WELLS FARGO ADVANTAGE FUNDS

October 2015

Outlook

Three areas of expertise, one source of investor guidance

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Our strategists offer their view on 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.

China, corporate earnings, and central banks

Goodbye, third quarter! It's nice to have that painful experience behind us. Is there more pain in store? While we believe the worst of the market mayhem is behind us, we are watching some hot spots.

Investors may be looking for evidence that China's growth slowdown isn't becoming unmanageable. Third-quarter reporting season begins for corporate America, and we'll likely hear the refrain of China's slowdown and a stronger dollar as excuses for earnings misses. Then, there are the central banks. If the Federal Reserve (Fed) delivers a rate hike at the end of October in the face of weakening growth or fails to deliver a rate hike in the face of stronger growth, or if the European Central Bank (ECB) fails to expand its asset purchase program, the tailwind of central bank support could become a gale of a headwind. We don't typically like to harp on the risks, but they are real, and investors should be prepared for them.

Key themes we are seeing

1. The economy: Will they/won't they markets
2. Equities: Slight shortfalls, big impacts
3. Fixed income: Bond markets diverge

View investment guidance for today's markets

1. The economy: Will they/won't they markets

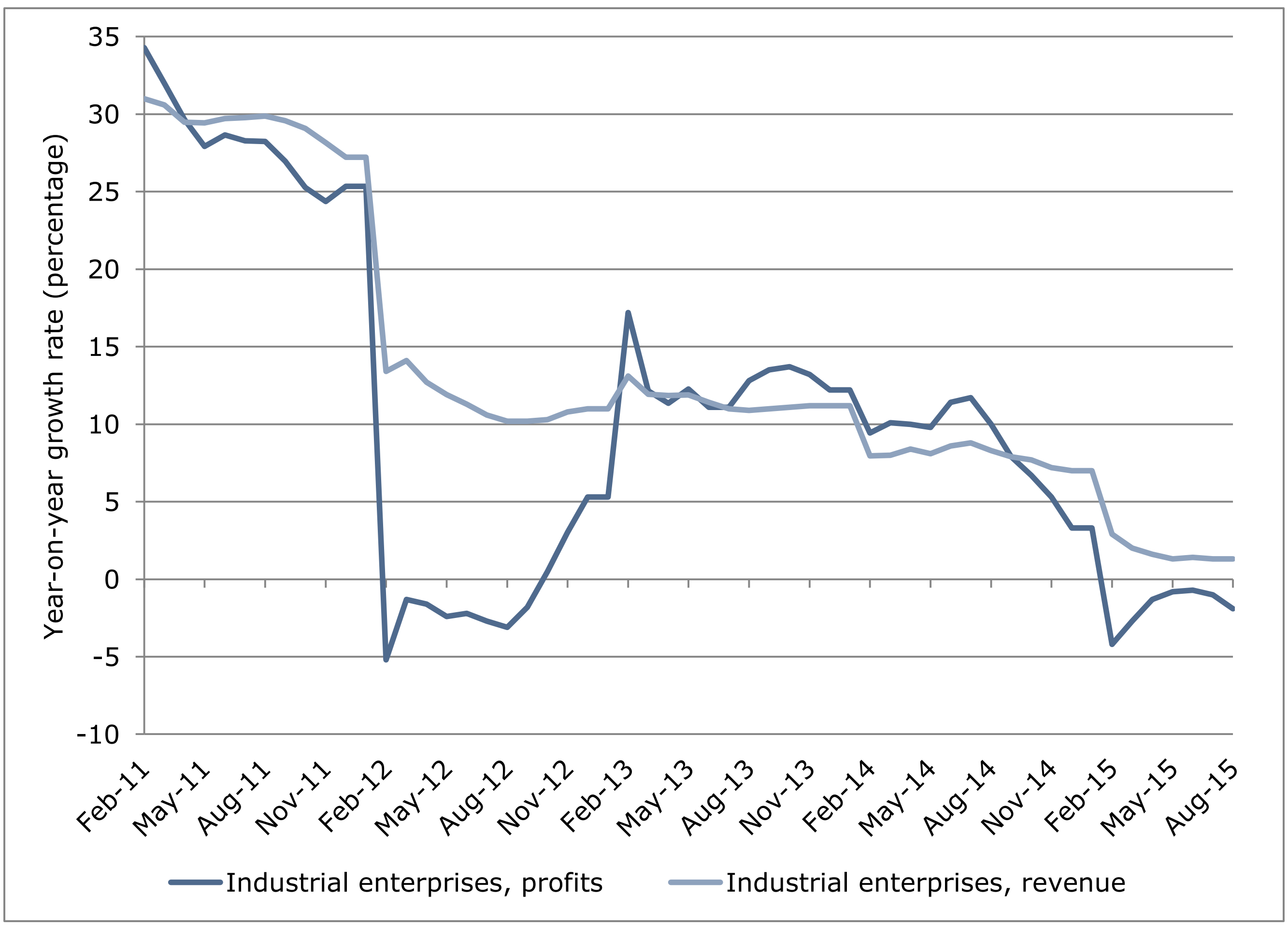
The market in September seemed to sell off at each sign of industrial weakness out of China. That's unfortunate, as China is much more than manufacturing and industrial production. As an example, industrial enterprises' profits dropped 1.9% in the January–August 2015 period compared with the same months in 2014, while industrial revenues grew 1.3%. Most of the weakness was concentrated in the commodity-related sector—for example, smelting and mining. Most other industries, from textiles to waste management, showed profit growth.

