2017 Outlook
Seeing Things Differently
A Letter to Investors from Darrell Cronk

It’s not what you look at that matters, it’s what you see.
—Henry David Thoreau

2016 was punctuated by several short bursts of volatility and quick reversals. Early in the year, global financial and commodity markets pulled back on worries about four potential Federal Reserve (Fed) rate hikes and China’s potential economic weakness. In the end, these concerns failed to materialize, as caution in Washington and Beijing promoted stability. Midyear, the “Brexit” vote shocked global markets, but investors soon realized that any repercussions were likely months, if not years, away. Finally, the U.S. election drama captivated investors to the very end. If investors were looking solely at these events, they would not have seen what was quietly happening in the background—nearly all asset classes were moving higher, some significantly so. A year like 2016 reminds us that seeing beyond the day-to-day volatility matters when it comes to investment performance.

As we head into 2017, we are looking at the continuation of many trends, but we are starting to see things a little differently.

Five shifts that we believe warrant investors’ attention.

1. For starters, we’re seeing consumers finally enjoying mutually reinforcing positives from employment, housing, and rising wages. Job gains and strength in the U.S. housing market have been supporting household spending. Looking ahead, more sustained wage growth should bolster continued modest economic and corporate earnings growth next year.

2. We also are seeing inflation differently. Throughout this economic recovery, inflation has been subdued and below the historical average. That may be starting to change. We do not yet view inflation as a threat, but it does appear to be trending toward a more historically average rate. In some ways, a normalizing rate of inflation is a positive—one sign of an improving economy. However, if inflation were to continue to rise through 2017, it could cap equity valuations and generate additional volatility in fixed-income markets.

3. Higher inflation could change how investors anticipate Fed rate increases in the coming years, a potential negative for U.S. financial markets. Our view is that the Fed will tread cautiously and may allow inflation to run above its target to promote economic growth.
Commodity prices appear to have bottomed in 2016, but we don’t see a substantial rebound in 2017. Instead, we expect sideways commodity price action and less volatility. This is typical for commodities at this point of the cycle, as supply and demand continue to rebalance amidst moderate global growth.

Finally, we forecast more tremors along geopolitical fault lines. Globalization is broadening from trade in goods to more diverse trade that includes capital investment in new technologies and businesses. As new industries emerge and manufacturing struggles, widening income inequality could fuel political discontent. Democracies worldwide are straining to maintain standards of living for all, and we expect these frustrations to spark bouts of financial market volatility.

With these five shifts as a foundation, we advise investors to consider the following as they chart a course for 2017:

- Equity valuations may not advance broadly next year; thus equity gains could be more limited and harder to capture in index-replicating strategies. Selectivity may become more important. We think investors will need to be more selective and active within their equity portfolio.
- The potential for inflationary surprises and geopolitical stresses leads our tactical guidance toward a more conservative emphasis—a change from the past seven years. In particular, we suggest investing in higher-quality assets to help reduce the impact of volatility.
- Though we do not foresee a U.S. recession in 2017, we are monitoring factors, such as household and corporate debt levels, that could contribute to the end of the current economic expansion. We advise investors to begin preparing by keeping a diversified portfolio that eschews taking more risk for higher yield, and rebalances more often.
- As the economic cycle matures, qualified investors should also consider increasing allocations to non-traditional or alternative strategies within their portfolios, such as hedge funds and private capital funds, which present attractive opportunities.

We may continue to see unexpected outcomes in 2017. But, investors needn’t be caught off guard by them. It is our view that often the signs of change are evident, and it is how we respond to those signs that matters. When making investment choices, we think investors should take a broad perspective considering the complexity of the world and the speed at which change is taking place. We have titled our 2017 Outlook “Seeing Things Differently” because we want to kick off 2017 by encouraging investors to broaden their perspectives.

We are grateful to all of you for being our clients and wish you much investment success in 2017.

Darrell Cronk, CFA
President, Wells Fargo Investment Institute
Chief Investment Officer, Wealth and Investment Management
Asset Class Overview

Global Economy

- We expect continued U.S. economic growth, but the rate of expansion is likely to be modest due to household and business caution.
- Policy changes from the new leadership in Washington could affect the economy, but the most impactful changes would be complex and likely to take a number of years to implement.
- We maintain a neutral view on the U.S. dollar against its main developed-market competitors, but expect higher volatility against other currencies.

Global Equities

- We remain tilted toward U.S. large-cap equities.
- We believe that cyclical sectors should generally outperform defensive sectors, given cyclical's greater potential to generate earnings growth.
- We expect a modest increase in international developed-market earnings.
- We believe that emerging-market profits will stabilize.

Global Fixed Income

- Given the results of the presidential election, we could see a significant pivot toward fiscal-spending programs in the U.S. over the next few years. New fiscal uncertainties could increase bond-market volatility.
- We continue to expect the Fed to raise rates at a gradual pace.
- We advise investors to focus on potential risks in the credit sector (particularly in high yield) and avoid an over-allocation.

Global Real Assets

- We expect commodity-price gains to slow and volatility to moderate in 2017.
- We believe that commodities remain stuck inside a bear super-cycle.
- Opportunities may exist in individual commodities, especially among agricultural commodities.

Global Alternative Investments

- Security selection should remain favorable; we are constructive on strategies that have low net-exposure profiles such as Equity Hedge and Relative Value.
- Macroeconomic uncertainty and episodes of volatility could create opportunities for both the Equity Hedge and Macro strategies.
- We also remain constructive on international Distressed/Special Situation strategies, particularly in Europe.

Source: Wells Fargo Investment Institute, Nov. 30, 2016. Subject to change.
Focus Themes: What to Watch in 2017 and the Years Ahead

Today’s investors face a complex environment. In the U.S., the economic recovery has produced unequal benefits for the employed vs. the unemployed, savers vs. consumers, and small businesses vs. large corporations. This disparity has spilled over into the political landscape. Outside the U.S., many countries also are dealing with divisions from the long-drawn-out recovery, ethnic and religious differences, and geopolitical and economic disruptions. Moreover, global trade, which contributed greatly to economic expansion in past years, could be affected by protectionist policies. Here are four focus themes we are watching for the years ahead:

The Divided Recovery

We are currently in the latter stages of the business cycle, but this recovery has lagged prior recoveries and the benefits have accrued unevenly to different groups of investors, workers and countries. Fixed-income assets can help stabilize portfolio values in times of market distress; we favor intermediate-term high-quality U.S. corporate bonds within a well-diversified fixed income portfolio.

Policies of Change

Old and new government policies will attempt to extend the maturing economic cycle. The mix of policies should create potential opportunities, but investors may need to be more selective. Alternative investments can take advantage of the maturing economic cycle, which we expect to increase price dispersion in equity markets.

The Agile Investor

We anticipate potential opportunities for those who are able to determine which industries will benefit from the next phase of globalization, expanding populations, and other trends. In this environment, tactical decisions may enhance performance returns. We also see value in using both active and passive strategies.

