

# Outlook

 | 

## 2015 Midyear

### Three areas of expertise, one source of investor guidance



**John Manley, CFA**  
Chief Equity Strategist

**James Kochan**  
Chief Fixed-Income Strategist

**Brian Jacobsen, Ph.D., CFA, CFP®**  
Chief Portfolio Strategist

Our strategists cover three areas of expertise: the economy, the equities markets, and the fixed-income markets, both in the U.S. and abroad. Their combined view of the investment landscape gives investors a comprehensive perspective on recent market activity and clear guidance for allocating their investment portfolios going forward.

## Turning points

As we enter the second half of the year, the markets seem to be at a crossroads. Powerful forces are at work to support growth in Europe and certain emerging markets. In the U.S., investors are concerned that the Federal Reserve (Fed) will disrupt fixed-income markets by raising interest rates and are wondering if they can still find value in the U.S. stock market.

### Key themes we are seeing

- 1 Why a turn up in global growth**
- 2 What changes to watch in stock and bond markets**
- 3 Where to turn as earnings expectations and interest rates rise**

*Read more inside* ►



# Action items for investors

Under each key theme, we list timely investment guidance focused on what is happening in the markets today.

## 1 Why a turn up in global growth

- Stay invested in the U.S. stock market. We believe it's still a good place to be.
- Look for diversification from geographically dispersed investments. Opportunities overseas—particularly in Europe and select emerging markets—could add some growth to your portfolio.

## 2 What changes to watch in stock and bond markets

- Ride out market volatility. Resist the urge to react to short-term developments.
- Continue to overweight equities versus fixed income.
- Look for opportunities in financials, industrials, and information technology.

## 3 Where to turn as earnings expectations and interest rates rise

- Stay diversified. Rising rates don't have to be a bad thing for investors who diversify their portfolios.
- Be patient. Be prepared to ride out any short-term market volatility that could arise.
- Emphasize income-producing investments in your fixed-income allocation over the next 6 to 12 months.
- Consider an allocation to mutual funds that offer alternative investment strategies.

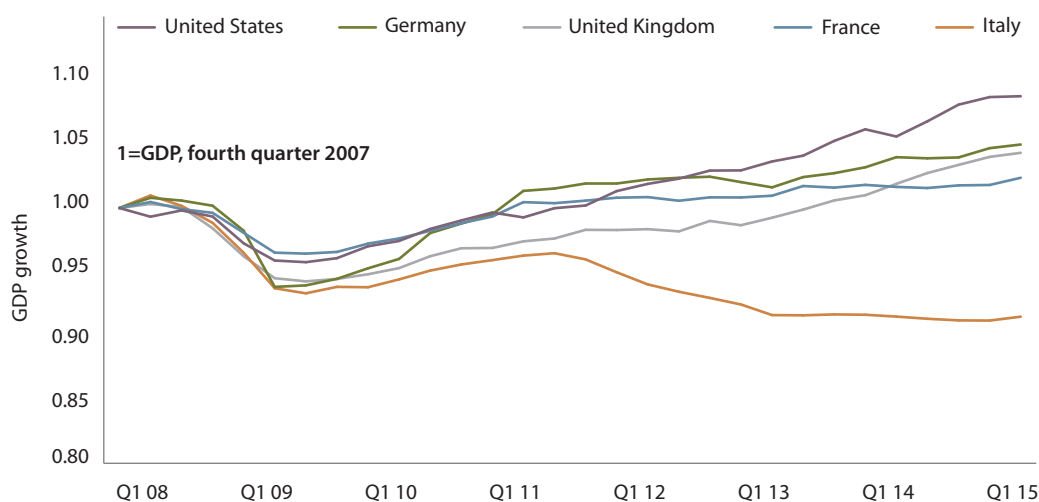
# 1

## Why a turn up in global growth

So far this year, global growth has been positive, and we think it should improve in the second half of 2015. In the U.S., we could have a repeat of 2014 gross domestic product (GDP) growth for 2015, which is about what we had in 2013. For brighter growth prospects, look outside the U.S.

