SEEING THINGS DIFFERENTLY

Mike Serio CFA, CAIA, Regional Chief Investment Officer

December, 2017
Today’s Topics

• The **Diametrical** State of the Economy and Markets
• Why are we so Unhappy?
• Investment Themes
• Actionable Ideas
• Market Comments on Potential Tax Reform
• What is on Your Mind?
2017 Economics & Markets
The Nature of Anxiety

“The biggest big business in America is not steel, automobiles or television. It is the manufacture, refinement and distribution of anxiety”

Eric Sevareid
CBS, 1974
Economics—Global Trends

Global Economic Forces

Tailwinds
- No recession: global growth
- Pro-growth U.S. policies
- Low but rising interest rates/strong housing demand
- Earnings acceleration
- Consumer/business optimism on the rise
- Investor Sentiment

Headwinds
- Global populism
- Anti-trade, anti-immigration policies/sentiment
- Housing shortage
- Federal Reserve (Fed) raises rates faster than anticipated
- Rising geopolitical risks
- Investor Sentiment

Wells Fargo Investment Institute, February 2017
Where Are We Today?

StoCk MarkEt At REdOrd High

Source: Bloomberg, Wells Fargo Investment Institute. 6/30/2017. Past performance is no guarantee of future results. An index is unmanaged and not available for direct investing.
Where Are We Today?

Volatility is low

Index Level

2013 2014 2015 2016 2017

S&P 500 Volatility

Average

Source: Bloomberg, Wells Fargo Investment Institute. 6/30/2017. S&P 500 Volatility measured by CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Past performance is no guarantee of future results. An index is unmanaged and not available for direct investing.
Confidence Builds Despite Uncertainty

CONSUMER AND BUSINESS CONFIDENCE IMPROVING

Source: The Conference Board, National Federation of Independent Business (NFIB); Bloomberg, Wells Fargo Investment Institute. 6/30/2017. Shaded area represents a U.S. economic recession. The CCI tracks sentiment among households or consumers. The NFIB Small Business Index tracks the general state of the economy as it relates to businesses.
U.S. Unemployment Rate Reaches New Cycle Low

U-3 (Left) = Headline Rate

U-6 (Right) = U3 + marginally attached part time 8.3%

Source: Bloomberg Finance 8/17
Companies Favoring Labor Over Capital

JOB OPPORTUNITIES DEPEND ON EDUCATION

Companies Favoring Labor Over Capital

WAGE GROWTH TRENDING HIGHER

### The College Majors Employers Want

Employers are on the hunt for engineering, business and computer-science graduates; here's how popular those majors are among college seniors.

<table>
<thead>
<tr>
<th>MAJOR</th>
<th>PCT. OF EMPLOYERS LOOKING TO HIRE</th>
<th>PCT. OF SENIORS IN MAJOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business/Accounting</td>
<td>81.3%</td>
<td>19.2%</td>
</tr>
<tr>
<td>Engineering</td>
<td>75.9%</td>
<td>5.2%</td>
</tr>
<tr>
<td>Computer sciences</td>
<td>64.3%</td>
<td>3.1%</td>
</tr>
<tr>
<td>Economics/Social sciences</td>
<td>33.9%</td>
<td>8.8%</td>
</tr>
<tr>
<td>Physical sciences</td>
<td>20.5%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Humanities</td>
<td>11.6%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Agriculture</td>
<td>4.5%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Education</td>
<td>1.8%</td>
<td>4.8%</td>
</tr>
<tr>
<td>Health sciences</td>
<td>1.8%</td>
<td>11.4%</td>
</tr>
</tbody>
</table>

Note: Current hiring plans compared with degrees conferred in 2015
Sources: National Association of Colleges and Employers; National Center for Education Statistics

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**THE WALL STREET JOURNAL.**
The Divided Recovery – The Forgotten “Person”


Source: Lakner, Christoph and Milanovic, Branko, Global Income Distribution: From the Fall of the Berlin Wall to the Great Recession (December 1, 2013). World Bank Policy Research Working Paper No. 6719. Page 33, Figure 1(a). Data covers 1988 to 2011 in 5 percent increments. PPP = purchasing power parity, an economic theory that uses a “basket of goods” approach to compare different countries’ currencies.
The Divided Recovery

Technology has a tremendous impact on a firm’s need for labor.

Enterprise Value ($Millions)

Amazon: $363,900
Walmart: $257,300

Number of Employees

Amazon: 230,800
Walmart: 2,300,000

Average $ Value per Employee

Amazon: $1,576,789
Walmart: $111,870

Source: FactSet; as of 11/01/2016.
U.S. Consumer in Good Shape

Are We Going Into a Recession?

United States Treasury Yield Curve

Chart shows one week prior, one month prior and one year prior to 12/31/16.