Industrial enterprises are only a subset of all enterprises in China. For perspective, industrial enterprises make up 35% of China's gross domestic product (GDP), so we think the hyper-focus of investors on every move of manufacturing data is unwarranted and unhealthy. It's much more important to look at the services sector of China, which is continuing to grow.

Chart 1

Industrial profits in China have been falling, mainly due to commodity price drops

However, industry is only 35% of China's GDP, and it's shrinking in importance.



Source: National Bureau of Statistics, China

An October rate hike is not off the table

In the U.S., personal income grew and consumer confidence rose. What didn't rise much was inflation. As long as U.S. economic indicators point to continued growth, an October rate hike is not off the table. The key for investors isn't so much whether the Fed hikes but why the Fed hikes. Fed Chair Janet Yellen has been trying to clarify why the Fed put a rate hike in abeyance in September. Initially, the market soared on the announcement that the Fed wasn't hiking. But when Chair Yellen started talking about China's slowdown, the market dropped—and kept dropping.

The messaging is key. If the Fed pauses its rate hike for risk management purposes, we would not worry about the effect on investors. Neither would we be overly concerned if the Fed hikes because of economic and financial strength. What would worry us is a Fed that hikes rates simply because it feels it has to or a Fed not hiking rates because its concerns about growth have turned to worry.

The will-they-or-won't-they meme will likely dominate a lot of news over the next month. Will China's growth slow even faster, or won't it? Will the Fed hike rates, or won't it? If these weren't enough to keep investors on edge, other questions also loom, including, "Will the government shut down or not?" On this latter question, our guess is that a federal government shutdown is unlikely to occur over a funding dispute in December (when the current short-term funding deal expires). A lot depends on who becomes house speaker. A consensus builder could usher through another spending deal. Plus, popularity polls are important to politicians, and government shutdowns aren't very popular. Still, it is a risk, which is why perspective is important.