Investing Across Generations

Baby Boomers and Millennials are trading places as the latter become the largest working generation and the former retire from the workforce. Boomers may want to acknowledge their expected longevity by including growth assets in their portfolios, while younger workers may want to start saving as early as possible for their retirement.
Start Seeing the Economy Differently

Many investors have been watching for a repeat of the 2008 financial crisis, but we see a different set of global economic challenges and opportunities. At home, a solid labor market, improved consumer spending and housing activity, and modest recoveries in business inventories and investment spending should drive continued U.S. economic growth. Yet, there is no apparent exuberance for spending on homes or financial assets, unlike earlier in the millennium. More the reverse: Excessive short-term debt and bank loans at businesses have preceded past recessions, but businesses have avoided this problem in recent years. Moreover, as the chart below indicates, households paid down debt over the past seven years, although this trend may be changing. We believe that a gradual recovery in debt could sustain the recovery beyond 2017, but household debt remains a factor to watch in the future.

Declining Household Debt Gives Consumers Spending Room

The financial crisis spurred Americans to shore up their personal balance sheets—household debt as a percent of GDP is currently at levels last seen back in 2002.


U.S. Recovery Heading Into the Latter Innings

The same trends suggest that the U.S. recovery has advanced to what, in baseball terms, might be a “seventh inning.” Looking ahead, wages should continue improving, but eventually should slow the pace of hiring. A pickup in consumer spending should gradually increase average household debt loads. Meanwhile, rising U.S. wage growth
and home-price appreciation, against low productivity gains, could accelerate inflation in 2017. The early steps in the new U.S. administration’s long-term tax cut and spending plans also may contribute to higher domestic inflation of around 2.2 percent at year-end 2017.

For its part, the global economic recovery is trailing that of the U.S. Recovering global trade and commodity prices should ease the recessions in commodity-producing countries such as Brazil and Russia and stabilize growth in other emerging economies.

When might the “bottom of the ninth inning” arrive with a new global economic recession? The timing and severity of the next contraction may depend on which excesses build in the economy and how quickly they develop. Rising debt loads and higher inflation ultimately could induce the next recession, possibly in two or three years. In particular, the faster (and more deeply) debt rebuilds, the more quickly the next recession is likely to come—and the more severe it is likely to be. Neither seems to be a large risk for 2017, but debt and economic challenges could become more prominent after 2017.

**The U.S. Dollar is Neutral—Awaiting Post-Election Clarity**

We maintain a neutral view on the U.S. dollar against its main developed-market competitors but are expecting potentially wide swings higher or lower. Dollar volatility may emerge as traders anticipate the implications of new U.S. leadership. Pro-growth fiscal stimulus should favor the dollar, but potential trade restrictions could trigger international retaliation, faster U.S. inflation, and a weaker dollar.

We also have a neutral outlook for the dollar against emerging-market currencies. Higher emerging-market yields may continue to attract capital flows to many of those currencies in 2017. Nonetheless, significant economic-growth challenges remain in emerging economies, while rising U.S. rates and range-bound oil prices should limit positive sentiment about emerging-market currencies.

**Risks to Our Outlook**

Policy changes from the new leadership in Washington could help or hinder the economy. U.S. trade restrictions could undercut growth and raise inflation, and wider government deficits could push borrowing costs higher. Meanwhile, risks abroad that seem unlikely today could develop over the coming years, including a financial disruption in China—if the country’s economic reforms miscalculate or China closes too many factories too quickly. Geopolitical risks also could escalate from a new European political crisis that prompts speculation about another fracture in the European Union.

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**INVESTOR WATCH**

› A U.S. recession does not seem imminent, but now may be a good time to align bond positions with strategic recommendations.

› The U.S. housing and labor markets support consumer spending but are not improving as quickly as before. A slower pace of improvement should limit increases in earnings.

› Inflation is still low by historical standards but is normalizing. This could jolt investors who are too complacent about low inflation.
S&P 500 Index Could Post Only a Modest Gain

Over the past 12 months, equity markets have managed periods of strong political and economic uncertainty, as well as times of optimism, as they anticipated the end of a four-quarter S&P 500 Index earnings recession. Since the U.S. elections, investors have leaned toward market sectors that could benefit from more growth-friendly economic policies.

› We foresee a 2017 S&P 500 Index gain of mid-single digits. Also, 2017 marks the first year of this market cycle for which we have not raised the index price/earnings (P/E) valuation.

› In 2015 and 2016, equity investors wrestled with the negative impact from the large decline in oil prices and Energy-sector earnings. We believe the four-quarter earnings recession ended in the third quarter of 2016. We also expect easier Energy-sector earnings comparisons in 2017 should allow S&P 500 Index earnings per share (EPS) to reach nearly $127.

› We enter 2017 with a neutral equity stance compared to a year earlier. In 2016, we tactically reduced our equity exposure by roughly four percentage points, and we expect moderate 2017 equity returns. While policy discussions next year may result in market volatility, many policies are likely to support long-term economic growth pursuits.

Energy-Sector Earnings Support the Broader Market

For more than a year, the Energy sector weighed down overall S&P 500 earnings growth. That trend began to reverse in 2016.

Sources: S&P Global Market Intelligence. The last points plotted are third-quarter earnings results aggregated as of Nov. 19, 2016. Past performance is no guarantee of future results.
Our tactical positioning still leans toward the large-capitalization S&P 500 Index, with an evenweight position for U.S. mid-cap stocks and an underweight for U.S. small-cap equities. We believe that these allocations represent a quality mix for domestic stocks. We also believe that cyclically-sensitive market segments should continue to outperform defensive segments, given their potential to generate earnings growth.

**International Fundamentals Appear to Stabilize**

We expect international developed markets to be heavily influenced by macro factors and by the potential for policy changes by the European Central Bank (ECB) and the Bank of Japan (BoJ). If we start to see the credit cycle improve, this would be a positive sign for the economy and markets. European banks have recapitalized, and most of them successfully passed the stress test administered in 2016. However, these financial institutions still could be impacted by unanticipated economic shocks.

We are expecting a modest increase in international developed-market earnings and believe that valuations will struggle to see any expansion of P/E multiples, given the modest economic outlook. The key driver of any earnings improvement will more than likely be the Financials and Consumer Discretionary sectors. Financials hold the largest weighting in the MSCI EAFE* (developed-market) Index. Further, the consumer should remain fairly healthy and help to drive consumption patterns that can fuel Consumer Discretionary returns.

Low developed-world interest rates, including U.S. rates, have attracted investors to potentially high-yielding emerging markets. The inflows from overseas have supported emerging-market currencies and equities this year. Emerging economies still face important challenges, and earnings have been declining since 2011. However, economic growth appears to be stabilizing, and low yields in the U.S. and developed economies provide time for emerging-economy fundamentals to improve. We see balanced upside and downside risks in 2017.