Source: Bloomberg, Wells Fargo Investment Institute. 12/31/2016. Yields represent past performance. Past performance is no guarantee of future results. Yields fluctuate as market conditions change. Current yields may be higher or lower than those shown above.
Acrophobia

Acrophobia

S&P 500 Forward P/E

Source: FactSet. The 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. An index is unmanaged and not available for direct investment. Shaded area represents timeframe of a U.S. economic recession. Past performance is no guarantee of future results.
From All-Time High

- Commodities: - 67%
- International REITs: - 45%
- EM Equities: - 32%
- EAFE Equities: - 28%
- Alternatives: -10%
- EM Bonds: -7%
- Small-Cap.: -2%

Source: Bloomberg, April 20, 2017. Past performance is no guarantee of future results. Commodities represented by the DBC, Real Estate represented by the RWX, Emerging Market Equities represented by the VWO, EAFE Equities represented by the EFA, Alternatives represented by the HFRI Fund Weighted Composite Index, Emerging Market Bonds represented by the EMB, and Small-Cap stocks represented by the IWM.
Why Aren’t we Happy?

Source: Strategas

Difference is approx. $30,000 a family—but diametric
Regulatory policy has increased business costs

13%

Increase in regulatory cost for all businesses (2008 – 2012)

3x

The cost of regulation per employee (Small manufacturers vs. all businesses)

Source: National Association of Manufacturers, Small Business Administration; as of September 2014.
Where is the bottleneck?

Small Loans As a Percent of All Domestic Commercial & Industrial Loans

Source: Strategas
Home Prices Hit New Highs—Inventory Shortages

Source: Standard and Poor’s, NAR, Univ. of Michigan and Wells Fargo Securities
Key Points

In our view:
- Increased government spending
- Elevated state of polarity
- % promises kept (but not passed) will be larger than previous administrations
- Proposed tax reform
- Continued Populism
- Repatriation creates both economic and investment opportunity
Ratio of Wine/Spirits to Beer Positive!!

Source: Evercore 9/17
Ways We’re Seeing Things Differently
Resurgent Consumers

As unemployment rates drop, consumers have regained confidence.

Source: FactSet; latest data as of 12/31/2016.
In 2017, inflation may finally prevail over deflation.

Source: Bloomberg; as of 1/18/2017. Dotted Line represents Wells Fargo Investment Institute Year-end 2017 forecasts. Forecasts are not guaranteed and subject to change. Listing of the year represents start of the year.
View 3: Central Banks are at a Turning Point

Negative interest rates test the limits of monetary policy.

Developed Market Bonds Ex-U.S.

07/08/2016

Negative Yields at Peak

- 32% Negative Yields
- 68% Non-Negative Yields

1/23/2017

Negative Yields at Present

- 21% Negative Yields
- 79% Non-Negative Yields

Source: Wells Fargo Investment Institute; as 1/23/2017. Developed Markets represented by the JP Morgan GBI Developed Markets Index in USD. Yields represent past performance. Past performance is no guarantee of future results. Yields will fluctuate as market conditions change and may be higher or lower than those quoted.
Estimated Treasury and MBS Runoff Pace

Fed TSY Holdings Maturity Profile (Notes & Bonds, in $BNs)

Ignoring T-bills, TIPS, and FRNs, the maturity profile for the Fed's holdings is about $40-$60 billion a quarter this year and about $100 billion a quarter next year.

Source: Strategas
Commodities are Stabilizing

Commodities remain in a bear market, but we believe greater stability is likely.

Source: FactSet; as of 1/18/2017. Shaded area represents timeframe of a U.S. economic recession. Forecasts are not guaranteed and subject to change. Listing of the year represents start of the year.
Rolling Geopolitical Shocks

Geopolitical unrest has rippled across countries with limited market impact.

Europe (esp. Brexit)

- Brexit
- Frexit
- Grexit
- Outstria
- Beljump
- Swedone
- Quitaly
- Departugal…
- Czech-Out.
2017 Investment Themes
Four Key Themes for 2017

✓ The Divided Recovery
✓ Policies of Change
✓ The Agile Investor
✓ Investing Across Generations
FOCUS THEME ONE
THE DIVIDED RECOVERY
Global economic growth has slowed since the financial crisis.

Source: Wells Fargo Investment Institute, FactSet Economics Standardized Database; as of 11/15/2016. Latest data as 12/31/2015. CAGR = Compound Annualized Growth Rate. Real Gross Domestic Product (GDP) Values in 2005 USD.
Theme 1: The Divided Recovery

Wealth disparity in the U.S. is diametric and is on the rise.

Source: U.S. Census Bureau, Survey of Income and Program Participation, 1996 and 2008 Panels. All dollar figures are in 2011 constant dollars. The inflation adjustment factor of 1.34 was used to convert 2000 figures into 2011 dollars. Median net worth statistics within quintiles of the net worth distribution are at the 10th, 30th, 50th, 70th, and 90th percentiles. The first, or the bottom, net worth quintile includes households with zero or negative net worth. Net worth may be zero or negative because a household's gross wealth is zero or because the value of a household's liabilities exceeds the value of its assets. Due to weighting, the median of the third quintile may not exactly match the median of the overall net worth (or debt) distribution. Latest study data as of 12/31/2011.
FOCUS THEME TWO
POLICIES OF CHANGE
Theme 2: Policies of Change

Companies have deferred capital investments.

Source: Wells Fargo Investment Institute, Bloomberg; as of 12/31/2016. Listing of the year represents start of the year.
# Net Imports Explained

<table>
<thead>
<tr>
<th>Trading Partner</th>
<th>Total Trade ($M)</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>598,475.00</td>
</tr>
<tr>
<td>Canada</td>
<td>500,869.00</td>
</tr>
<tr>
<td>Mexico</td>
<td>484,509.00</td>
</tr>
<tr>
<td>Japan</td>
<td>201,505.30</td>
</tr>
<tr>
<td>Germany</td>
<td>162,236.70</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>113,598.80</td>
</tr>
<tr>
<td>South Korea</td>
<td>113,321.70</td>
</tr>
<tr>
<td>France</td>
<td>79,720.60</td>
</tr>
<tr>
<td>India</td>
<td>66,572.90</td>
</tr>
<tr>
<td>Switzerland</td>
<td>60,700.50</td>
</tr>
<tr>
<td>Italy</td>
<td>60,615.90</td>
</tr>
<tr>
<td>Ireland</td>
<td>57,267.50</td>
</tr>
<tr>
<td>Netherlands</td>
<td>56,019.90</td>
</tr>
<tr>
<td>Vietnam</td>
<td>53,196.00</td>
</tr>
<tr>
<td>Brazil</td>
<td>51,786.90</td>
</tr>
</tbody>
</table>

Source: Bloomberg
Theme 3: The Agile Investor

Strategic and tactical allocation impact returns.

# Theme 3: The Agile Investor

**Tactical shifts can help mitigate risks or enhance return potential.**

<table>
<thead>
<tr>
<th>Global Fixed Income</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Taxable Investment Grade FI</td>
<td>Overweight</td>
</tr>
<tr>
<td>U.S. Intermediate Term Taxable FI</td>
<td>Overweight</td>
</tr>
<tr>
<td>High Yield Taxable FI</td>
<td>Underweight</td>
</tr>
<tr>
<td>Developed-Market Ex.-U.S. FI</td>
<td>Underweight</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Global Equity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Small Cap Equity</td>
<td>Underweight</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Global Real Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Commodities</td>
<td>Underweight</td>
</tr>
<tr>
<td>Public Real Estate</td>
<td>Overweight</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Global Alternative Strategies*</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedge Funds—Relative Value</td>
<td>Overweight</td>
</tr>
<tr>
<td>Hedge Funds—Event Driven</td>
<td>Underweight</td>
</tr>
<tr>
<td>Hedge Funds—Equity Hedge</td>
<td>Overweight</td>
</tr>
</tbody>
</table>

Source: Wells Fargo Investment Institute, Tactical Allocations as of 1/18/2017.

*Alternative investments are not suitable for all investors. Any offer to purchase or sell a specific alternative investment product will be made by the product’s official offering documents. Investors could lose all or a substantial amount investing in these products.*
Investor Emotions: Market Timing

Average Equity Fund Investor Underperformed Benchmark (1996-2016)

- Average Investor Return: 4.67%
- S&P 500: 8.19%
- Inflation: 2.20%

Source: Dalbar, Inc. 2016, 20 years from 1996-2015; "Quantitative Analysis of Investor Behavior" by Dalbar, Inc. (6/6/2016) and Lipper. Dalbar computed the "average stock fund investor return" by using industry cash flow reports from the Investment Company Institute. The "average stock fund return" figure represents the average return for all funds listed in Lipper’s U.S. Diversified Equity fund classification model. All Dalbar returns were computed using the S&P 500 Index. Returns assume reinvestment of dividends and capital gain distributions. The fact that buy and hold has been a successful strategy in the past does not guarantee that it will continue to be successful in the future. The performance shown is not indicative of any particular investment. 

Past performance is not a guarantee of future results.
Good News: The Retail Investor is Leaving

Source: Strategas
Investor Emotions: Market Timing

Missing the Best Days in the Market

- Remain Fully Invested: 7.74%
- Missing 10-Best Days: 5.11%
- Missing 20-Best Days: 3.35%
- Missing 30-Best Days: 1.83%
- Missing 40-Best Days: 0.43%
- Missing 50-Best Days: -0.86%

Source: Morningstar Direct, Wells Fargo Investment Institute. 12/31/2016. For illustrative purposes only. Past performance is no guarantee of future results. An index is unmanaged and not available for direct investment.
FOCUS THEME FOUR

INVESTING ACROSS GENERATIONS
Theme 4: Investing Across Generations

The largest generational transfer of wealth on the horizon.

8-10% Transferred every 5-Years

4-6% Transferred every 5-Years

Theme 4: Investing Across Generations

Trading Places: Millennials have surpassed Boomers in the workforce.

Source: Wells Fargo Investment Institute, Pew Research Center. Note: percentages are based on the annual average in 1995 and the first quarter average in 2015. Due to data limitations, Greatest Generation not identified in 2015 and Silent Generation is overestimated in 2015; as of May 2015.
Theme 4: Investing Across Generations

Millennials are buying homes in a low inventory environment

Source: Wells Fargo Investment Institute, Census Bureau – International Database (last updated August 2016); as of 11/16/2016.

Census Bureau Projections after Year 2014. Listing of the year represents start of the year.
Theme 4: Investing Across Generations

Millennials concerned about entitlements and saving for the future.

“Social Security will not be available for me when I plan to retire”

- 74% Agree
- 26% Disagree

Believe Saving for Retirement is Important Part of Becoming a ‘Financial Adult’

- 85% Yes
- 11% No

Have Started Saving for Retirement

- 59% Yes
- 41% No

[Base: Total Millennials (n=1005)]
Update on Market Views of Tax Reform
Tax Reform

Market Placing High Odds on Passing, Less Positive on Repatriation

Source: Strategas 12/14/17.
Tax Reform

Potential Stimulus is Material

Source: Strategas 12/14/17
Key Points: Market Views

- Senate Tax Cuts and Jobs Act could add 1% to GDP in ’19. Stimulus works up to 2026. ‘03 tax cuts were very stimulative
- Bond market not pricing in magnitude of tax cuts
- More voters THINK their taxes will increase than decrease (wrong). Not factored into consumer stocks.
- Basket of net interest >30% underperforming
- Repatriation creates both economic and investment opportunity

Source: Strategas 12/14/17
Thank You!!

“Attention is the rarest and purest form of generosity.”

Simone Weil
What’s On Your Mind?

michael.serio@wellsfargo.com
Disclosures
Index Definitions

**Large Cap Stocks: 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.

**Mid Cap Stocks: Russell Midcap® Index** measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 25% of the total market capitalization of the Russell 1000® Index.

**Small Cap Stocks: 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.

**International Stocks: MSCI EAFE Index (Europe, Australasia, Far East) Index** (MSCI EAFE GR) is a free float-adjusted market capitalization index designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The index consists of the following 21 developed-market country indexes: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

**Emerging Market Stocks: MSCI Emerging Markets Index** (MSCI EM GR) is a free float-adjusted market capitalization index designed to measure equity market performance of emerging markets. The index consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

**Developed Market Bonds: JP Morgan GBI Index (JPM GBI Global USD)** is a total return, market capitalization weighted index, rebalanced monthly, consisting of the following countries: Australia, Germany, Spain, Belgium, Italy, Sweden, Canada, Japan, United Kingdom, Denmark, Netherlands, France and the United States.

**Commodities: Bloomberg Commodity Index** is a broadly diversified index that allows investors to track commodity futures through a single, simple measure. The index is composed of futures contracts on physical commodities and is designed to minimize concentration in any one commodity or sector. It currently has 22 commodity futures in seven sectors. No one commodity can compose less than 2% or more than 15% of the index and no sector can represent more than 33% of the index. Commodity weights are derived in a manner that attempts to fairly represent the importance of a diversified group of commodities to the world economy.

**Stoxx Europe 600 Index** is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 17 countries of the European region: Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom.
Asset Class Risk

Different investments offer different levels of potential return and market risk. Please see below for the risks associated with the representative asset classes.

Equity investments are subject to market risk which means their value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors.

Stocks offer long-term growth potential but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations.

The prices of small and mid-company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Investments in fixed-income securities are subject to interest rate and credit risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond’s price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. The prices of various commodities may fluctuate based on numerous factors including changes in supply and demand relationships, weather and acts of nature, agricultural conditions, international trade conditions, fiscal monetary and exchange control programs, domestic and foreign political and economic events and policies, and changes in interest rates or sectors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies which may expose investors to additional risks.

There are special risks associated with an investment in real estate, including the possible illiquidity of the underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

There is no assurance that any of the target prices or other forward-looking statements mentioned will be attained.