CHART 1

GDP growth in Europe is catching up with GDP growth in the U.S.



### Key insight

GDP growth relative to fourth quarter 2007 shows why we see value in Europe. Even Italy is turning a corner.

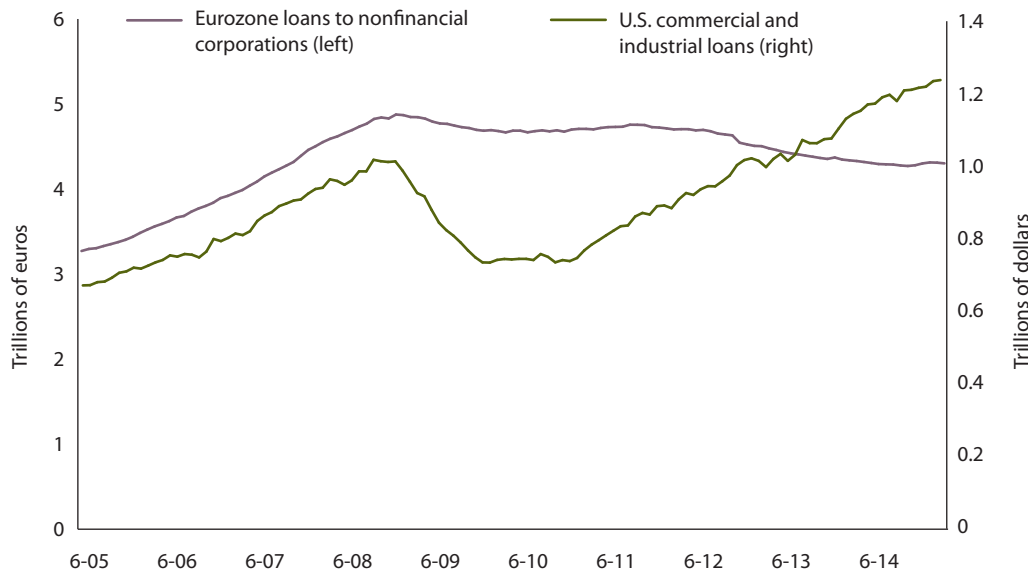
Source: FactSet

In January, the European Central Bank rolled out an asset-buying program of 1 trillion-plus euros. This kind of economic stimulus has worked in the U.S., the U.K., and Japan, as far as the markets are concerned. We don't see why it shouldn't work in the eurozone, too. Data has already shown improvement in the eurozone: The GDP for the first quarter was 0.4% for the quarter, beating consensus expectations.

A turn up in the eurozone's growth is also apparent in the increased support the economy is receiving from the banking system. Chart 2 shows that eurozone banks have likely stopped shrinking their lending to businesses. That's a powerful force for growth. Extremely low bond yields have helped boost growth around the world—especially in Europe, where yields have been unsustainably low.

CHART 2

## A pickup in eurozone lending is driving the turn to growth in Europe



Sources: European Central Bank and FactSet

### Key insight

Banks are starting to finance growth in the eurozone.

## U.S. may see stronger growth

Spending on structures—such as houses and office buildings—is still lagging in the U.S. The growth trajectory over the past six months has been slow and bumpy, with setbacks from factors like weather, port shutdowns, and declines in capital spending by energy companies. But the economy has bounced back. Because the negative effects of lower oil and a higher dollar may soon be behind us, and the positive consumption and production effects of lower energy prices may be in front of us, we expect growth to improve in the second part of the year and going into 2016.

## Investment themes

- Pursue opportunities for compound interest in a low-yielding fixed-income market. The sectors that provide the best interest income may also provide the best insulation against rising short-term rates.
- Look for opportunities in Europe and emerging markets, especially in dividend-paying stocks.

## What to watch

- Watch for a U.S. growth bounce early in the second half of 2015. If this doesn't occur, then our earnings growth outlook will materially change.
- Keep an eye on the dollar's value and oil prices, both of which should, in our view, stabilize. However, if the dollar rises and the price of oil falls, the Fed may push its first rate hike from mid-2015 to mid-2016.
- Watch payroll data. Gains of over 250,000 are not sustainable in the long term, but gains of over 175,000 should stay with us for the year.

