WELLS FARGO
INVESTMENT INSTITUTE

Investment Strategy

WEEKLY GUIDANCE FROM OUR INVESTMENT STRATEGY COMMITTEE

September 18, 2017

Introducing Our 2018 Year-End Targets

Global Investment Strategy Team

Key Takeaways

» *Gradually rising, but benign inflation should produce small interest-rate increases, while we expect moderate global economic growth to generate low-to-mid single-digit total returns from current levels for most equity asset classes.*

» *The U.S. economic cycle is likely in the final third of its run, while the international expansion probably is in its first third. With these cycles at late and early stages, global growth still may face headwinds from various factors, especially the increasingly uncertain geopolitical landscape expected to await investors in 2018.*

What It May Mean for Investors

» *Late in the U.S. economic cycle, it becomes more important for investors to assess whether each investment's expected return offers adequate compensation for the expected risk. We recommend that investors use this report to assess expected risks against our return forecasts.*

The synchronized global recovery that took hold in 2017 should gain in 2018, though restrained by ongoing global headwinds from high debt, slow labor recoveries overseas and political uncertainties around the world. In addition, financial markets that now are fully valued may slow wealth creation. We believe that excess global commodity supply will hold key commodity prices within their 2017 ranges. We also anticipate that earnings gains will fuel moderately higher U.S. and international equity markets. With fixed-income demand still strong, we project limited interest-rate gains and some additional flattening across the yield curve. Nevertheless, we continue to project a positively sloped yield curve at year-end 2018—suggesting that more gas remains in the economic tank.

Risk awareness is basic to investing, but becomes particularly important late in the U.S. economic cycle. Investors should assess whether each investment's expected return offers adequate compensation for the anticipated risk. We recommend that investors use this report to assess expected risks against our return forecasts.

Asset Group Overviews

Introducing Our 2018 Year-End Targets

2018 Year-End Targets versus Current 2017 Estimates and 2016 Actuals

GLOBAL ECONOMY	2018 Year-End Targets	2017 Year-End Targets	2016 (A)
U.S. GDP Growth	2.4%	2.3%	1.5%
U.S. Inflation	2.2%	2.0%	2.1%
U.S. Unemployment Rate	4.2%	4.5%	4.7%
Global GDP Growth	3.6%	3.3%	3.2%
Developed-Market GDP Growth	2.1%	1.7%	1.7%
Developed-Market Inflation	1.9%	1.7%	1.3%
Emerging-Market GDP Growth	4.7%	4.4%	4.3%
Emerging-Market Inflation	4.3%	5.2%	5.7%
Eurozone GDP Growth	2.0%	1.6%	1.8%
Eurozone Inflation	1.6%	1.2%	1.1%
Dollar/Euro Exchange Rate	$1.16-$1.24	$1.08-$1.16	$1.05
Yen/Dollar Exchange Rate	¥110-¥120	¥105-¥115	¥117

GLOBAL EQUITIES	2018 Year-End Targets	2017 Year-End Targets	2016 (A)
S&P 500 Index	2450-2550	2300-2400	2239
S&P 500 Operating Earnings Per Share	$138	$129	$117
Russell Midcap® Index	1910-2010	1820-1920	1784
Russell Small Cap Index	1350-1450	1270-1370	1357
MSCI Europe, Australasia, Far East (EAFE) Index	1980-2080	1890-1990	1684
MSCI Emerging Markets (EM) Index	1090-1170	1010-1090	862

GLOBAL FIXED INCOME	2018 Year-End Targets	2017 Year-End Targets	2016 (A)
10-Year U.S. Treasury Yield	2.50%-3.00%	2.25%-2.75%	2.44%
30-Year U.S. Treasury Yield	3.00%-3.50%	3.00%-3.50%	3.07%
Fed Funds Rate	1.75%-2.00%	1.25%-1.50%	0.75%

GLOBAL REAL ASSETS	2018 Year-End Targets	2017 Year-End Targets	2016 (A)
West Texas Intermediate Crude Price ($ per barrel)	$40-$50	$40-$50	$54
Brent Crude Price ($ per barrel)	$45-55	$45-55	$57
Gold Price ($ per troy ounce)	$1,150-$1,250	$1,150-$1,250	$1,152

Sources: Forecasts and targets are from Wells Fargo Investment Institute; 2016 actuals are from Bloomberg; S&P Capital IQ. As of 9/18/17. A= Actual. Targets, forecasts and estimates are based on our current views of market and economic conditions and are subject to change. Forecasted returns are not guarantees of future performance which could differ substantially.