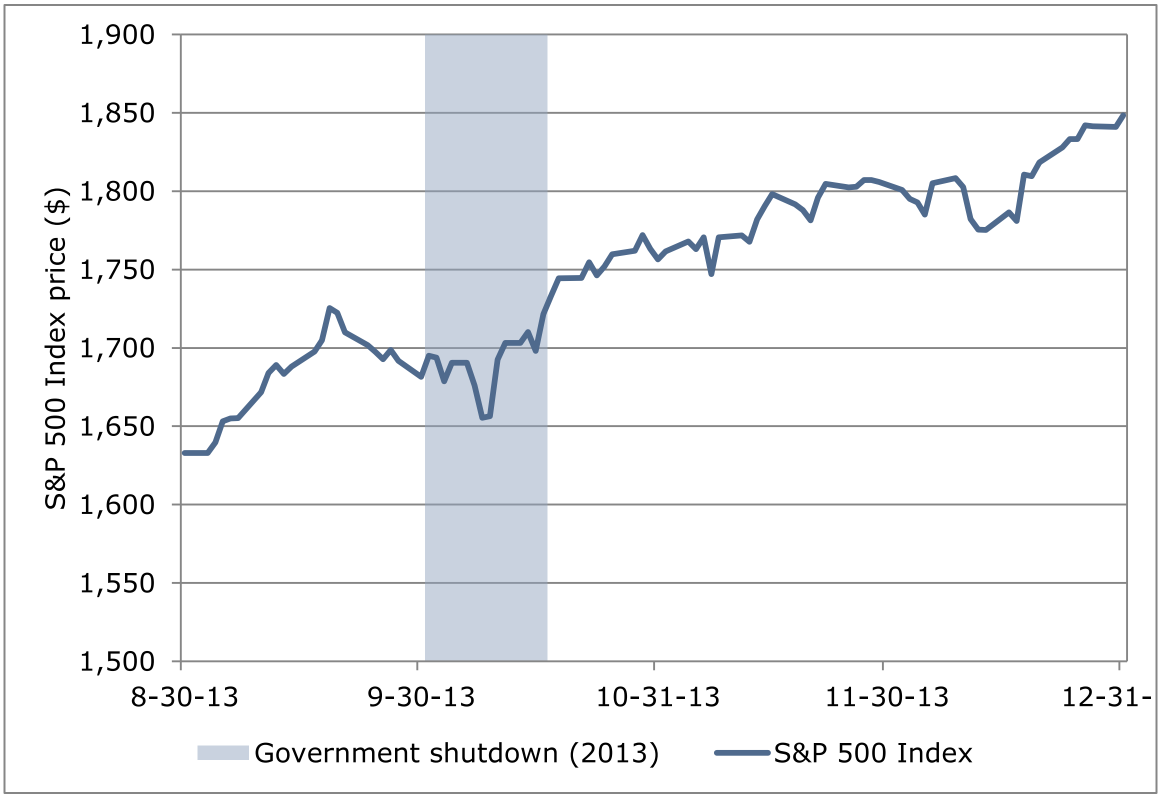
A look at the market response to the 2013 government shutdown

In the October 2013 government shutdown, the market was wrestling with a lot of global issues (Europe's slowdown, for one, and questions about the Fed's tapering of its asset purchase program), but the government shutdown didn't leave a lasting scar on the market.

The shutdown was from October 1–16, 2013. From the September peak to the October trough, the S&P 500 Index lost 4% but quickly recovered. Similarly, the 10-year Treasury had a peak yield of 2.98% in early September 2013, dropped to 2.62% in the midst of the shutdown, then dropped to 2.51% on October 23, 2013. Arguably, the drop in the 10-year Treasury yield during October could have been due to the Fed postponing the tapering of asset purchases from its third round of quantitative easing. While then-Chairman Bernanke announced the prospect of tapering on May 22, 2013, the Fed took a pass on tapering at its September 18, 2013, meeting (despite teeing it up at its June meeting). The 10-year Treasury ended the year at 3.04%.

Chart 2

The government shutdown in 2013 did not leave lasting marks on the market



Source: FactSet

Past performance is no guarantee of future results.

While we still think August 25 marked the low for the S&P 500 Index during this correction, there's a nonnegligible risk that we could see that low tested and broken if we get some bad answers to those will-they-or-won't-they questions. Our downside target is 1,840 on the S&P 500 Index, and we think it will be tough to break through 2,000 without soothing news from China or encouraging words from the Fed.

2. *Equities: Slight shortfalls, big impacts*

This year, September lived up to its reputation as a bad month for equity investors. Despite signs of improving economic strength in the U.S. and Western Europe, sellers focused on indications of a slowdown in China's industrials sector and worries about emerging markets corporate leverage. One day, the markets sold off because the Fed failed to raise rates (was the Fed worried about international growth?). Soon after, the markets sold off again because Chair Yellen indicated that rates would likely rise by year-end (did she forget that the Fed was worried about China?).

Behind all the drama, forward earnings expectations for the S&P 500 Index dipped slightly. That does not look good. Still it may be seasonal or it may only be a wobble. We will keep watching for additional slippage once the third quarter's preannouncement period is over.

The good news is that valuations seem moderate by historical standards and the Fed, notwithstanding its handwringing, seems unlikely to tighten policy in the face of advertised and obvious negative concerns.