# 2

## What changes to watch in stock and bond markets

We believe that stock valuations show the potential for continued positive returns, even for U.S. investors (see Chart 3). This view is based, in part, on the absence of the kind of investor enthusiasm that has heralded the end of a bull market in past decades. The Fed is unlikely to stymie economic growth, even as it raises rates to more normal levels. If the economy expands, company profits in the U.S. should do likewise.

CHART 3

Current valuations show the potential for continued positive returns

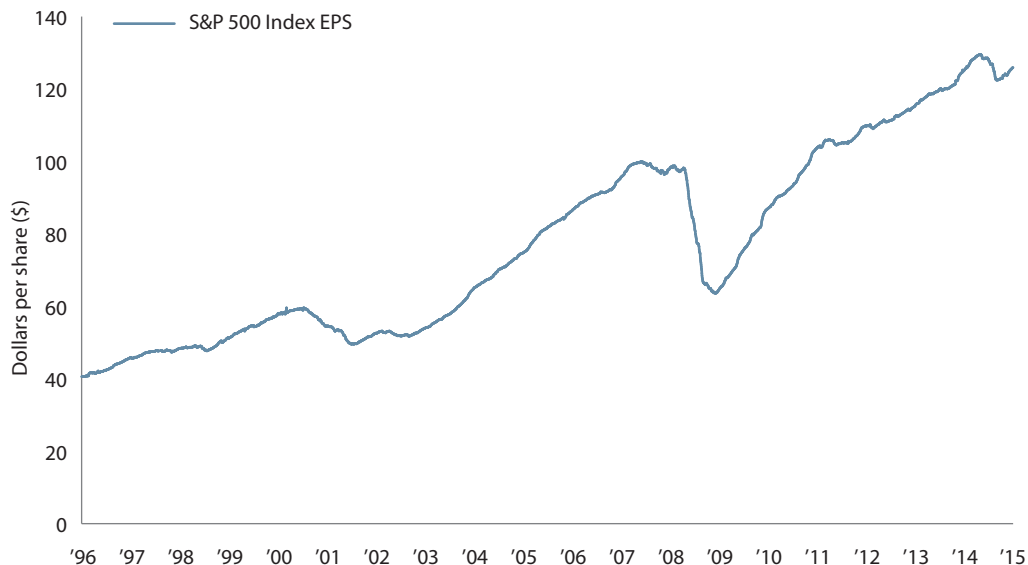


Source: FactSet

Although expectations of profits were declining until fairly recently, we think it was a temporary dip. Earnings per share (EPS) for the S&P 500 Index went up from 2011 through the third quarter of 2014, but a combination of oil and the dollar pushed them lower (see Chart 4). These numbers are stabilizing now, and we believe several factors will help them rise: capital expenditure plans that are beginning to gain steam, consumer confidence that remains healthy, and purchasing manager indexes that continue to be in expansionary territory in most of the developed world. While U.S. equities no longer look cheap—and, by some measures, they look expensive—we believe the excessive investor zeal that could signal the start of a bear market is absent.

CHART 4

## EPS dipped but are now stable—and rising



Source: FactSet

### Key insight

The prospect of strengthening earnings is good news for the stock market.

The growth prospects for the U.S. economy in the second half of the year will be important to the bond markets as well. At present, the markets are expecting better growth. That might result in somewhat higher bond yields later this year. If, instead, the economy falters, bond yields could decline back to around the ranges seen in the first quarter of the year.

The Fed will be a key influence. We expect the federal funds rate to rise slowly and modestly in the second half of 2015. That could produce an emotional overreaction in the bond markets, which could provide buying opportunities in markets such as corporates and municipals.

Europe might also affect the U.S. markets. U.S. yields increased in step with yields in Europe during April and May of 2015. Significant additional movements in Europe could cause U.S. yields to move in the same direction.

