S. troop presence in South Korea.

North Korean Development Lags China and South Korea
Satellite image shows lack of city lights compared with its neighbors

We also heard wide skepticism about a new war on the Korean peninsula, mainly because the risk appears to heavily outweigh the potential reward. North Korea's nuclear facilities are likely to be dispersed and may not all be susceptible to a U.S. air attack, but North Korean retaliation to a U.S. attack remains a high risk. Hundreds of thousands of American, Chinese, and Japanese citizens live in and around Seoul—all in the direct path of potential North Korean retaliation. So, of course, are the roughly 25 million South Koreans living in and around Seoul, which is a mere 35 miles south of the demilitarized zone.

Another preventive measure might be China's balanced attitude toward the North Korean regime. Beijing prefers a communist regime between its border and U.S. ally South Korea but also regards North Korea as a threat to regional stability. Thus, China supplies North Korea with energy and key supplies but holds North Korean leaders at arm's length. Statements from Beijing suggest China does not want a war and could intervene quickly to discourage an invasion or internal coup.1

During our visit, there was some concern about the North Korean threat, but many aspects of life were unaffected. We saw somewhat reduced tourism, but the Seoul shopping malls were full and the street traffic seemed even more congested than on our previous visits. One former South Korean diplomat noted that South Koreans fear a U.S. withdrawal more than a new war on the peninsula.

**Market Implications and Risks**

There is still room for considerable uncertainty and financial market volatility:

**Sanctions have not had a lasting financial market impact yet, but sanctions have degrees.** Early market reactions to missile tests and retaliatory sanctions were subdued, perhaps recognizing that North Korea can deflect most of the pain of sanctions to its population in order to continue nuclear weapons testing. Yet, the U.S. might sanction business with Chinese companies to encourage more Chinese economic pressure against North Korea. Such U.S. pressure could reduce Sino-U.S. trade, which could dent global economic growth and disrupt financial markets.

**Other responses could fuel greater investor concern.** North Korea could respond to the sanctions with a new escalation—for example, exploding a hydrogen bomb over the Pacific Ocean, which would be a new provocation, even if done away from shipping lanes. Washington could, in turn, respond by asking Japan and South Korea to accept U.S. short- or medium-range nuclear weapon deployments as a deterrent. Alternatively, the U.S. could attempt to intercept a North Korean missile. Whether it succeeds or fails, an interception attempt would probably alter the negotiating leverage between Pyongyang and Washington, D.C.—and could prompt a deeper reaction than those seen so far in global markets.

**Indecision among friends can be costly.** Uncertainty and market variability are likely while the U.S. and its allies disagree over a clear strategy. South Korea prefers negotiation while Japan sides with the U.S. for a tougher stance. Yet, South Korean public opinion shifted since the missile shots began last summer. Its polls now show that the public favors accepting U.S. interceptor missiles.¹ Ultimately, the allies must decide whether to tolerate a nuclear-armed North Korea.


**KEY TAKEAWAYS**

- A new war on the Korean peninsula seems unlikely. Risks clearly remain, but many viable alternatives are still available to all sides, and the potential risk of any preemptive military strike significantly exceeds the potential benefit.
- However, additional global market volatility is likely, depending upon how quickly and how much the U.S. and North Korean tactics escalate the risk of an unintended war.
- The potential risks cover a wide range of possible outcomes, and we recommend a broadly diversified portfolio to balance the unknowable outcome and investment trends we see.
Equities

Over the next several years, market composition changes, innovation, and corporate governance reforms are likely to raise earnings and support valuations closer to those in the U.S. These changes should promote faster economic and earnings growth generally and may generate new opportunities in East Asian consumer sectors and services. Medical, agricultural, and environmental-service sectors seem poised to be particular priorities of Chinese government planners. Equity markets appear fully valued in late 2017, but we also note that investor caution since 2012 may have left many portfolios below their long-term target allocations in international equities. Since our economic and market outlook is for multiyear improvement, we recommend that investors include East Asian exposure as they gradually complete their long-term target allocations in international markets.

Interest Rates and Currencies

There are implications for bonds and currencies, as well. Asia has very high savings rates (see chart on page 6), in part because social safety nets are small and narrowly defined. If local labor forces can grow and wages rise, spending should increase, reducing savings and thereby raising inflation and yields.