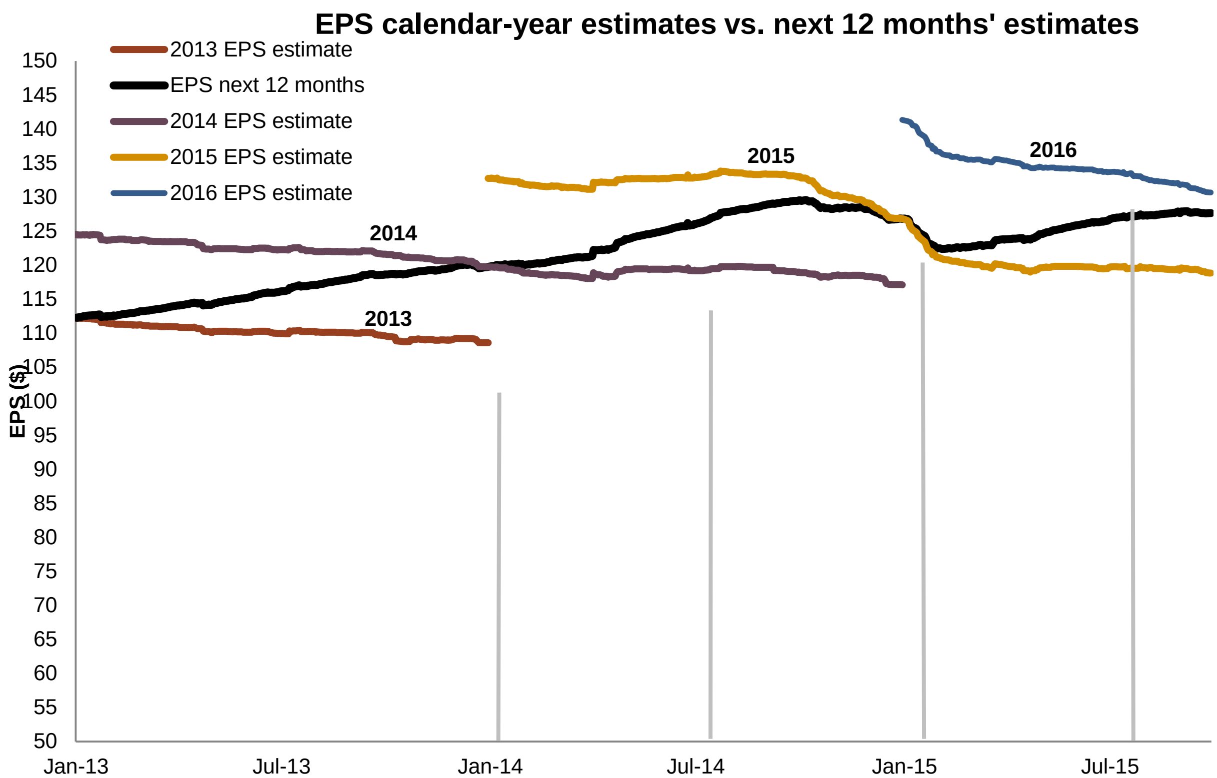
The equity market's technical outlook is terrible, but technicals do not always hold sway. Fundamentals *do* matter from time to time, and fundamentals, while far from perfect, still seem largely benign.

While we are nervously constructive on the U.S., we would continue our focus offshore. Western European economies seem to be improving but still may need further monetary and/or quantitative prodding. That can be a happy combination for equity investors.

In the interim, keep your eye on earnings and remember that stocks do rise every now and then.

Seasonal shift, wobble, or something more ominous?

Forward earnings expectations for the S&P 500 Index dipped slightly in September



Source: FactSet, September 2015

Past performance is no guarantee of future results.

3. Fixed income: Bond markets diverge

High-yield corporate bonds are often called equities with a coupon, in part because their performance is more closely correlated with that of stocks than Treasury bonds. The third quarter provided another example of that paradigm. Equities had a terrible quarter, and the high-yield market recorded the worst total return since 2011. If, as we suggest in the equity section of this report, the equity correction is in its late stages, the performance of the high-yield market may be positioned to rebound in the fourth quarter.

The yield on the BofA Merrill Lynch U.S. High Yield Master II Index has increased more than 200 basis points (bps; 100 bps equals 1.00%) over the past four months to the highest since the euro crises in 2011 and 2012. The yield on the BofA Merrill Lynch BB U.S. High Yield Index that does not include the weakest credits is now 150 bps higher than in early June. Yields this high marked below-investment-grade bonds as good investment values in 2012 and 2014 and, in our view, are doing so again now.

The investment-grade corporate market (as measured by the BofA Merrill Lynch U.S. Corporate Index) has also struggled in recent months. Those yields are back near the levels reached after the Fed started tapering its quantitative easing program in 2013 and the bond market experienced a sell-off. In contrast, the yield on the 10-year Treasury is almost 100 bps lower now than at the end of 2013. As a result, corporate-to-Treasury yield spreads in the 10-year maturity segment are almost 75 bps wider than a year ago—the most generous since the financial crisis. With spreads this wide, we believe the corporate market may be poised to produce better total returns than Treasuries in the months ahead.