**Risks to Our Outlook**

An unexpected pickup in inflation or inflation expectations could result in higher-than-expected interest rates and the potential for overly aggressive tightening from the Fed. Excessive inflation could also put pressure on equity valuations. The major risk for developed markets is if central-bank policy is materially altered. If the ECB or BoJ decide to change course due to the perceived ineffectiveness of their easing policies, it would be a major negative for financial markets.

*Europe, Australasia, and Far East*

**INVESTOR WATCH**

- We are looking for 6 or 7 percent earnings growth for the S&P 500 Index in 2017. We remain tilted toward U.S. large-cap equities.
- International developed equity markets are likely to see a slight improvement in earnings. However, we would not expect much valuation expansion.
- We continue to favor quality issues and opportunities that offer cyclical earnings growth.

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**Equity Recommendations for 2017**

- **Overweight**
  - Large-Cap Equities
- **Evenweight**
  - Mid-Cap Equities
  - Developed-Market Equities
  - Emerging-Market Equities
- **Underweight**
  - Small-Cap Equities
- **Top Sectors**
  - Consumer Discretionary
  - Financials
  - Health Care
  - Industrials
  - Information Technology
Slow Rate Hikes With a Dose of Volatility

Economic growth is likely to remain subdued next year as slow productivity growth continues to be a weak link in the recovery. In the past, central bankers have reacted to the slow-growth environment by crafting new monetary tools in an attempt to provide economies with enough momentum to escape growth issues that have plagued global economies. Using monetary policy as a blunt instrument seems to be wearing thin. Many central bankers are now openly lobbying legislators to use fiscal spending to a greater extent to support the recovery effort.

However, because of growing government debt levels, governments have been hesitant to increase fiscal stimulus. Given the results of the U.S. presidential election, there is a potential that we will see a significant pivot toward fiscal-spending programs domestically in 2017. Globally, we could see new spending initiatives in Japan, but European governments, wary of rising debt levels, are likely to be less aggressive in crafting new fiscal stimulus.

Low Rates to Persist

Our year-end target for the federal funds rate is 1.00-1.25 percent. We continue to expect the Fed to raise rates at a gradual pace in 2017. It is unlikely that any new fiscal spending initiatives will meaningfully impact the U.S. economy or Fed direction in 2017. We believe that investors should focus on the gradual path of rate hikes rather than the exact months in which the Fed may increase rates.

Yields Are Anchored by Inflation Expectations

Even after turning higher after the elections, Fed Five-Year Forward Inflation Expectations remain at low levels, offering a good anchor for 10-year U.S. Treasury yields.
Fiscal uncertainty and occasionally stronger-than-expected inflation may spark yield volatility, however, our targets suggest longer-term yields should remain near current levels. Several long-term macro trends support a low-rate environment:

- Low inflation expectations—even as near-term inflation measures appear to edge higher. Forward inflation expectations offer a good anchor for longer-term Treasury yields.
- Global interest rates well below U.S. yields in many countries should continue to support domestic fixed-income markets as global investors seek higher-yielding assets.
- Significant government debt levels limit the potential for sustained fiscal spending.

**Portfolio Considerations**

**Credit:** Credit was one of the best-performing sectors, while investors sought yield. As prices have moved higher in credit, risks are more apparent and may limit price upside. We advise investors to focus on potential risks in the credit space (particularly in high yield) and avoid over-allocating, particularly to lower-credit-quality names.

**Municipals:** Near-term prospects for lower tax rates and higher issuance should put municipal securities under pressure. We would view further weakness as a buying opportunity and recommend focusing on higher-quality issues rated “A” or better, particularly in the essential-service revenue sector of the municipal market.

**International:** Developed-market bonds surprised with strong relative performance in the first half of 2016. However, in recent months, a strong dollar and rising rates have led these bonds to significantly underperform domestic fixed income. A neutral to somewhat stronger view of the dollar for 2017, yields that remain significantly below U.S. Treasury rates, and uncertainties about monetary policy in Europe and Japan lead us to maintain our underweight recommendation in this asset class.

The fundamentals of many emerging-market economies remain challenged, but we expect more stable returns in dollar-denominated emerging-market sovereign bonds. With valuations near historical averages, we recommend an evenweight position in emerging-market debt.

**Risks to Our Outlook**

An uncertain fiscal spending outlook could unexpectedly increase the pace of economic growth. Further, an unexpected pickup in inflation and inflation expectations could push interest rates above our year-end targets.

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**INVESTOR WATCH**

- At current valuations, we believe that Treasury Inflation-Protected Securities (TIPS) offer an affordable hedge against unexpected inflation that could emerge as trade strategies and fiscal plans become clearer.
- We continue to favor intermediate-maturity investments. We believe that their returns are likely to outpace those of short-term issues and cash alternatives in a low-rate environment. Long-term maturities can expose a portfolio to increased interest-rate volatility.
- We advise investors with an income-oriented strategy to diversify income sources and avoid overconcentration in below-investment-grade securities.

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**Fixed-Income Sector Recommendations for 2017**

**Overweight**

- U.S. Taxable Investment Grade
- U.S. Intermediate Term Taxable

**Evenweight**

- Cash Alternatives
- U.S. Short-Term Taxable
- High Yield Taxable
- Emerging Market

**Underweight**

- U.S. Long Term Taxable
- Developed Market Ex-U.S.

**Top Sectors for 2017**

- Inflation-Linked Fixed Income
- Essential Service Revenue
Commodities Stabilize While REITs Brace for Volatility

Our 2017 outlook for commodities is a neutral, or evenweight, position. Following decent price gains in 2016, we expect commodity-price gains to slow in 2017. We also suspect that price volatility will moderate relative to what we witnessed in 2016. On the positive side, this is the point in traditional bear super-cycles when some individual commodities could break away from the pack, offering unique opportunities. The chart below tracks the correlations between the Thomson Reuters Continuous Commodity Index (CCI) and its individual commodities. The correlations have started to weaken in recent years. We believe that this means the overwhelming influence of the current bear super-cycle is starting to diminish.

Shrinking correlations can provide individual commodity opportunities. In 2017, we believe that an opportunity may exist in the softs* and agricultural (food) sub-sectors. As for the two most popular commodities, gold and oil, we do not see much upside for either in 2017.

*Softs generally are commodities that are grown (e.g., cotton) instead of being mined (e.g., gold).

Weakening Correlation in Commodity Prices may Present Opportunities

The correlations between the Thomson Reuters Continuous Commodity Index and its individual commodities have weakened, possibly indicating a waning of the current bear super-cycle’s influence.

Sources: Bloomberg and Wells Fargo Investment Institute. Daily Data: Sept. 7, 1979 - Oct. 24, 2016. Correlations based on daily returns. Thomson Reuters Continuous Commodity Index comprises 17 commodity futures that are continuously rebalanced: cocoa, coffee, copper, corn, cotton, crude oil, gold, heating oil, live cattle, lean hogs, natural gas, orange juice, platinum, silver, soybeans, sugar no. 11, and wheat. When making the comparison, West Texas Intermediate crude oil futures were used as a proxy for crude oil.