## Investment themes

- Consider emerging markets bonds. Relative to non-U.S. developed markets bonds, they may provide better value and performance.
- Consider financials. Higher short-term rates could help bank profitability as the Fed continues to push liquidity toward the economy.
- Look for opportunities in information technology, which should benefit as corporations continue to improve efficiencies.

## What to watch

- Watch earnings expectations like a hawk. We expect them to begin to rise again.
- Watch investor sentiment. Investors almost always become enthusiastic before the end of a significant bull market. That has not yet happened; but a rise in earnings expectations could trigger some enthusiasm.
- Keep your eye on company debt and where it might become excessive. Into early 2014, the energy sector had too much debt growth. There aren't many signs today of excessive debt buildup, but that can change quickly.
- In fixed income, watch for reasonable credit growth supported by the fundamentals.

# 3

## Where to turn as earnings expectations and interest rates rise

Low and slow—that’s our expectation for a rise in short-term interest rates. The federal funds rate—which is one of the Fed’s target interest rates—is so close to zero now that even if the Fed was to increase it twice over the next six months, it could still be significantly below 1% by year-end. The historically low rate that the Fed will be using as a starting point will, we think, keep rates low over the near future.

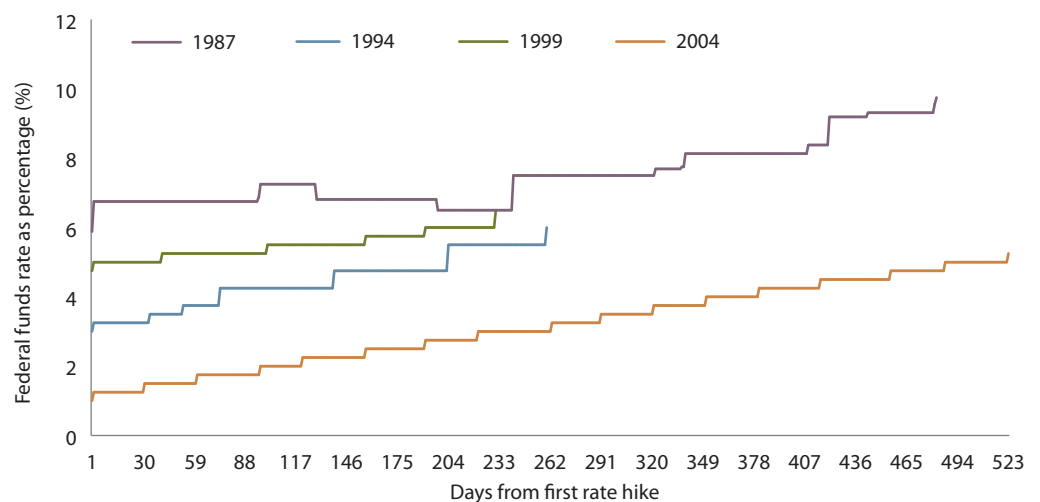
Our view is supported by the Fed’s reference to a gradual approach to rising rates as a step toward normalizing monetary policy. In its comments, the Fed also said it will raise rates carefully to avoid adverse effects to the markets. Since the economy rarely moves in a straight line, interest rates will probably not rise in a straight line either. Instead, we believe it will be a long and winding road to normal as the Fed takes a measured approach to rate hikes based on economic data.

### Key insight

We think the Fed has learned its lesson from previous rate-hiking cycles, during which rates rose either too mechanically (as in 2004) or erratically (as in 1987, 1989, and 1994). Note, too, that previous cycles have started at higher rates than today’s near-zero federal funds rate.