The potential currency effects are mixed, but we believe they will favor appreciating local currencies. Lower savings and higher inflation should trigger local-currency depreciation against the U.S. dollar. However, additional overseas demand and more attractive domestic investment opportunities for local investors should bring home some capital currently allocated overseas that, in turn, should support local-currency appreciation. On balance, the appreciation effects should be larger and favor U.S. and other dollar-based investors.
Index Definitions

CSI 300 is a weighted stock market index designed to replicate the performance of 300 stocks traded in the Shanghai and Shenzhen stock exchanges.

KOSPI Index is a capitalization-weighted index of all common shares on the Korea Exchange. The preferred shares are excluded in calculating the index as of June 14, 2002.

KOSPI 200 Index is a market-capitalization index that tracks 200 large companies that trade on the Korea Exchange.

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

MSCI China Index captures large- and mid-cap representation across China H shares, B shares, Red chips, P chips, and foreign listings (for example, American depositary receipts). With 150 constituents, the index covers about 85 percent of this China equity universe.

MSCI Japan Index is designed to measure the performance of the large- and mid-cap segments of the Japanese market. With 320 constituents, the index covers approximately 85 percent of the free-float-adjusted market capitalization in Japan.

MSCI Korea Index is designed to measure the performance of the large- and mid-cap segments of the South Korean market. With 112 constituents, the index covers about 85 percent of the Korean equity universe.

MSCI Taiwan Index is designed to measure the performance of the large- and mid-cap segments of the Taiwan market. With 89 constituents, the index covers approximately 85 percent of the free-float-adjusted market capitalization in Taiwan.

Nikkei 225 Stock Average is a price-weighted index comprising 225 blue-chip companies traded on the Tokyo Stock Exchange.

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.

Shenzhen A-Share Stock Price Index is a capitalization-weighted that tracks the daily price performance of all A-shares listed on the Shenzhen Stock Exchange, which are restricted to local investors and qualified institutional foreign investors.

Taiwan Capitalization Weighted Stock Index (TAIEX) covers all of the listed stocks traded on the Taiwan Stock Exchange, excluding preferred stocks, full-delivery stocks, and stocks listed less than one calendar month.

Tokyo Price Index (TOPIX) is a capitalization-weighted index of firms in the “first section” of the Tokyo Stock Exchange. The section organizes all large firms on the exchange into one group.

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. Currency risk is the risk that foreign currencies will decline in value relative to that of the U.S. dollar. Exchange rate risk between the U.S. dollar and foreign currencies may cause the value of an investment to decline. Bonds are subject to market, interest rate, price, credit/default, call, liquidity, inflation, and other risks. Prices tend to be inversely affected by changes in interest rates. These risks are heightened in lower-rated bonds.
About the Authors

Paul Christopher, CFA
Head Global Market Strategist


Prior to joining Wells Fargo, he developed economic strategies to trade in global financial and commodity futures markets for Eclipse Capital Management. In previous positions, Mr. Christopher supplied international economic perspectives for Wells Fargo predecessor A.G. Edwards and advised institutional clients of Istanbul-based Global Securities on the oil-based economies of the Caucasus and Central Asia. He has consulted with the governments of Hong Kong, Egypt, Russia, Kazakhstan, and the Kyrgyz Republic on monetary policy issues. He is based in St. Louis.

Sean Lynch, CFA
Co-Head of Global Equity Strategy

In his current role, Mr. Lynch is responsible for developing global equity strategy and oversees proprietary equity strategies as well as the equity trading desk. He has represented Wells Fargo to the media on numerous occasions, providing insights and perspectives on the global markets. He has also written extensively about global issues and the implications on client portfolios, appearing in Bloomberg, The Wall Street Journal, USA Today, Money, and also on CNBC.

Mr. Lynch has been with Wells Fargo for 20 years. Prior to his current role, he served as a global investment strategist for Wells Fargo Private Bank. He has traveled extensively internationally—from Asia to South America to Europe—to gather firsthand knowledge and information and has shared his observations and perspectives with clients and team members. He has been in the investment management and trust industry for 25 years. Mr. Lynch is located in Omaha, Nebraska.

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