Past performance is no guarantee of future results. An index is unmanaged and not available for direct investment.
Master Limited Partnerships (MLPs)
The performance of MLPs in 2017 should generally track that of oil prices, which we expect to be relatively flat. Today, many MLPs offer generous yields for investors, so total MLP performance, the combination of capital appreciation plus distributions, should outpace oil prices. At this point in the cycle, the greatest risk to MLPs is the threat of continued bankruptcies from their main customers, Exploration & Production (E&P) companies. E&P bankruptcies may have peaked this cycle, which should be beneficial for MLP prospects over the next year.

Real Estate Investment Trusts (REITs)
REITs performed strongly throughout most of 2016 as fundamentals were solid, yet prices started to fade in the third quarter, thanks to concerns about rising interest rates. We suspect REIT price performance will be slightly better from year-end 2016 through year-end 2017. Add in the average 3 to 5 percent potential dividend yield, and we're expecting mid-to-high single-digit total returns for 2017.

REIT fundamentals are generally sound today, albeit not as strong as we've observed in recent years. That said, we do have some concerns about REITs, which is why we recommend an evenweighting to this asset class as we enter 2017. Our greatest concern for REIT investors is that Fed rate hikes are likely in 2017, which could add volatility to REIT performance. In addition, price gains have started to slow, banks have been tightening lending standards, and insider sentiment has become nervous regarding future conditions. To be clear, these concerns are not outright negatives, just concerns at this point.

Risks to Our Outlook
While not our base case, the main risks to our outlook for commodities include a sinking U.S. dollar, rising inflation and inflation expectations, and stronger-than-expected global growth.

The U.S. dollar could become weaker than expected and lead to higher commodity prices. Today's commodity bear super-cycle could begin deviating from history. Since the bear began in 2011, it has largely tracked the typical historical pattern, but that could change in 2017. Meanwhile, OPEC might change course and decide not to defend oil prices from sinking back into the $20 range. This could have far-reaching commodity consequences beyond lower oil prices.

What Is a Super-Cycle?
If you look at commodity prices over the very long term (hundreds of years), it becomes evident that they tend to move in overall bull and bear cycles, some lasting decades. These are super-cycles. If a particular commodity (gold, for example) is in a bear super-cycle, you might see short-term bull markets, but over the longer term, lower prices would be expected.

INVESTOR WATCH

› Sideways commodity price action is likely for a few more years, but opportunities may arise in individual commodities and sub-groups.
› Flat oil prices in 2017 should support MLP investors—and, thereby, MLPs themselves—while MLPs should maintain generous distributions.
› Solid but not outstanding fundamentals should support mid-to-high single-digit 2017 REIT returns, but Fed rate hikes could add price volatility.
Global Alternative Investments

Prepare for Volatility

Alternative Investment Strategies Offer Opportunities in Uncertain Times

After a difficult start to 2016, alternative-investment performance rebounded due to managers right-sizing their portfolios and exposures as market volatility subsided and normalized. The third quarter was particularly strong, as the benefits of skill-based security selection and opportunistic asset allocation benefited portfolios.

Looking forward, we see a landscape that is potentially ripe with opportunities for alternative-investment strategies. Security selection should remain favorable, which is why we are more constructive on strategies that have low net-exposure profiles such as Equity Hedge and Relative Value. While investor demand for yield in a low-rate environment is likely to persist, rising prices and historically still-low interest rates, coupled with lower supply and increased demand, should continue to support the Structured Credit strategy.

Both Long and Short Alpha Reemerged in the Third Quarter

We were encouraged to see the short index decline and the long index appreciate in the third quarter.


A declining Goldman Sachs Hedge Fund VIP (Short) Index reflects a decrease in the price of short equity positions. Past performance is no guarantee of future results. An index is unmanaged and not available for direct investment.

While inflation may tick higher in 2017, we expect a modest pace of economic growth to persist. However, we remain cognizant of the risks of further pullbacks and market swings that can be exacerbated by macroeconomic uncertainty and episodes of volatility. We believe that this creates opportunities for both the Equity Hedge and Macro strategies that reflect our constructive-but-selective outlook for equity markets while reducing risk.
We also believe that Private Capital is among the most compelling opportunities for qualified long-term investors. We remain constructive on international Distressed/Special Situation strategies, particularly where European opportunities may unfold from Brexit. Additionally, Private Equity Energy Infrastructure could offer robust opportunities if U.S. infrastructure spending increases. Further, select Latin American and Asian markets are starting to appear attractive, particularly where the commodity downturn has exposed corporate overleveraging, battered currencies, and lowered entry valuations.

**Risks to Our Outlook**

Sudden pullbacks and rapid recoveries may not be an ideal environment for active management or alternative-investment strategies, particularly trend-following strategies. Liquidity and regulatory restrictions could produce volatility and mark-to-market losses in the credit-sensitive strategies, such as Structured and Distressed Credit. Finally, central-bank policy can distort asset prices, suppress volatility, and raise correlations—creating an environment that’s typically challenging for the Macro and Equity Hedge strategies.

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<tr>
<th>Relative Value</th>
<th>Equity Hedge</th>
<th>Private Capital</th>
<th>Macro</th>
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<td><strong>Overweight</strong></td>
<td><strong>Overweight</strong></td>
<td><strong>Evenweight</strong></td>
<td><strong>Evenweight</strong></td>
<td><strong>Underweight</strong></td>
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<tr>
<td>Structured Credit and Long/Short Credit may benefit in 2017 from supportive fundamentals and complement traditional fixed income. A steeper yield curve and an increase in fixed-income volatility could benefit Arbitrage strategies.</td>
<td>Globally diversified low-net managers can navigate higher volatility. This can allow investors to focus on unlocking value and complement allocations to traditional equities.</td>
<td>We favor Distressed/Special Situation strategies, particularly in Europe and emerging markets. Financials, Healthcare, and Energy sector changes should benefit infrastructure, venture and growth, buyout, and other strategies.</td>
<td>Low correlations to traditional fixed income give the Macro strategy diversification potential during volatility in fixed-income markets. However, sudden trend reversals (e.g., from monetary policy) are unfavorable for this strategy.</td>
<td>Lower default and policy uncertainties may limit gains for active investing. We remain cautious on the strategy. We see pockets of opportunity in stressed sectors, especially energy and retail companies.</td>
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**INVESTOR WATCH**

- We remain constructive but selective on global equity markets—but we do believe that the environment may become more challenging in the longer term.
- In anticipation of a challenging environment, we suggest strategies that can diversify investor portfolios, unlock value, or complement allocations to equity and fixed income allocations.
- Implementing alternative strategies that are Balanced, Opportunistic, Low-net and Tactical, or “BOLT”, can help investors to offset sudden bouts of volatility, minimize losses, and protect capital.
## Economic and Market Forecast

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<th>2017E</th>
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### Global Equities

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<td>S&amp;P 500 Index</td>
<td>2230-2330</td>
<td>2199 A</td>
<td>2044</td>
</tr>
<tr>
<td>S&amp;P 500 operating earnings per share</td>
<td>$127</td>
<td>$119 E</td>
<td>$118</td>
</tr>
<tr>
<td>Russell Midcap® Index</td>
<td>1750-1850</td>
<td>1767 A</td>
<td>1596</td>
</tr>
<tr>
<td>Russell Small Cap Index</td>
<td>1170-1270</td>
<td>1322 A</td>
<td>1135</td>
</tr>
<tr>
<td>MSCI EAFE Index</td>
<td>1660-1760</td>
<td>1630 A</td>
<td>1716</td>
</tr>
<tr>
<td>MSCI Emerging Markets (EM) Index</td>
<td>850-930</td>
<td>863 A</td>
<td>794</td>
</tr>
</tbody>
</table>

### Global Fixed Income

<table>
<thead>
<tr>
<th>Yield</th>
<th>2017E</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>10-year U.S. Treasury yield</td>
<td>2.00-2.50%</td>
<td>2.38% A</td>
<td>2.3%</td>
</tr>
<tr>
<td>30-year U.S. Treasury yield</td>
<td>2.75-3.25%</td>
<td>3.03% A</td>
<td>3.0%</td>
</tr>
<tr>
<td>Fed funds rate</td>
<td>1.00-1.25%</td>
<td>0.4% A</td>
<td>0.4%</td>
</tr>
</tbody>
</table>

### Global Real Assets

<table>
<thead>
<tr>
<th>Price</th>
<th>2017E</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>West Texas Intermediate Crude Oil</td>
<td>$40-50</td>
<td>$49 A</td>
<td>$37</td>
</tr>
<tr>
<td>Brent Crude price</td>
<td>$45-55</td>
<td>$50 A</td>
<td>$37</td>
</tr>
<tr>
<td>Gold price</td>
<td>$1150-1250</td>
<td>$1173 A</td>
<td>$1061</td>
</tr>
</tbody>
</table>

Sources: FactSet, Bloomberg, and Wells Fargo Investment Institute, Nov. 30, 2016
GDP = gross domestic product
E = estimate  A = actual price as of market close on Nov. 30, 2016
West Texas Intermediate Crude Oil is a light, sweet (i.e., low sulfur) crude oil which is the main type of U.S. crude oil traded in U.S. futures markets. Brent Crude Oil is a light, sweet crude oil extracted from the North Sea. It serves as a major benchmark price for purchases of oil worldwide.
Wells Fargo Investment Institute forecasts. Forecasts are not guaranteed and are subject to change.
2017 FOCUS THEMES
What to Watch in 2017 and the Years Ahead

Tracie McMillion, CFA
Head of Global Asset Allocation Strategy
Luis Alvarado
Global Research Analyst
Michael Taylor, CFA
Global Research Analyst

Chris Haverland, CFA
Global Asset Allocation Strategist
Tom Boden
Portfolio Manager
Paul Christopher, CFA
Head Global Market Strategist
What Makes This the Age of Discontent?

- The divided recovery has led to unequal benefits for market participants.
- Wage and real-income stagnation may be fueling protectionism and geopolitical unrest.
- Technology and innovation may be contributing to job/worker mismatch.

Impatience With Slow Global Economic Growth

By many measures, this has been a divided recovery with a distinct set of winners and losers. In the U.S., the economic recovery has produced unequal benefits for market participants. The employed vs. the unemployed, savers vs. consumers, and small businesses vs. large corporations are likely to have experienced this recovery differently. The U.S. economy has led the recovery for the past eight years among developed markets. While the domestic economy continues to expand modestly, the pace of growth has stalled around 2 percent and is not improving quickly enough for many.

For more than two decades, workers and businesses in emerging economies have competed increasingly effectively with those in the developed economies. The chart below illustrates how global growth has increased the lowest incomes (including in emerging economies) while incomes in the upper percentiles (mostly the advanced economies) have mostly lost ground—except for the wealthiest, who have been able to exploit global economic development.

Winners and Losers in Income Growth

For more than two decades, workers and businesses in emerging economies have competed increasingly effectively with those in the developed economies.

Source: Lakner, Christoph and Milanovic, Branko (Dec. 31, 2013), Global Income Distribution: From the Fall of the Berlin Wall to the Great Recession. 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.
Changing Workforce, Changing Demographics
In the U.S., one of the greatest challenges to advancing the economic recovery is regaining quality jobs lost to the financial crisis. Since 2010, the U.S. has created more than 15 million jobs and the number of unemployed workers has shrunk from 15 million in October 2009 to roughly eight million in October 2016. Yet, the focus has steered toward the quality of new jobs, the labor market’s ability to generate jobs, and the improving unemployment rate without reducing the labor-force participation rate.

Technology and innovation may have widened the gap for displaced workers as technological advancement has been accelerating faster than the ability of many workers to acquire new skills. As of September 2016, there were 5.5 million job openings in the U.S., while 7.9 million individuals remained unemployed. This mismatch of job skills with employer needs suggests that opportunities do exist for workers with the appropriate skill sets.

We are currently in the latter stages of the business cycle, but this recovery has lagged prior recoveries. Wages have lagged productivity for the past three decades, for low-wage workers and middle-income households in the U.S. The presidential election outcome surprised many and arguably for many is a call for a Washington outsider to remedy the growing divisiveness. Overseas, growing popular discontent has already produced the UK’s decision to separate from the European Union.

Change Creates Winners and Losers
The new U.S. administration’s promised policy changes eventually could significantly affect economic growth. Tax cuts and reform, along with increased spending and deregulation, may fuel faster economic growth but also may widen the government’s deficit, add to debt, and raise borrowing costs. Likewise, trade restrictions may help protected industries but could raise inflation by hurting domestic companies that rely on international supply chains. Changes to health care rules could reduce costs but are likely to create new uncertainties for businesses and workers.

Source:

Plan for the Unpredictable
In view of the populist sentiment and the varied possibilities of Washington’s responses, we recommend that investors stay diversified. If new policies support faster growth and inflation, equity exposure and real assets should benefit; if growth slows or if politics remain unpredictable, bond positions could benefit and stabilize portfolios.

Adjust to Market Swings
It is not unusual for policies to be approved and implemented slowly. In this case, the economy’s slow-and-steady improvement should support financial markets, but ongoing uncertainties about global political decisions may produce occasional swings. In cases where sentiment wavers but economic fundamentals are steady, we recommend rebalancing portfolios regularly to account for shifts in sentiment.

Go for Quality
Against the possibility of more geopolitical tensions, we suggest quality assets in the portfolio. Risks to long-term bond yields from the potential for higher inflation beyond 2017 lead us to favor intermediate-term high-quality U.S. corporate bonds.