CHART 5

### Low and slow rise of federal funds rate



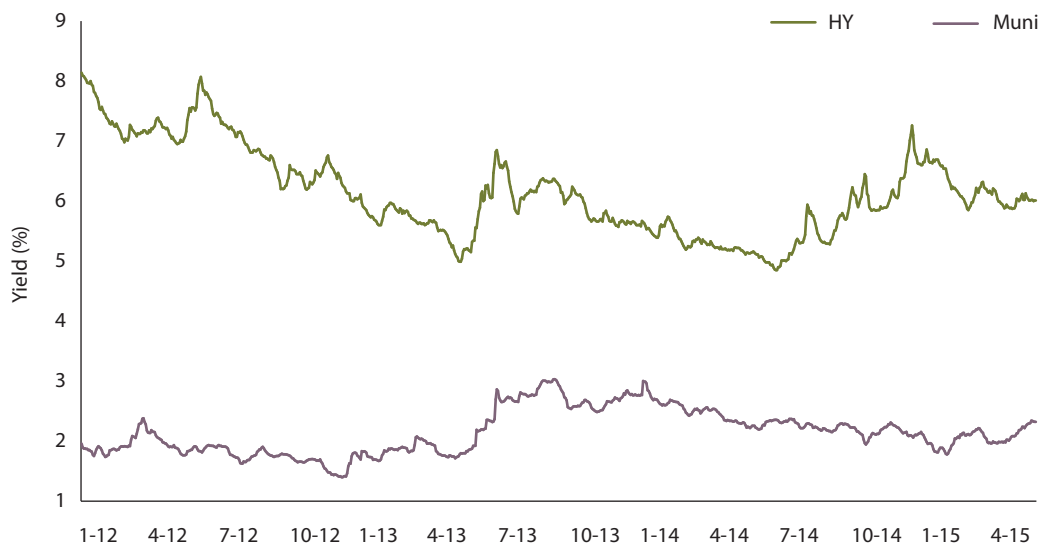
Source: FactSet



We don't expect the Fed to raise rates faster than earnings expectations increase. In the short term, we expect earnings expectations to rise more significantly than rates, and that should create a positive scenario for stocks. If rates go higher, it's because the economy has improved. Better earnings would more than offset whatever damage is done by higher interest rates. The risk to equities is that valuations could compress, which happened from 2004 to 2006. The key for investors is to identify companies that grow earnings faster than valuations compress.

CHART 6

### Consider corporate high-yield and muni bonds



Source: Bloomberg

Corporate high-yield bonds are represented by the BofA Merrill Lynch U.S. High Yield Index, and municipal bonds are represented by the Bloomberg 10-Year AAA Municipal Benchmark Index (that is, the Bloomberg Valuation Benchmark Municipal Curve).

#### Key insight

We believe the yield history of 10-year AAA muni and corporate high-yield bond markets suggests opportunity for fixed-income investors.

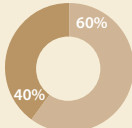
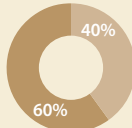
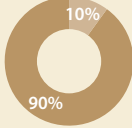
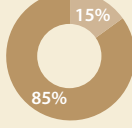
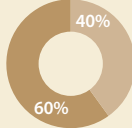
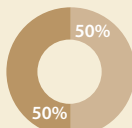
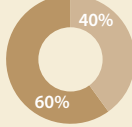
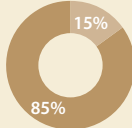
## Investment themes

- Look at high-yield bonds. Credit fundamentals still favor high yield and should do so until the economy moves toward a recession.
- Consider muni bonds, particularly A-rated and BBB-rated bonds. In our view, the combination of somewhat higher yields and unusually generous yield ratios has produced the best values in the muni market in more than 12 months.
- Avoid very long duration strategies. Look instead at intermediate maturity duration portfolios, which would be expected to perform somewhat better.
- Lean slightly toward cyclical stocks.

## What to watch

- Watch muni yields, which would be expected to rise less if Treasury yields rise further.
- Keep your eye on the Fed. While it has emphasized a gradual and measured approach to hiking rates, the bond markets might still react negatively.
- Watch Treasuries and Treasury Inflation-Protected Securities, which may be vulnerable to rising short-term rates. They also tend to get pushed around by geopolitical events, which could add volatility to a portfolio rather than reduce it.