Economic Outlook

Summary: We foresee slow but steady U.S. economic growth, but economic expansion that is a bit stronger overseas. In addition, we expect moderate inflation in developed economies but easing inflation in emerging economies.

A steady U.S. economic-growth pace should extend through 2018, driven by ongoing gradual gains in consumer spending and housing. Flat business and government spending should weigh on growth, especially while tax reform remains uncertain. Stable commodity prices and gradual gains in shelter and service price inflation point to a continued slow U.S. inflation uptrend, from a low level. Overall, low inflation and steady economic growth should generate more jobs and point to a lower U.S. unemployment rate.

In the developed and emerging economies, steady commodity prices, stronger international trade, and rising confidence should drive growth. Still, slow European job growth and high debt levels around the world likely will limit the international improvement. Strengthening economic growth in developed Europe and Asia should fuel somewhat higher inflation. Finally, among the largest emerging economies (China, Russia and Brazil), less stimulative monetary policy and low, but stable, commodity prices should sustain the trend toward easing inflation. Political uncertainty poses the primary risk to our economic forecasts. U.S. tax reform could materialize in the first few months of 2018. In that case, sentiment, economic growth, and inflation could improve more than we forecast. By contrast, investors may be dismayed if Italian elections (due to be held in May 2018) were to deliver an anti-euro government. Further, global economic activity may suffer if U.S. trade policy turns restrictive (e.g., North American Free Trade Agreement [NAFTA] restrictions or sanctions on Chinese exporters). Negative political shocks could cool economic growth and guide inflation lower.

Currency Exchange Rates

Summary: We look for appreciation in the euro and in emerging-market currencies to drive U.S. dollar depreciation of between four and five percent.

We view rising U.S. interest rates and residual European political risks as only partial offsets to euro positives, which include recovering Eurozone economic growth and reduced monetary stimulus. By contrast, full-throttle Japanese monetary stimulus implies yen depreciation. Both the euro and yen are currently undervalued against the dollar, based on their respective inflation differences. However, the yen tends to revert more slowly to its inflation-based fair value while risk appetite attracts Japanese investors overseas. On balance, we expect a somewhat weaker yen, but our wide target range accounts for fluctuations for risk aversion around political risks.

We anticipate moderate emerging-market currency appreciation, ranging between four and five percent against the dollar. Investment flows have favored the emerging markets for two years. Emerging-market currencies may find some further support as U.S. interest rates remain low.

Currency-exchange-rate volatility arises mainly from a myriad of political and economic risks. Even beyond Europe's election risks, for example, China may accelerate its economic reforms, a potential negative for emerging-market currencies. Also, U.S. trade policy may become an issue for key currencies in Mexico, Japan, and Brazil. Finally, an unexpected shift to a more aggressive pace of U.S. interest-rate hikes could provoke sudden depreciation in exchange rates around the world.

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Co-Head of Global Equity Strategy

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Co-Head of Global Equity Strategy

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U.S. Equities: Modest Upside Potential in 2018

Summary: Somewhat stronger and broader global growth should support earnings growth and equity gains in 2018.

We expect stronger U.S. economic growth from mid-2017 through 2018, and we anticipate that stronger global growth will support S&P 500 revenue and earnings per share (EPS) growth of 5.5 and 7.0 percent, respectively, next year. Our initial year-end 2018 S&P 500 Index target range is 2450-2550 (versus 2300-2400 in 2017), alongside $138 in EPS. Our 2018 target represents an 18.1x trailing price/earnings (P/E) multiple that is in line with our year-end 2017 trailing P/E valuation, yet higher than the 16.7x long-term median multiple. Somewhat stronger global growth should favorably impact cyclically-sensitive industries' revenues and earnings in 2018, even as energy earnings comparisons become more difficult. Multinational companies should find additional support from the broader economic expansion and modest dollar weakness that we expect.