Risks Warrant Caution
Uncertain monetary policy globally, added to potential risks from election outcomes in Europe, supports our recommendation to hold developed-market ex-U.S. debt below target allocations. Finally, emerging equity markets still face important challenges, although earnings growth appears to be stabilizing.
Will Growth Improve?

The new U.S. administration appears to favor tax cuts and rolling back regulations, which could be positive for U.S. growth.

Central-bank stimulus programs appear less effective since economic growth slowed in 2015.

The new U.S. administration’s policies may be more restrictive to global trade.

Government Stimulus Policies at an Inflection Point

Despite the record amounts of stimulus provided by global central banks, many developed countries are struggling to rejuvenate their economies. Central bankers have long acknowledged that accommodative monetary policy alone cannot lift economic growth. In our view, central banks are likely to continue accommodative policies, but some policymakers are looking for government spending policies to complement monetary policy.

The new U.S. administration is likely to try additional fiscal stimulus, but limits also apply to these policies. New tax cuts and extra government spending should spark economic growth and may raise productivity somewhat. However, the resulting deficit widening likely will raise borrowing costs and could undo much of the original benefit in later years. We believe that sustainable economic growth is most likely to result from a gradual reduction of unemployment and a reduction of excess factory capacity. Economies that utilize reforms to restore full employment may be attractive places to invest capital.

Trade Policies and Regulation Are Evolving

Sources: Wells Fargo Investment Institute and World Economic Outlook from International Monetary Fund (IMF); as of Oct. 2016. Dotted lines represent IMF projections.

Changes to U.S. trade policy from the new administration could hinder global trade prospects.
Volatility risk could come from political discord and inward-looking policies. According to a working paper published by the International Monetary Fund, there has been a growing debate about the impact of trade agreements and cross-border economic integration, particularly in regards to fair competition and the effect on jobs and wages. An important task for policymakers is to address the resentment toward global trade since prolonged uncertainty about the evolution of these protectionist trends may lead firms to defer investment and hiring decisions. This could, in turn, affect consumer sentiment and spending, slowing economic activity even further in the near term. If the new U.S. administration pushes trade restrictions, U.S. inflation could rise and undercut the U.S. dollar and fixed income values.

For perspective, we see clear evidence that globalization is not withering but merely growing in different ways. New communication technologies have taken global dependencies beyond trade in goods. For example, currency flows around the world total over $5 trillion per day, up four-fold since 2001, according to the Bank for International Settlements. Much of this growth in international flows has been directed toward investment in local manufacturing and service providers, especially in emerging economies.

Regulation is another important source of policy. Environmental regulation is still evolving and affects the Industrial, Energy, and Materials sectors. Since the financial crisis, governments have struggled to find a consensus view on regulation, especially on rules to help prevent another banking crisis. The new rules come at a time when many European, Japanese, Indian and other global banks have difficulty writing off bad debt and raising capital. Meanwhile, the new U.S. administration appears to favor rolling back the recently adopted rules for U.S. banks. The divergence in financial regulation policies could favor the U.S. Financials sector over international counterparts.


**IMPLICATIONS FOR INVESTORS**

**Increased Risk for Recession**

We expect increasing recession risks beyond 2017, as debt levels and inflation continue to rise, and as geopolitical tensions build. These factors suggest the need for broad diversification and more cautious portfolio positioning.

**Uncertainty in Long-Term Fixed-Income Markets**

While fixed income is an important component of diversified portfolios, volatility in longer-term fixed income may increase in the near term as potentially higher inflation in late 2017 fuels speculation about future monetary policy. Given the price sensitivity of longer-maturity holdings, we remain underweight this asset class.

**Look to Alternative Investments**

The maturing economic cycle may increase price dispersion in equity markets, potentially creating an attractive environment for alternative investments.

**Equity Sector Winners and Losers**

New policies could benefit loan growth and lending margins in the Financials sector. Lower corporate taxes could benefit capital spending and hiring. Consumer Discretionary should benefit from job and consumer-income growth. Some Health Care industry segments could benefit from less aggressive regulatory action, and more infrastructure and capital spending could benefit the Industrials and Information Technology sectors. As we enter 2017, we expect the more defensive sectors likely will receive less attention from investors.
FOCUS THEME THREE
THE AGILE INVESTOR

What Strategies Do We Believe Are Right for Now?

- We expect several asset classes to trade within a range of values in the coming years.
- Tactical decisions may enhance asset performance in this environment.
- Active managers may find opportunities to add return in the coming years.

In navigating the complexities of today’s economic environment, market participants appear especially sensitive to macro conditions. Investors and investment professionals alike may be challenged to generate returns amid an uncertain political and financial landscape, mounting government deficits, and an increase in consumer and business skepticism.

Fixed income, equities, and commodities may all trade within a range of values in the coming years. We anticipate potential opportunities for those industries that will benefit from globalization, new technologies, expanding populations, alternative energy, and other trends. In addition to a long-term multi-asset-class approach, we see better prospects for dynamic shorter-term positioning for investors. This includes the ability to resize allocations according to our macroeconomic outlook and to adjust tactically based on shifting fundamentals and market sentiment.

Investors Are Opting for Passive Over Active Strategies

Since 2005, equity investors have chosen passive strategies over active, mainly due to lower costs and performance considerations.

Sources: Wells Fargo Investment Institute and Morningstar Direct; as of Oct. 31, 2016. Data extracted from Morningstar Asset Flows Database. It includes the Asset Flows of U.S. Equity Open-end Mutual Funds and Exchange Traded Funds excluding Money Market Funds, Fund of Funds, and Obsolete Funds. Categories: Active and passive are defined and grouped by Morningstar. Actively managed means the manager uses discretion to choose securities that the fund owns in accordance with a particular investment strategy; passively managed means the manager does not use discretion to choose securities that the fund owns but seeks to construct a portfolio that replicates or mirrors a benchmark index, such as the S&P 500.
Consider Active and Passive Investment Management
Passive investment vehicles have nearly half a century of history. But only recently, asset flows from active managers to passive strategies have intensified. In fact, cost and performance considerations have favored passive strategies since 2005 (see chart on page 22).

We believe active and passive strategies offer different advantages and drawbacks. Passive strategies generally are inexpensive and easy to implement in a diversified portfolio. Yet, investors should recognize the benefits that active management can add to an investment strategy and evaluate managers based on their merits vs. lower fees. Given that active strategies tend to be more expensive to implement in a diversified portfolio, investors may want to consider passively managed, lower-cost exchange-traded funds (ETFs). On the other hand, investors can find attractive characteristics among many active managers, including the manager’s ability to take advantage of market inefficiencies and to base their trading activity on research and not just on changes to an index.

We believe the active/passive debate does not yield a clear-cut winner. In our view, both strategies can be utilized together to help maximize expense reduction without fully eliminating the investment opportunities offered by active managers. More important than choosing one approach over another is identifying the appropriate strategic and tactical allocation that will help investors achieve their goals. Moreover, our work suggests that active managers may outperform their passive peers in the latter part of a recovery, where we believe this recovery may currently be.