# Asset allocation guide: Summary

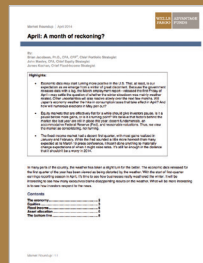
Equity recommendations	Strategic recommendation*
<b>U.S. vs. non-U.S. developed equities</b> We think the view that the U.S. is doomed to low growth ignores the ability of U.S. businesses to adapt and thrive. Still, from a valuation perspective, non-U.S. equities are relatively more attractive, meriting a continued overweight.	 <ul style="list-style-type: none"> <li>U.S. equities</li> <li>Non-U.S. developed equities</li> </ul>
<b>Growth vs. value equities</b> Look for real growth, which could be in traditional value sectors. We think the theme for the next few years will be to identify mispriced growth opportunities—that means looking for value stocks in growth sectors and growth stocks in value sectors.	 <ul style="list-style-type: none"> <li>Growth</li> <li>Value</li> </ul>
<b>Large-cap vs. small-cap equities</b> Large-cap stocks have more attractive valuation characteristics, but sector selection is likely more important than getting the capitalization exposure right.	 <ul style="list-style-type: none"> <li>Large</li> <li>Small</li> </ul>
<b>Developed equities/emerging markets equities</b> Long-term growth is still likely in emerging markets, but not every emerging market is going to emerge. Some may submerge. We prefer dividend-paying emerging markets equities to generate income while long-term valuations normalize.	 <ul style="list-style-type: none"> <li>Developed equities</li> <li>Emerging markets equities</li> </ul>
Fixed-income recommendations	Strategic recommendation*
<b>Credit risk exposure</b> Default rates are low and should stay low, which may make higher-yielding instruments more attractive. Lower-yielding—or investment-grade—securities don't currently offer an attractive spread relative to Treasuries.	 <ul style="list-style-type: none"> <li>Higher yield</li> <li>Lower yield</li> </ul>
<b>Fixed-income duration</b> As investors try to figure out when, and by how much, the Fed will raise rates, we expect to see turbulence but nothing permanently damaging. Until we get through this period of uncertainty, the yield pickup may be more attractive from taking on credit risk than the yield pickup from extending duration.	 <ul style="list-style-type: none"> <li>Short duration</li> <li>Long duration</li> </ul>
<b>Fixed vs. floating rates</b> We prefer fixed-rate short-term debt, which tends to have more investor-friendly debt-covenant characteristics than floating-rate. Also, some floating-rate debt doesn't float until rates rise above a certain threshold, which might make it perform in unanticipated ways. That could become evident as the Fed starts to hike rates.	 <ul style="list-style-type: none"> <li>Fixed rate</li> <li>Floating rate</li> </ul>
Alternative investment strategies	Strategic recommendation*
<b>Alternative investment strategies vs. traditional investments</b> Our investment guidance for alternative investment strategies may range from 0% to 20% based on our risk assessment. We believe the risks in the near future are slightly above average, leading us to recommend a 15% weighting.	 <ul style="list-style-type: none"> <li>Traditional investments</li> <li>Alternative investment strategies</li> </ul>

\*A time frame of three years or longer

# Connect with us

Get the economic and market commentary you want, when and how you want it.

At *Wells Fargo Advantage Funds*®, we know you're always on the lookout for smart, relevant market and investing information. That's why we offer timely access to commentary by our capital market strategists on economic indicators, Fed movements, and newsworthy events to help you make informed investment decisions.



## Monthly Outlook

An investment perspective on global market and economic movements over the previous month and what to watch going forward



## Economic News and Analysis

Event-driven reports covering breaking news, such as Fed announcements, economic reports, and market trends



## AdvantageVoice blog

An ongoing conversation about breaking news, investing trends, and economic insights, including *On the Trading Desk*<sup>SM</sup> podcasts and *Wells Fargo Daily Advantage*<sup>SM</sup> market recaps and commentary

## To subscribe

Please visit our website at [wellsfargoadvantagefunds.com](http://wellsfargoadvantagefunds.com)

Follow us on Twitter @WFAAssetMgmt

# Strength. Expertise. Partnership.

*Wells Fargo Advantage Funds* skillfully guides institutions, financial advisors, and individuals through the investment terrain to help them reach their financial objectives. Everything we do on behalf of our investors is built on the standards of integrity and service established by our parent company, Wells Fargo & Company; the expertise of our independent investment teams and rigorous ongoing investment review; and the collaborative level of superior service that is our trademark.