Yields on the longer Treasury notes and bonds are again near the lower bounds of the ranges of the past two years. In the two-year segment of the curve, yields have increased in anticipation of a higher federal funds rate. In contrast, yields on the 10-year note and the 30-year bond have declined enough to flatten the yield curve by more than 100 bps since early last year. A flatter yield curve provides less protection to the longer maturities from what could be a prolonged rise in the federal funds rate.

Municipal yields have declined with Treasury yields—10-year AAA yields are down approximately 30 bps since mid-July. This is the time of year when new-issue calendars often become sufficiently heavy to push yields higher. In recent weeks, however, demand has been strong enough to absorb the new issues at lower, not higher, yields. While municipal yields are relatively high versus Treasury yields, the recent declines have probably made this market vulnerable to a correction if Treasury yields were to rise as the Fed begins to raise rates in October or December.

Where to look as interest rates rise

The Treasury and municipal markets (as measured by the Bank of America Merrill Lynch U.S. Municipal Securities Index) recorded the best total returns in the third quarter, but the yield declines that contributed to those returns might hurt performance if, as we expect, the Fed starts raising the federal funds rate sometime in the fourth quarter. Those markets in which yields have been increasing—investment-grade and high-yield corporates as well as emerging markets—are probably better positioned to withstand the onset of a cyclical rise in short-term rates. The greater interest income those markets now offer could be the key factor producing positive returns as short-term rates trend upward.

Table 1

At a glance: Year-to-date bond market returns (%)

Index name	2013	2014	Q3 2015	Sep 2015	Year to date
Broad Market Index	-2.25	6.27	1.24	0.67	1.19
Corporate	-1.46	7.51	0.39	0.52	-0.07
Treasuries	-3.35	6.02	1.90	0.90	1.78
Agencies	-1.79	4.04	1.05	0.60	1.65
Mortgages	-1.39	6.07	1.31	0.57	1.52
High yield	7.42	2.51	-4.90	-2.59	-2.53
Municipal	-2.89	9.78	1.70	0.67	1.80
International bond (ex U.S.)	1.34	9.21	1.48	0.55	0.75
Emerging markets ($ den.)	-3.01	4.84	-2.47	-1.33	0.26
5-year Treasury	-2.42	2.93	1.78	1.03	2.91
10-year Treasury	-7.83	10.72	2.90	1.44	2.38
30-year Treasury	-15.12	29.43	5.14	1.38	-1.13

Source: Bloomberg L.P.

Past performance is no guarantee of future results.

Investment guidance for today's markets

Action items

- Brace for risk but position for opportunity.
- Do not chase rallies.
- Look for equity opportunities in Europe, where fundamentals seem to be improving.
- Look for fixed-income opportunities in high-yield corporates. Avoid Treasuries and Treasury Inflation-Protected Securities.
- Explore strategies for capturing and compounding interest income.

Investment themes

- Macro themes—such as China's slowdown and central bank moves—drove the markets in the third quarter, and that may continue in the fourth.
- European economies are steadying. We expect markets to follow suit.
- We don't believe that U.S. equities are expensive.
- The Fed is aware of the problems that we are aware of and will act accordingly.

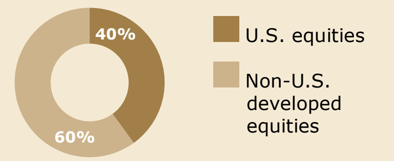
What to watch

- Listen to whether the Chinese government reiterates its commitment to market reforms during the Fifth Plenum of the Communist Party in October.
- Pay close attention to the messaging around a Fed rate hike—especially to the tone of Fed comments. The risks associated with raising rates may slow its rise.
- Watch earnings expectations. Indications of deterioration or improvement in the U.S. should first appear there.
- Watch investor sentiment. There is not a lot of enthusiasm for stocks these days. That could be good for investors seeking value.