Tactical Decision-Making
Knowing one’s investment goals, time horizon, and risk tolerance are the key starting points for building an investment plan, but manager selection and tactical shifts can enhance the effectiveness of the plan. Our analysis shows that asset allocation is responsible for explaining, on average, 79 percent of the variation in portfolio returns. Tactical allocation, on the other hand, explains about 7 percent of the variation in returns.¹ Tactical adjustments may allow investors to exploit temporary market dislocations and mitigate short-term risks. Tactical asset allocation also includes seeking higher-quality investments when market volatility is more likely. Managing downside risk is crucial for smoothing overall portfolio performance. Additionally, drawing on the appropriate active or passive strategy based on market conditions may help enhance returns.


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IMPLICATIONS FOR INVESTORS

Think Long Term
Consider a strategic asset allocation that includes exposure to fixed income, equities, real assets, and, for qualified investors, alternative investments based on long-term investment goals and risk tolerance.

Adjust Short Term
Your strategic allocation may be enhanced with shorter-term tactical adjustments that may help capitalize on market dislocations and seek to minimize downside risk.

Mix it Up
Select a mix of active and passive strategies that are appropriate for current market trends and reflect your investment goals, time frame, and risk tolerance. Maintain an allocation to liquid assets (such as cash or cash alternatives) that can be used as a source of funds when opportunities arise.

Keep Your Portfolio Aligned to Your Goals
Rebalance regularly back to strategic targets so market movements do not inadvertently alter your portfolio’s risk profile.
How Do You Prepare for the Next Step?

- Many feel the U.S. is facing a retirement crisis, exacerbated by perpetually low interest rates.
- Over the next few decades, the Baby Boomers and Millennials will be trading places.
- The largest generational transfer of wealth is expected to occur over the next several decades.

A major societal shift is about to occur. Over the next few decades, the Baby Boomers and Millennials will be trading places. Baby Boomers will move out of the workforce as Millennials become the largest segment of U.S. workers. This generational shift will drive evolving investment goals for both generations. Baby Boomers will be entering the spending phase of their retirement plans, while Millennials will need to develop and adhere to investment plans to help provide for future expenses.

The largest generational transfer of wealth is expected to occur over the next several decades. Investors with sound investment plans and defined investment objectives should be better equipped to navigate through this journey successfully.

Simple Questions, Complex Answers

Since the end of the financial crisis, economic conditions have increased the complexities of managing a successful retirement strategy. Low interest rates and uncertain fixed-income returns—along with public-debt levels and fiscal imbalances near all-time highs—are among the macroeconomic considerations facing those

Largest Generational Transfer of Wealth on the Horizon

approaching retirement. Meanwhile, possible changes to fiscal and tax policies from the new administration augment this complexity. Based on our findings, prospective retirees are more concerned than ever about outliving their savings. We found that 81 percent of workers and 70 percent of retirees feel retirement in the U.S. is in a “crisis state.”

In some cases, retirees have seen their incomes decline due to low interest rates. Furthermore, many of the country’s pension plans are underfunded with implied discount rates that are significantly higher than current market rates.

At the other end of the generational spectrum, Millennials, those between the ages of 22 and 35, are just starting to build their financial lives. Our findings show that this group is split—55 percent feel financially well off, while 44 percent do not. The same study found that 48 percent of this demographic are living paycheck to paycheck, and 34 percent carry a student-debt load averaging nearly $20,000. This leaves little means for many Millennials to save for retirement. Yet, it is important for this planning to begin early, as compounding has the most significant impact on savings over longer periods of time.

**Intergenerational Wealth Transfer**

The U.S. will experience an unprecedented intergenerational wealth transfer of an estimated $30 trillion over the next 30-40 years. The intergenerational transfer of assets from the “Silent Generation,” born from 1928 to 1945, to their children, mostly Baby Boomers and those in Generation X, has had a sizable impact on generational wealth. However, there will be a significantly larger intergenerational transfer that could occur in two stages over the next 30 to 40 years.

› In the first 15-year stage, every five years will see 4 to 6 percent of total investable assets in the U.S. transferred between generations.

› In the second stage, the oldest of the Baby Boomers will join the remainder of the Silent Generation to transfer 8 to 10 percent of investable assets to the younger generations every five years.  

1Source: 2016 Wells Fargo Retirement Study  
2Source: 2016 Wells Fargo Millennial Study  

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**IMPLICATIONS FOR INVESTORS**

**Invest for Growth and Income**

In today’s environment, we think it is important for many retired investors to hold a portion of their retirement assets in equities. They may consider owning a mix of dividend-paying, value-tilted stocks for income as well as growth stocks for capital appreciation and an offset to inflation.

**Play Catch Up**

Workers nearing retirement age may be able to take advantage of “catch-up” contributions. This is an IRS provision that allows workers ages 50 or older to make additional tax-deferred contributions.

**Remember Your Health Care**

Workers may also consider investing in a tax-deferred Health Savings Account, an investment account that is paired with a high-deductible health insurance plan. Savings in these accounts are tax exempt as long as the money is used for covering health-care expenses.

**Start Saving Today**

It is important for younger workers to take advantage of time and start saving for retirement, no matter how small their initial contributions. Within long-term retirement accounts, we recommend a diversified asset-allocation strategy, but one that is focused on growth with broad exposure to equities.
Definitions

Indexes

An index is unmanaged and not available for direct investment.

Bloomberg Barclays U.S. Aggregate Bond Index covers the U.S. dollar-denominated, investment-grade (rated Baa3 or above by Moody’s), fixed-rate, and taxable areas of the bond market. This is the broadest measure of the taxable U.S. bond market, including most Treasury, agency, corporate, mortgage-backed, asset-backed, and international dollar-denominated issues, all with maturities of one year or more.

BoFA Merrill Lynch U.S. High-Yield Master II Index tracks the performance of below-investment-grade publically issued U.S. corporate bonds.

Goldman Sachs Hedge Fund VIP (Long) Index consists of hedge fund managers’ “very important positions,” or the U.S.-listed stocks whose performance is expected to influence the long portfolio of hedge funds. Those stocks are defined as the positions that appear most frequently among the top 10 long equity holdings within the portfolios of fundamentally driven hedge fund managers. The index is rebalanced on a quarterly basis to reflect changes in reported hedge fund manager holdings.

Goldman Sachs Hedge Fund VIP (Short) Index consists of hedge fund managers’ “very important positions,” or the U.S.-listed stocks whose performance is expected to influence the short portfolio of hedge funds. Those stocks are defined as the positions that appear most frequently among the top 10 short equity holdings within the portfolios of fundamentally driven hedge fund managers. The index is rebalanced on a quarterly basis to reflect changes in reported hedge fund manager holdings.

MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & 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.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is 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.

Russell 2000® Index (small cap) 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.

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.

S&P Composite Index EPS Growth is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market. The index is unmanaged and not available for direct investment.

S&P 500® Index consists of 500 industrial, financial, utility, and transportation companies with market capitalizations of $4 billion or more.

Risk Considerations

All investing involve risks, including the possible loss of principal. There can be no assurance that any investment strategy will be successful or will meet its investment objective. Investments fluctuate with changes in market and economic conditions and in different environments due to numerous factors some of which may be unpredictable. Each asset class has its own risks and return characteristics.

An investment in a mutual fund or exchange-traded fund will fluctuate and shares, when sold, may be worth more or less than their original cost. Exchange-traded funds are subject to risks similar to those of stocks and may yield investment results that, before expenses, generally correspond to the price and yield of a particular index. There is no assurance that the price and yield performance of the index can be fully matched.

The risks associated with the asset classes discussed in this report include:

Alternative Strategy Risk: Alternative investment strategies employ aggressive investment techniques, including short sales, leverage, swaps, futures contracts, options, forward contracts, and other derivatives which can expose the investor to substantial risk. The use of alternative investment strategies may require a manager’s skill in assessing corporate events, the anticipation of future movements in securities prices, interest rates, or other economic factors. No assurance can be given that a manager’s view of the economy will be correct, which may result in lower investment returns or higher return volatility. Some of the risks associated with alternative investment strategies include: 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. They involve buying securities on one market for immediate resale on another market in order to profit from a price discrepancy. Such strategies entail the use of short selling. Distressed strategies involve a high degree of risk. Distressed companies could declare bankruptcy shortly, could currently be in bankruptcy proceedings or just emerging from bankruptcy. Because of their distressed situation, these securities may be illiquid, have low trading volumes, and be subject to substantial interest rate and credit risks. Equity Hedge strategies maintain positions both long and short in primarily equity and equity derivative securities. Event Driven strategies involve investing in opportunities created by significant transactional events, such as spinoffs, mergers and acquisitions, bankruptcy reorganization, recapitalization and share buybacks. Managers who use such strategies may invest in, and might sell short, the securities of companies where the securities’ price has been, or is expected to be, affected by a distressed situation. Infrastructure-related risks: Investments in infrastructure companies expose an investment to potentially adverse economic, regulatory, political and various other risks, including governmental regulations, high interest costs associated with capital construction programs, costs associated with compliance, and changes in environmental regulation, economic slowdown and surplus capacity, competition from other providers of services, and other factors. Long/Short Credit strategies seek to mitigate interest rate and credit risks regardless of market environment through investment in credit-related and structured debt vehicles. These strategies involve the use of market hedges and involve risks such as derivatives, fixed income, foreign investment, currency, hedging, leverage, liquidity, short sales, loss of principal, and other material risks. Macro managers trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Relative Value strategies focus on exploiting perceived imbalances or valuation discrepancies between related markets or instruments. Special situations is a strategy that involves investing in a company based on the belief that its value will go up because of a specific, anticipated event related to the company. There is no guarantee that the specific event will occur or that the market will react as expected with respect to such events. In addition, the securities of such companies may lose more value than the securities of more stable companies, which can result in greater share price volatility. Structured credit strategies are not suitable for all investors. These strategies aim to generate returns via positions in the credit sensitive area of the fixed income markets.
**Cash alternatives:** Cash alternatives typically offer lower rates of return than longer-term equity or fixed-income securities and provide a level of liquidity and price stability generally not available to these investments. Some examples of cash alternatives include: bank certificates of deposit, bank money market accounts, bankers’ acceptances, federal agency short-term securities, money market mutual funds, Treasury bills, ultra-short bond mutual funds or exchange-traded funds, and variable rate demand notes. Each type of cash alternatives has advantages and disadvantages, which should be discussed with your financial advisor before investing.

**Commodities:** Investing in commodities is not suitable for all investors. Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. The commodities markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Commodities may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or other factors affecting a particular industry or commodity.

**Currency:** 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 a portfolio’s investments to decline.

**Derivatives:** The use of derivatives, such as futures, options, swaps and swaptions (options on swaps), or other derivative instruments can expose the investor to additional risk. Derivatives generally have implied leverage, which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty, and management risks, which may hurt a fund’s performance. Counterparty risk is the risk that the other party to the agreement will default at some time during the life of the contract. The use of derivatives for other than hedging purposes is considered speculative and involves greater risks than those associated with hedging. Investing in derivatives carries the risk of the underlying instrument as well as the derivative itself and may not be successful, resulting in losses, and the cost of such strategies may also reduce returns.

**Equity investments:** 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. There is no guarantee that dividend-paying stocks will return more than the overall stock market or that value stocks will increase in value or that their intrinsic values will eventually be recognized by the overall market. Dividends are not guaranteed and are subject to change or elimination. The value type of investing tends to shift in and out of favor.

**Master limited partnerships (MLPs):** MLPs involve certain risks which differ from an investment in the securities of a corporation. MLPs may be sensitive to price changes in oil, natural gas, etc., regulatory risk, and rising interest rates. A change in the current tax law regarding MLPs could result in the MLP being treated as a corporation for federal income tax purposes, which would reduce the amount of cash flows distributed by the MLP. Other risks include the volatility associated with the use of leverage, volatility of the commodities markets, market risks, supply and demand, natural and man-made catastrophes, competition, liquidity, market price discount from Net Asset Value, and other material risks.

**Fixed-income securities:** Investments in fixed-income securities are subject to market, interest rate, credit/default, liquidity, inflation, and other 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/or principal. This risk is heightened in lower-rated bonds. 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.

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

**Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. These bonds are subject to credit risk and potentially the Alternative Minimum Tax. Quality varies widely depending on the specific issuer.

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

**Sector specific:** An investment that is concentrated in certain sectors may present more risks than a portfolio that is broadly diversified over numerous sectors of the economy. This will increase a portfolio’s vulnerability to any single economic, political, or regulatory development affecting the sector and may result in greater price volatility. Investing in financial services companies will subject the fund to adverse economic or regulatory occurrences affecting the sector. Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market. Utilities are sensitive to changes in interest rates, and the securities within the sector can be volatile and may underperform in a slow economy.

**Short selling:** Short selling involves the risk of potentially unlimited increase in the market value of the security sold short, which could result in potentially unlimited loss to a portfolio. In addition, taking short positions in securities is a form of leverage, which may cause a portfolio to be more volatile.

**Small- and mid-capitalization stocks:** The prices of small- and mid-cap 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.

**Sovereign debt:** In addition to the risks associated with investing in international and emerging markets, sovereign debt involves the risk that the issuing entity may not be able or willing to repay principal and/or interest when due in accordance with the terms of the debt agreement.

**Treasury Inflation-Protected Securities (TIPS):** TIPS are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond in the portfolio to fluctuate more than other fixed income securities.
Investment Expertise and Advice That can Help You Succeed Financially

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For assistance with your investment planning or to discuss the points in this report, please talk to your investment professional.