As noted, our 2018 valuation projection is in line with our 2017 trailing multiple. While we expect 7.0 percent S&P 500 Index earnings growth next year, following 10.0 percent this year, late-cycle increases in the federal funds rate and 10-year Treasury yield tend to pressure valuations. A full year of tax reductions next year, if implemented, could potentially benefit earnings growth for both large and mid-cap stocks by an incremental three-to-four percentage points. We continue to anticipate more volatility in the coming quarters, given full valuations, geopolitical risks, and monetary and fiscal policy risk—as optimism over pro-growth fiscal measures may fade heading into 2018.

For mid caps (Russell Midcap Index), we expect revenue and earnings growth of 5.5 percent and 8.8 percent, respectively, next year. We also foresee some margin expansion during the first half of 2018. The midpoint of our year-end 2018 target range is 1960 (versus 1870 this year). Our 2018 earnings forecast is $99. This represents a trailing valuation roughly in line with the index's long-term median. Mid caps, which historically have had more stable margins and earnings than small caps, typically exhibit better later-cycle performance than smaller-cap issues.

Current small-cap equity valuations appear to reflect a more normalized economic cycle. Yet, U.S. growth has been slower, and consequently, U.S. small-cap earnings have persistently disappointed. With a 48x trailing multiple, the index trades well over its long-term average 36x P/E valuation. While we foresee the potential for 18 percent earnings growth in 2018, the market appears to be reflecting even higher earnings levels. Small-cap margins, in this cycle, have remained low relative to those of other U.S. equity asset classes. Yet, earnings growth for U.S. small-cap equities could potentially benefit by an additional 14 percentage points if a full year of corporate tax reductions is implemented by Congress. Finally, small caps tend to underperform late in a cycle as investors may focus on high quality, lower-risk shares with greater market liquidity.

International Equities: Earnings Should Fuel Growth in 2018

Summary: Earnings should drive modest 2018 growth for international equities.

Improving earnings have carried the day for developed equity markets to date in 2017, and we expect that trend to continue next year. Most of the gains that investors have experienced in 2017 have come from earnings improvement, rather than higher valuations. We would expect more of the same in 2018—as our projected return for the group is very close to our projected earnings growth.

We foresee modest earnings gains for international developed markets in 2018. Our earnings target of $127 for the MSCI EAFE Index represents a 5 percent increase over our 2017 forecast. Our 2018 year-end target range of 1980-2080 for the MSCI EAFE Index should be supported by higher earnings, low interest rates, credit growth, and consumption continuing to improve across the globe. As noted, our valuation assumption calls for little multiple expansion in these markets. This is predicated on the belief that earnings are likely to grow more slowly in 2018. We felt that earnings needed to catch up to valuations in 2017 and believe that this will be the case in 2018. The risk to the upside is that earnings exceed our expectations and a new leg of growth in these markets leads to higher valuations. We view this upside risk as roughly balancing against the risk that interest rates rise, or that the tapering of Eurozone monetary stimulus may start to limit the nascent recovery in these economies.

Our year-end 2018 target range for the MSCI Emerging Markets Index is 1090-1170. We foresee slightly higher earnings growth in emerging markets (EMs) than in developed markets. Our 2018 earnings target for the MSCI Emerging Markets Index of $84 per share represents 10.5 percent growth over our 2017 target. Our projected P/E multiple based on our 2018 targets and earnings is 13.5x—slightly above the historical average of 12.3x. This reflects an improving earnings outlook from areas such as Information Technology (IT). Earnings stabilization in 2017 was one reason EMs have performed so well. In 2018, to maintain and build on 2017's market gains, earnings will have to continue improving. As with the developed ex-U.S. markets, we believe that investors will require additional evidence of sustainable earnings growth before sentiment will support richer valuations. In addition, we also see balanced risks between faster earnings growth and political risk, especially if global interest rates rise. Yet, the sector composition of the MSCI Emerging Markets Index has changed dramatically over the past five years as IT is now the largest sector, while Energy and Materials have been greatly diminished. This may result in higher EM valuations in future years.

	2018 Year-End Targets	2017 Year-End Targets	2016 (A)
S&P 500 Index	2450-2550	2300-2400	2239
Earnings Per Share	$138	$129	$117
Russell Midcap® Index	1910-2010	1820-1920	1784
Earnings Per Share	$99	$91	$75
Russell Small Cap Index	1350-1450	1270-1370	1357
Earnings Per Share	$39	$33	$29
MSCI EAFE Index	1980-2080	1890-1990	1684
Earnings Per Share	$127	$121	$103
MSCI Emerging Markets Index	1090-1170	1010-1090	862
Earnings Per Share	$84	$76	$63

Sources: Forecasts and targets are from Wells Fargo Investment Institute; 2016 actuals are from Bloomberg; S&P Capital IQ. As of 9/18/17. A=Actual. Targets, forecasts and estimates are based on our current view of market and economic conditions and are subject to change. Forecasted returns are not guarantees of future performance which could differ substantially.

FIXED INCOME

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A Modest Rise in U.S. Rates and Yield Curve Flattening in 2018

Summary: Continued monetary tightening is likely to further flatten the Treasury interest-rate curve. Demand for fixed income should remain strong—limiting concerns that interest rates could increase materially.

We expect the Federal Reserve (Fed) to continue tightening monetary policy slowly and deliberately in 2018; we look for two fed funds rate increases next year in addition to an expected rate increase late this year. We look for the Fed to slowly reduce its balance sheet throughout 2018. While balance-sheet reduction does not directly impact the federal funds rate, it is another factor that should allow the Fed to remain patient regarding future fed fund rate increases. Our expectations of modest growth, modest inflation and easing of the dollar depreciation trend also should help to limit the number of rate increases that could be expected in 2018.

We do not believe that Fed balance-sheet normalization will be a disruptive event in the fixed income markets. We also don't expect the Fed to sell bonds outright. Instead, we anticipate that the Fed will simply decrease the total reinvestment of maturing positions. The Fed's balance sheet should see a substantial increase in maturing securities from its Treasury holdings in 2018. As a result, even if the full balance-sheet reduction plan is implemented, the Fed will buy more Treasury securities through its reinvestment program in 2018, than in 2017.

As the Fed slowly raises short-term rates, we look for the Treasury yield curve to continue its flattening trend. Our year-end 2018 target for the 10-year Treasury yield is 25 basis points (0.25 percent) higher than our year-end 2017 target. Our year-end 2018 30-year Treasury yield target is unchanged from our 2017 target. While we expect curve flattening to continue next year, our 2018 rate targets still project a positively sloped yield curve at year-end—suggesting that more gas remains in the economic tank.

GLOBAL FIXED INCOME	2018 Year-End Targets	2017 Year-End Targets	2016 (A)
10-Year U.S. Treasury Yield	2.50%-3.00%	2.25%-2.75%	2.44%
30-Year U.S. Treasury Yield	3.00%-3.50%	3.00%-3.50%	3.07%
Fed Funds Rate	1.75%-2.00%	1.25%-1.50%	0.75%

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John LaForge, CFA
Head of Real Asset Strategy

Commodity Bear Super-Cycle Should Keep Oil and Gold Prices Range-Bound

Summary: For 2018, we expect $40-$50 per barrel West Texas Intermediate (WTI) crude oil ($45-$55 per barrel for Brent crude oil). Yet we suspect that gold prices will come under pressure, sinking below $1,300 per ounce, to our $1,150-$1,250 year-end target.

Oil

Our year-end 2018 target for the WTI oil benchmark price is $45 per barrel, the midpoint of our expected range of $40-$50 per barrel. Our 2018 projection is the same as our 2017 target—as oil continues to struggle with oversupply issues. In the longer term, on a strategic basis (10+ years), WTI oil appears stuck inside a commodity bear super-cycle (a very long-term cycle, some lasting decades)—which we believe has a wider range of $30 to $60 per barrel. For comparison, we target a $45-$55 per barrel year-end 2018 range for Brent crude oil. Brent crude oil should maintain a $5 per barrel premium over WTI while U.S. oil remains mostly oversupplied, and unavailable for export.

For 2018, we suspect that global supply and demand will continue to balance, but not enough to see oil prices move meaningfully higher. Oil prices remain volatile. There likely will be periods during which WTI prices exceed the top end of our $40-$50 per barrel range. Yet, we suspect that these rallies will not last. Rallies above $50 in the past three years have induced more oil production, which has kept oil prices from rising too high. We expect more of the same in 2018.

Gold

Our year-end 2018 target range for gold is $1,150-$1,250 per ounce, the same as in 2017. We believe that gold's 2017 rally will start to fade as we begin 2018, but there is always the chance that geopolitical risks worldwide could keep gold prices higher for longer. The history of commodity bear super-cycles suggests that gold should retest the lows seen in December 2015 of around $1,050 per ounce. We doubt that gold will fall quickly from today's $1,325 to $1,050 level, but we do believe that gold will start making its way lower in 2018.

GLOBAL REAL ASSETS	2018 Year-End Targets	2017 Year-End Targets	2016 (A)
West Texas Intermediate Crude Price ($ per barrel)	$40-$50	$40-$50	$54
Brent Crude Price ($ per barrel)	$45-55	$45-55	$57
Gold Price ($ per troy ounce)	$1,150-$1,250	$1,150-$1,250	$1,152

Sources: Forecasts and targets are from Wells Fargo Investment Institute; 2016 actuals are from Bloomberg; S&P Capital IQ. As of 8/28/17. A= Actual. Targets, forecasts and estimates are based on our current view of market and economic conditions and are subject to change.

Adam Taback
Head of Global Alternative Investments

Compelling Opportunities across Most Strategies in 2018

Modest economic growth, rising interest rates, and inflation approaching target levels historically have been supportive of active management in the alternative investment space. The added influence of monetary-policy divergence (especially the removal of liquidity in the U.S.), coupled with late-cycle dynamics, has the potential to generate a robust environment for alternative investments in 2018. We continue to expect opportunities across nearly all strategies, although there are subtle (but important) shifts taking place.

Within hedge funds, we anticipate that security selection opportunities could drive outperformance from both Relative Value and Equity Hedge strategies—given a more supportive active management environment. Both corporate and structured credit markets are exhibiting late-cycle behavior, and large-scale issuance (with weaker underwriting standards) is a precursor to opportunities for Long/Short Credit strategies. We believe that structured credit yields remain attractive relative to corporate credit yields, but our return expectations are moderating as recovery from the first quarter 2016 dislocation matures.

Within Equity Hedge, as long as correlation and dispersion metrics remain favorable, we anticipate an improving opportunity set for generating long and short alpha. Whether fueled by a tax reform package, or the desire for management teams to optimize corporate structure and generate growth, we anticipate another year of heavy deal volume that should support a variety of Event Driven strategies. While Merger Arbitrage strategies may be the immediate beneficiaries, we remain most excited about the emerging opportunity set within Distressed Debt investing.

The illiquidity premium of Private Capital strategies likely will increase in 2018. We expect this to be a function of late-cycle dynamics within the equity and credit markets. We see the best opportunities next year within small- and mid-cap buyout strategies, secondary purchases and venture/growth equity. We believe that Private Debt strategies focused on distressed debt and special situation strategies—especially internationally in areas like Latin America or post-Brexit Europe—are particularly compelling.

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.

Finally, we see continued opportunities within specialty areas of the real estate market that can capitalize on U.S. demographic trends or other themes internationally. Return expectations for core real estate are likely to moderate in 2018, with income the main driver (as opposed to price appreciation).

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.

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.

S&P 500 Index is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation and financial companies.

Russell Midcap Index measures the performance of the mid-cap segment of the U.S. equity universe.

Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index

MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of 21 developed markets, excluding the U.S. & Canada.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 23 emerging markets.

General Disclosures

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