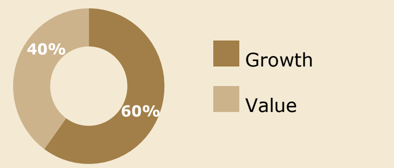
Asset allocation guide: Summary

Equity recommendations — Strategic recommendation*

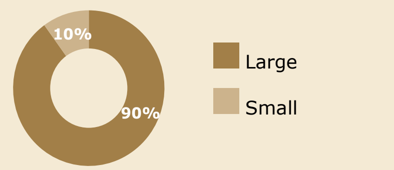
U.S. vs. non-U.S. developed equities
We think the view that the U.S. is doomed to low growth ignores the ability of the U.S. businesses to adapt and thrive. Still, from a valuation perspective, non-U.S. equities are relatively more attractive, meriting a continued overweight.



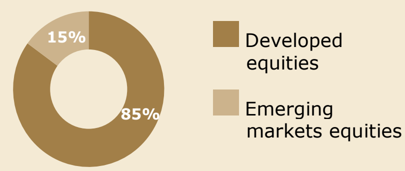
Growth vs. value equities
Look for real growth, which could be in traditional value sectors. We think the theme for the next few years will be to identify mispriced growth opportunities—that means looking for value stocks in growth sectors and growth stocks in value sectors.



Large-cap vs. small-cap equities
Large-cap stocks have more attractive valuation characteristics, but sector selection is likely more important than getting the capitalization exposure right.

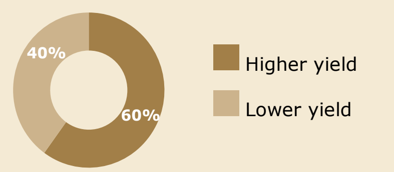


Developed equities vs. emerging markets equities
Long-term growth is still likely in emerging markets, but not every emerging market is going to emerge. Some may submerge. We prefer dividend-paying emerging markets equities to generate income while long-term valuations normalize.

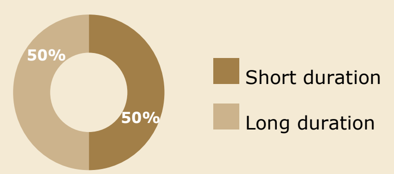


Fixed-income recommendations — Strategic recommendation*

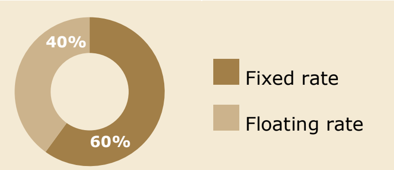
Credit-risk exposure
Default rates are low and should stay low, which may make higher-yielding instruments more attractive. Lower-yielding—or investment-grade—securities don't currently offer an attractive spread relative to Treasuries.



Fixed-income duration
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.

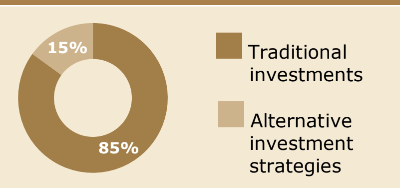


Fixed vs. floating rates
We prefer fixed-rate short-term debt, which tends to have more investor-friendly debt-covenant characteristics than floating-rate debt. Also, some floating-rate debt doesn't float until rates rise above a certain threshold, which might make it perform in unanticipated ways. That could become evident as the Fed starts to hike rates.



Alternative investment strategies — Strategic recommendation*

Alternative investment strategies vs. traditional investments
Our investment guidance for alternative investment strategies may range from 0% to 20%, based on our subjective assessment of risk. We believe the risks in the near future are slightly above average, leading us to recommend a 15% weighting.



*A time frame of three years or longer

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

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.

The BofA Merrill Lynch U.S. High Yield Master II Index is a measure of the broad high-yield market and is a commonly used benchmark index for high-yield corporate bonds.

The BofA Merrill Lynch U.S. Corporate Index is an unmanaged index composed of U.S. dollar–denominated investment-grade corporate debt securities publicly issued in the U.S. domestic market with at least a one-year remaining term to final maturity.

The BofA Merrill Lynch Global Broad Market ex-U.S. Index tracks the performance of investment-grade debt publicly issued in the major domestic and eurobond markets, including sovereign, quasi-government, corporate, securitized, and collateralized securities and excludes all securities denominated in U.S. dollars.

The BofA Merrill Lynch U.S. Municipal Securities Index is an unmanaged, market-value-weighted index composed of investment-grade, fixed rate, coupon-bearing municipal bonds.
The BofA Merrill Lynch BB U.S. High Yield Index tracks the performance of BB1-rated and BB3-rated high-yield bonds.

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 Treasury yields. 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-bp change in Treasury yields.

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