More information about *Wells Fargo Advantage Funds* is available free upon request. To obtain literature, please write, email, or call:

Wells Fargo Advantage Funds | P.O. Box 8266 | Boston, MA 02266-8266

Email: [wfaf@wellsfargo.com](mailto:wfaf@wellsfargo.com) | Individual investors: 1-800-222-8222 | Retail investment professionals: 1-888-877-9275  
Institutional investment professionals: 1-866-765-0778 | Website: [wellsfargoadvantagefunds.com](http://wellsfargoadvantagefunds.com)

Price/earnings (P/E) is the price of a share of a stock divided by earnings per share, usually calculated using the latest year's earnings.

The Bloomberg 10-Year AAA Municipal Benchmark Index (that is, the Bloomberg Valuation Benchmark Municipal Curve) is the baseline curve for all tax-exempt munis. It is populated with high-quality U.S. muni bonds with an average rating of AAA by Moody's and S&P.

The asset allocation positioning represented by the pie charts is in no way intended to offer individualized advice about which investments to choose or how much to allocate to any particular investment option. The asset allocation charts are provided for illustration purposes only and do not predict or guarantee the performance of any Wells Fargo Advantage Fund. When applying an asset allocation strategy to your own situation, variables such as your investment objectives, time frame, income requirements and resources, inflation, and potential rates of return should be considered when you determine which investments will best suit your risk profile. Please consult a financial advisor for advice on your specific facts and circumstances.

Diversification does not ensure or guarantee better performance and cannot eliminate the risk of investment losses.

The BofA Merrill Lynch U.S. High Yield Index tracks the performance of below-investment-grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market. You cannot invest directly in an index.

The 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. You cannot invest directly in an index.

The ratings indicated are from Standard & Poor's and/or Moody's Investors Service. Credit-quality ratings: Credit-quality ratings apply to corporate and municipal bond issues. Standard & Poor's rates the creditworthiness of bonds from AAA (highest) to D (lowest). Ratings from A to CCC may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the rating categories. Moody's rates the creditworthiness of bonds from Aaa (highest) to C (lowest). Ratings Aa to B may be modified by the addition of a number 1 (highest) to 3 (lowest) to show relative standing within the ratings categories.

Duration is a measurement of the sensitivity of a bond's price to changes in that bond's yield. A fund's duration is the weighted average of duration of the bonds in the portfolio. Duration should be interpreted as the approximate change in a bond's (or fund's) price for a 100-basis-point change in Treasury yields.

The views expressed are as of 6-5-15 and are those of Chief Portfolio Strategist Brian Jacobsen; Chief Equity Strategist John Manley; Chief Fixed-Income Strategist James Kochan; and Wells Fargo Funds Management, LLC. The information and statistics in this report have been obtained from sources we believe to be reliable but are not guaranteed by us to be accurate or complete. Any and all earnings, projections, and estimates assume certain conditions and industry developments, which are subject to change.

The opinions stated are those of the authors and are not intended to be used as investment advice. The views and any forward-looking statements are subject to change at any time in response to changing circumstances in the market and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally, or any mutual fund. Wells Fargo Funds Management disclaims any obligation to publicly update or revise any views expressed or forward-looking statements.

*Carefully consider a fund's investment objectives, risks, charges, and expenses before investing. For a current prospectus and, if available, a summary prospectus, containing this and other information, visit [wellsfargoadvantagefunds.com](http://wellsfargoadvantagefunds.com). Read it carefully before investing.*

Wells Fargo Funds Management, a wholly owned subsidiary of Wells Fargo & Company, provides investment advisory and administrative services for *Wells Fargo Advantage Funds*. Other affiliates of Wells Fargo & Company provide subadvisory and other services for the funds. The funds are distributed by **Wells Fargo Funds Distributor, LLC**, Member FINRA, an affiliate of Wells Fargo & Company. 233689 06-15

**NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE**