WELLS FARGO

INVESTMENT INSTITUTE

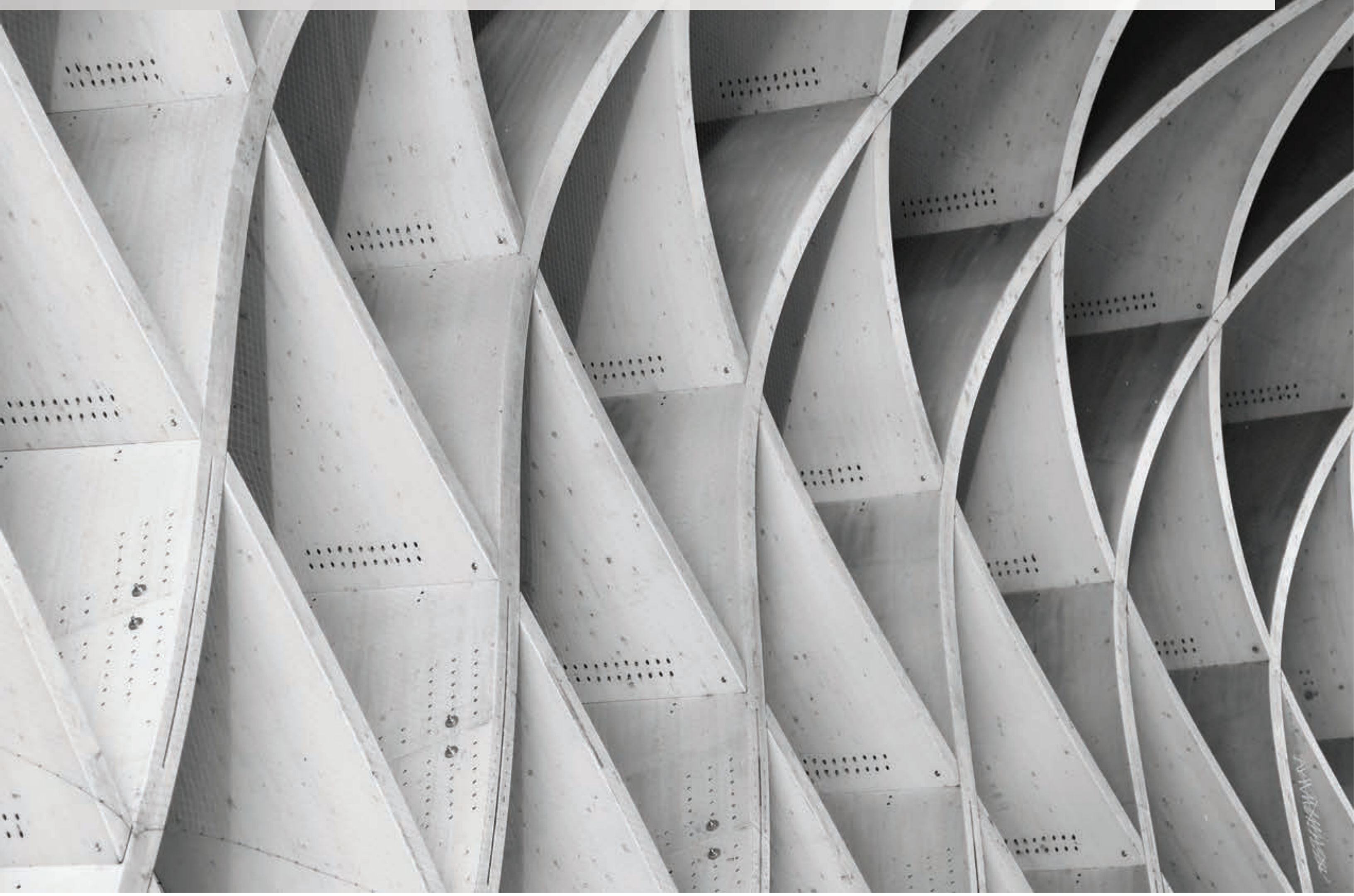
Investing Late in a Bull Market

Essential Strategies for Today's Investor

April 2018

Will this be the longest U.S. bull market ever?

We are in the ninth year of a U.S. economic expansion that coincides with an equity bull market (measured by the S&P 500 Index) that turned nine years old on March 9, 2018. If we avoid a bear market through August, this will become the longest U.S. bull market ever recorded. Yet, age typically has little to do with why a stock market rally ends. We believe U.S. economic data supports the case for continued economic recovery and further stock market gains. The challenge for investors is to remain alert to the risks that accompany the latter stages of a bull market—including heightened volatility—while also taking advantage of the market's potential for still-sizable returns.



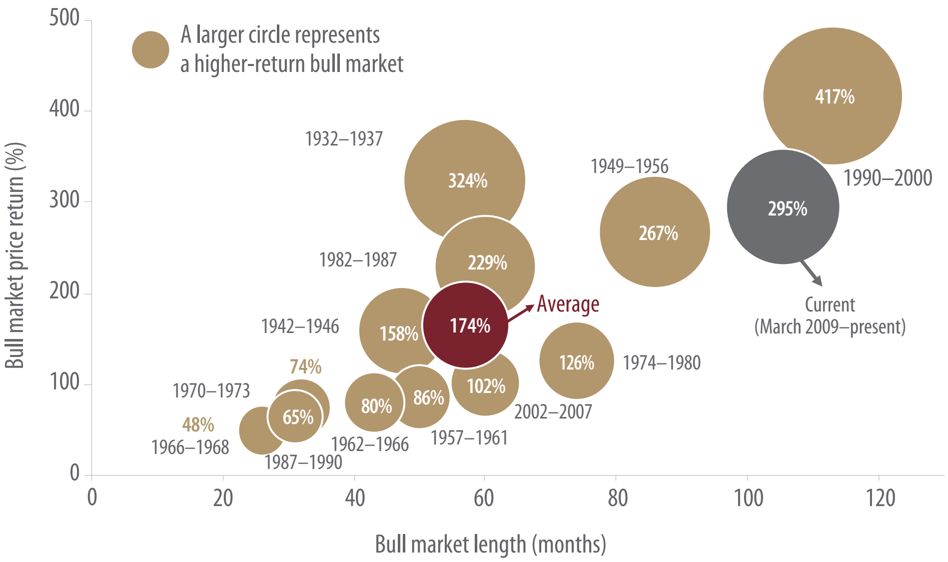
Investing late in a bull market

In this report, we review the current macroeconomic environment and identify signals that might indicate whether the bull market is nearing its end. We also discuss how asset classes historically have performed in the latter stages of the business cycle and extended bull markets and how investors can consider positioning their portfolios for today's environment.

What's inside

This bull market may be one for the record books

As of March 31, 2018, this is the second-longest S&P 500 Index bull market on record, with the third-highest price return (295%).



Sources: Bloomberg, FactSet, and Wells Fargo Investment Institute, as of March 31, 2018.

For illustrative purposes only. The market is represented by the S&P 500 Index. Index returns reflect general market results; assume the reinvestment of dividends and other distributions; and do not reflect any deduction for fees, expenses, or taxes applicable to an actual investment. The S&P 500 Index is a market-capitalization-weighted index composed of 500 widely held common stocks that are generally considered representative of the U.S. stock market. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment.

Key questions we answer in this report

How near are we to the end of this equity bull market?

What types of behaviors do investors typically exhibit late in a bull market?

Does asset class performance typically change late in the cycle?

How does performance shift when an equity bear market occurs?

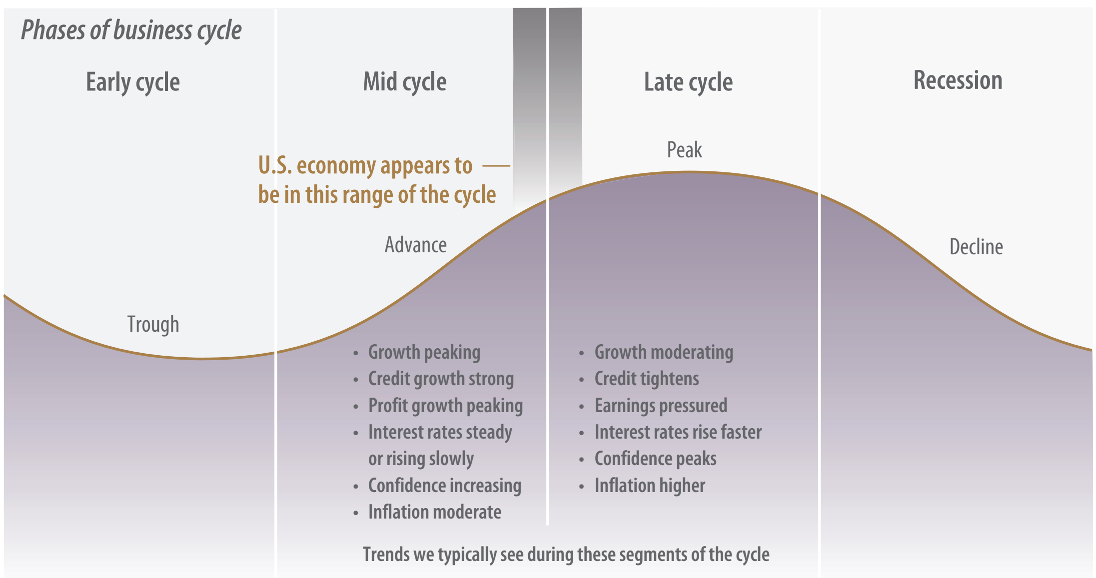
Our current location

Where we stand in the U.S. business cycle

A business cycle typically is composed of three stages—early, middle, and late—followed by recession, and is measured by a variety of economic indicators.

Business cycles tend to exhibit common characteristics as they progress through each phase.

We believe that the U.S. economy is entering the late stage of expansion in what has been an extended business cycle.



Source: Wells Fargo Investment Institute, April 2018

U.S. economic growth has been supported by a strong labor market, healthy household spending and borrowing, and a recent pickup in business investment. These factors all appear to be consistent with an economy that is still expanding yet likely entering (or in) the late-growth stage. The current cycle was lengthened by the slower-than-expected growth that followed the 2007–2008 financial crisis. The passage of tax reform in December 2017 could help further extend the cycle's life span.

Taking a broader perspective, the business cycles of global developed and emerging economies are behind the U.S. cycle. We think developed economies are entering the middle stage, and overall conditions outside of the U.S. may continue to improve even after the U.S. eventually enters a recession. Emerging economies, as a group, are even earlier in their business cycles, with many still in the early growth phase. We believe this provides an opportunity to diversify across global markets, taking advantage of faster-growing economies when the U.S. economy begins to slow.

Factors that support economic growth

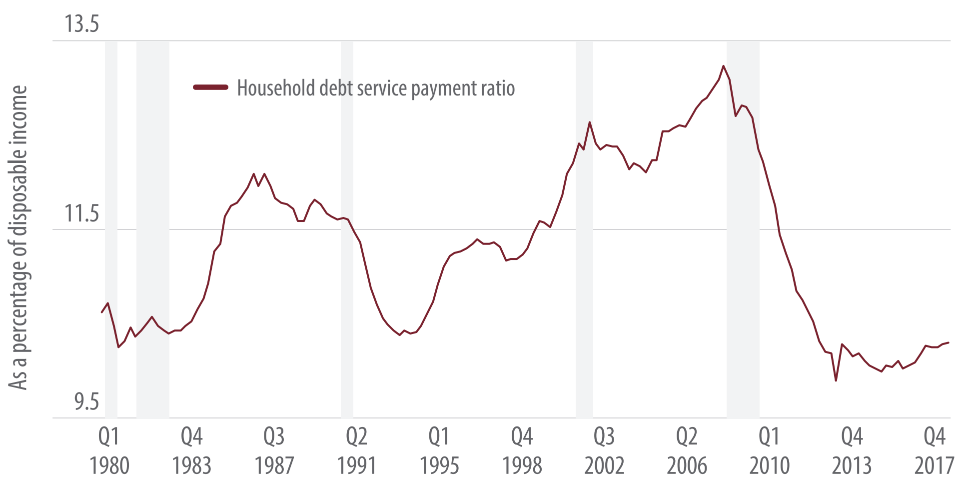
Labor market: The U.S. labor market remains strong. Solid payroll growth and low unemployment have given households the confidence to spend. However, wage growth has been slow to improve and is not yet approaching levels that typically cause the economy to overheat.

Business investment: Business investment has been low for much of the current cycle. Yet, various measures of business optimism are now at or near all-time highs, and business spending has increased since the start of 2017. A combination of higher business and consumer spending should lead to increased economic growth.

Tax reform: The U.S. tax cuts are expected to provide more take-home pay for the majority of workers. In addition, businesses received significant benefits that we believe will encourage business investment. Additional stimulus in the latter stages of the cycle is likely to support further spending and extend the recovery.

Affordable household debt payments help support consumer spending

Household borrowing has reached an all-time high, supported by the strong labor market, yet consumer debt payments remain affordable relative to recent history. A combination of higher household incomes and low financing costs is allowing households to spend.



Sources: Federal Reserve and Wells Fargo Investment Institute. Series represents consumer debt payments as a percent of disposable personal income. Shaded areas indicate recessions as designated by the National Bureau of Economic Research (NBER). Data as of December 31, 2017. The NBER defines a recession as a significant decline in economic activity spread across the economy; lasting more than a few months; and normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.

Key takeaways

- The U.S. economy is currently in the late-growth stage of its expansion.
- U.S. economic growth has been supported by a strong labor market, healthy household spending and borrowing, and a recent pickup in business investment.
- The passage of the Tax Cuts and Jobs Act in December 2017 could help further extend the cycle's life span.

A recent Wells Fargo retirement survey indicated a growing sense of optimism among investors, likely reflecting increased confidence in the stock market.

62% vs. 52%

The percentage of workers who said they will have enough savings to live on comfortably in retirement versus one year ago.

46% vs. 50%

Workers who indicated they will need to work until at least age 70 versus one year ago.

Source: 2017 Wells Fargo Retirement Study, October 17, 2017

Late business-cycle signals to monitor

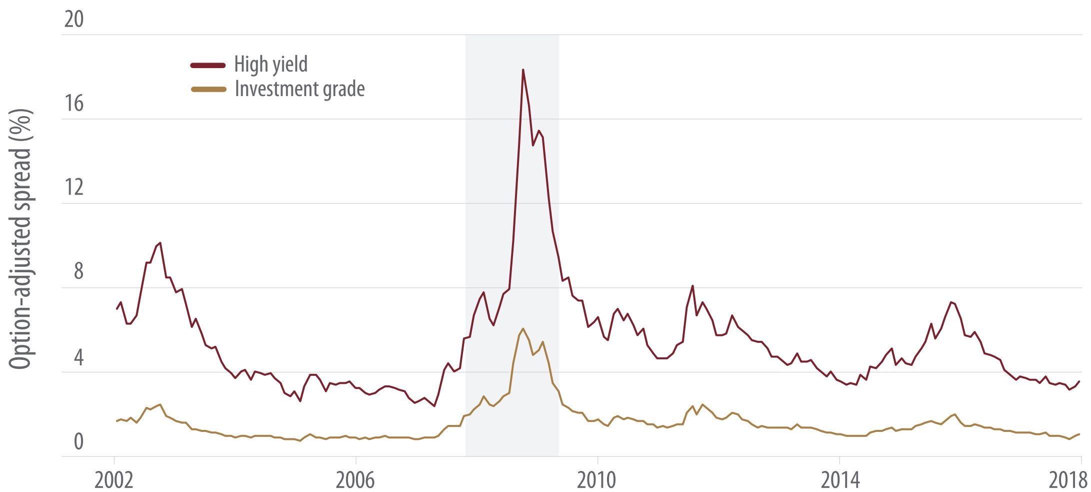
As the business cycle matures, we continue to look for indications of increased risk in the economy and in the markets.

Widening credit spreads: Credit spreads measure the amount of increased return an investor requires for a given company's credit risk. During a strong economy, credit spreads will tighten (narrow). As the economy enters the latter stages of the cycle, business risk increases, with investors demanding more return to compensate for this risk—resulting in wider (higher) credit spreads. At this time, neither high-yield nor investment-grade credit spreads have shown signs of widening.

Investor complacency: Late in a long bull-market run, investors may remain calm even during bouts of volatility. Many have become accustomed to a stock market that continues to climb higher. When volatility returns, many investors may be taken by surprise and overreact to a downturn. As the bull market ages, we believe that investors should be alert to further periods of volatility and maintain a diversified portfolio in line with their longer-term investment plan.

U.S. credit spreads have yet to significantly widen

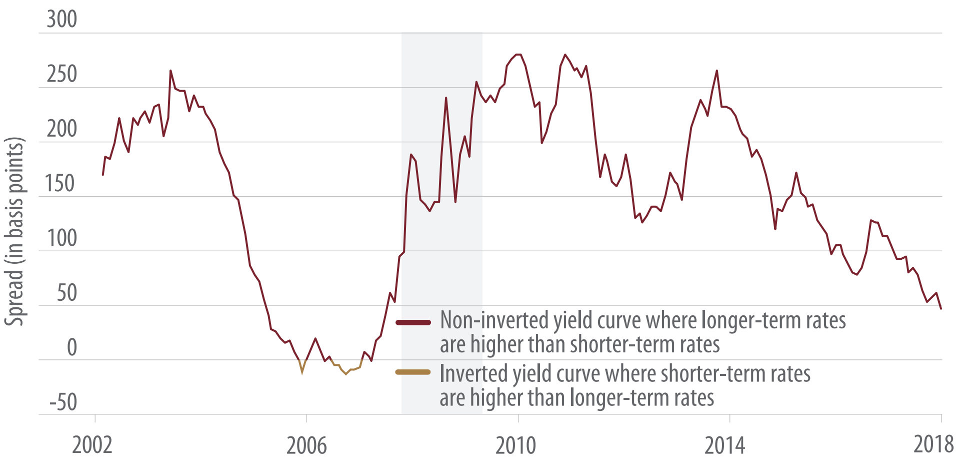
Neither high-yield nor investment-grade credit spreads on taxable bonds have shown signs that investors are asking for higher returns to compensate for increased risk.



Sources: Bloomberg and Wells Fargo Investment Institute. **Past performance is no guarantee of future results.** The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based measure of the investment-grade, U.S.-dollar-denominated, fixed-rate taxable bond market. The Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the U.S.-dollar-denominated, high-yield, fixed-rate corporate bond market. An index is unmanaged and not available for direct investment. Option-adjusted spread is the difference in yield over equivalent-duration Treasuries. Investment grade is represented by Bloomberg Barclays U.S. Aggregate Bond Index; high yield is represented by Bloomberg Barclays U.S. Corporate High Yield Bond Index. Shaded area indicates a recession as designated by the National Bureau of Economic Research.
Data as of March 31, 2018.

The yield curve has flattened but has not inverted

A key signal that a recession may be looming is when the yield curve becomes inverted, which has not happened yet.



Sources: Bloomberg and Wells Fargo Investment Institute. Series represents the difference between the constant-maturity 10-year U.S. Treasury and the constant-maturity 2-year U.S. Treasury. Yields represent past performance. **Past performance is no guarantee of future results.** Current yields may be higher or lower than quoted above. Yields fluctuate as market conditions change. One basis point is equal to 1/100 of 1%. 1% equals 100 basis points. Shaded area indicates a recession as designated by the National Bureau of Economic Research. Data as of March 31, 2018.

Rising rates: As the economy strengthens, the Federal Reserve (Fed) typically raises rates to prevent the economy from overheating and inflation from accelerating. Currently, short-term interest rates are increasing but are not considered restrictive. A key signal of an impending recession is when the yield curve inverts, such as when the 2-year U.S. Treasury note has a higher yield than the 10-year U.S. Treasury note. While every recession has been preceded by an inverted yield curve, not every inverted yield curve has led to a recession. As the Fed has raised short-term rates, the spread between 2-year and 10-year Treasury securities has tightened but has not yet inverted.

Potential asset bubbles: New cash tends to enter the equity market in the latter stages of a bull-market run, due to investors' fear of missing out on market gains. Such inflows tend to drive up price levels ahead of fundamental measures, like earnings. When valuations rise above historical averages, investors are buying assets at a premium price, which may result in asset bubbles. We believe most markets are fairly valued at this time.

Key takeaways

- As the business cycle matures, we remain on the lookout for signals that may point to increased risk in the economy and in the markets.
- Historically, indicators such as widening credit spreads, investor complacency, an inverted yield curve, and rising asset valuations signal that positive economic and market cycles may be nearing their end.
- Although we have seen signs of investor complacency in 2017 and early 2018, credit spreads and the yield curve are not foretelling that a recession is likely in the near term, supporting our view that the bull market still has some room to run.

Late bull-market strategies

Bull market
is defined as a prolonged trend of rising prices without a decline of
20% or more

Correction
is defined as a decline of
10% or more

Bear market
is defined as a decline of
20% or more

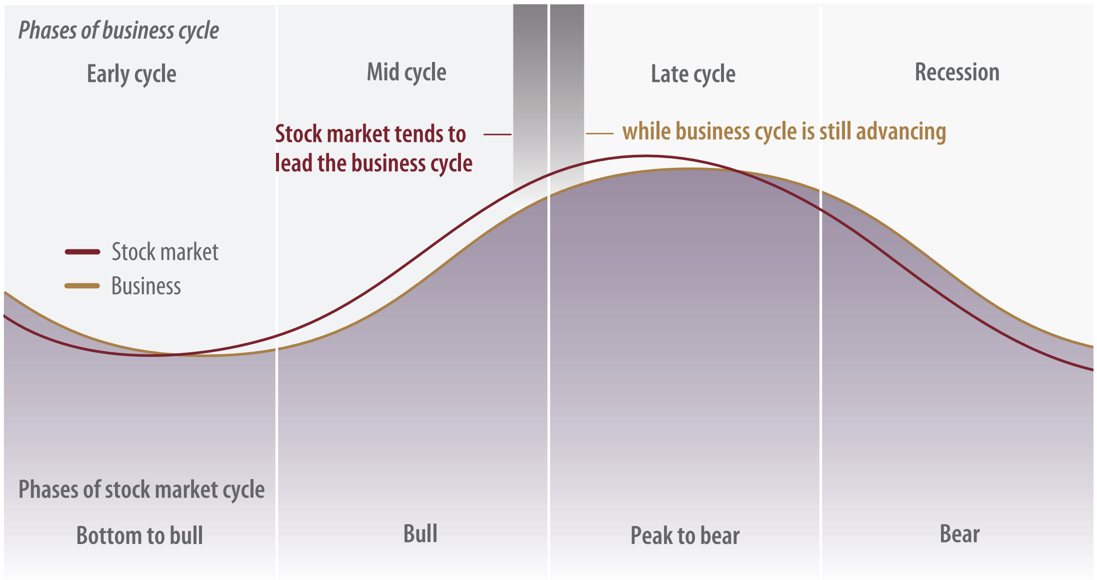
Navigating an extended bull market

Since the 2007–2008 financial crisis, the U.S. equity market has climbed higher without a major pause. However, we believe the U.S. equity market could be nearing the end of its bull-market run, although we also believe it likely will extend well into 2019. History has shown that bull markets do not end suddenly; instead, there are several corrections (of 10% or more) ahead of a downturn, which characterizes the start of a bear market (a decline of 20% or more). The best—and most difficult—time to prepare for a bear market is before the bull market has reached its end.

However, identifying the end of a bull market isn't easy, in part because a bull market can reach its peak and begin to decline before the business cycle reaches its peak. Nevertheless, there are commonalities between a late-cycle bull market and the latter stages of the business cycle. Both typically coincide with rising interest rates and inflation as well as more expensive stock valuations. It's at this stage of a market cycle that hunting for stock market bargains becomes more challenging for investors.

The dynamics of a bull market

The stock market cycle and business cycle tend to move together, with the stock market staying one step ahead, anticipating the direction of the business cycle.



Source: Wells Fargo Investment Institute, April 2018

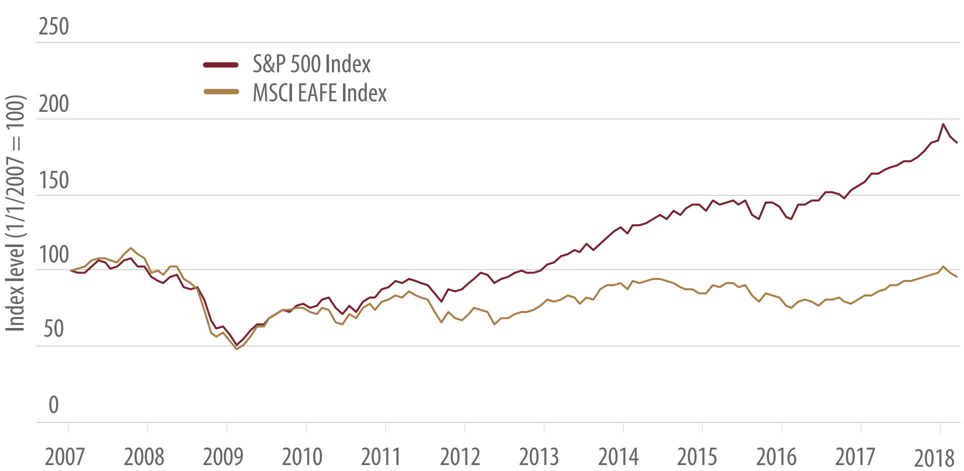
Globalize equity allocations

Investors may be wondering if now is a good time to reduce their equity holdings. Our research shows that the final stages of a bull market can be lucrative for investors and an early exit can be detrimental to an investor's long-term returns. It also may be difficult from a psychological perspective to watch the markets climb higher while maintaining an underweight position in equities. In our view, investors should consider maintaining full equity exposure because the final years of bull markets historically have been strong. Moreover, in our estimation, a recession in the U.S. is not likely over the next 12 to 18 months.

Investors might consider globalizing their portfolios if they have not already done so. We believe international markets may not be as far along in their economic and stock market cycles as the U.S. is. In fact, Europe and Japan appear to have begun their economic recovery much later than the U.S. did, perhaps as late as 2014. Their respective equity markets have lagged the U.S. stock market (as measured by the S&P 500 Index) in recent years. This means that their stock markets could continue to climb even if the U.S. stock market takes a pause in the coming years.

Other developed market equities have lagged U.S. equities

Because the developed markets of Europe and Japan entered economic recovery later than the U.S. did, their markets could continue to rally even if the U.S. rally ends.



Sources: Bloomberg and Wells Fargo Investment Institute, as of March 31, 2018. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment. The MSCI EAFE Index is an equity index that captures large- and mid-cap representation across developed market countries around the world, excluding the U.S. and Canada. The S&P 500 Index is a market-capitalization-weighted index consisting of 500 stocks considered representative of the U.S. equity market.

Some of the best returns have come before the bear

Average returns prior to a bear market

Intermediate-term government bonds	
12 months prior	3.9%
24 to 12 months prior	6.3%
36 to 24 months prior	5.2%
Large-cap equities	
12 months prior	24.2%
24 to 12 months prior	14.4%
36 to 24 months prior	14.2%
Small-cap equities	
12 months prior	36.4%
24 to 12 months prior	13.7%
36 to 24 months prior	18.5%

Sources: Morningstar Direct and Wells Fargo Investment Institute, March 31, 2018.

Monthly data from August 31, 1926, to September 30, 2007. Returns are for one-, two-, and three-year periods before the beginning of a recession as defined by National Bureau of Economic Research. Performance results are for illustrative purposes only and do not represent the performance of any investment, nor should they be interpreted as a forecast or as an indication of how the asset classes may perform in any future recession period. **Past performance does not guarantee future results.** Index returns represent general market results; assume the reinvestment of dividends and other distributions; and do not reflect the impact of any fees, expenses, or taxes applicable to an actual investment. Please see page 15 of this report for the definitions of the indices and for the risks associated with the asset classes discussed in this report. Intermediate-term government bonds are represented by the Ibbotson Associates Stocks, Bonds, Bills and Inflation Series (IA SBBI) U.S. Intermediate-Term Government Bonds TR Index. Large-cap equities are represented by the Ibbotson Associates Stocks, Bonds, Bills and Inflation Series (IA SBBI) U.S. Large Stock TR Index. Small-cap equities are represented by the Ibbotson Associates Stocks, Bonds, Bills and Inflation Series (IA SBBI) U.S. Small Stock TR Index. An index is unmanaged and not available for direct investment.

Focus on cyclical sectors late in a bull market

One way to address elevated markets is by focusing on the sectors that historically have tended to outperform in a late bull-market environment. In this bull market, Financials and Consumer Discretionary have performed stronger later in the bull market than historical trends. The demand for these sectors' products and services is closely tied to an improving business cycle.

As the bull market peaks and transitions to a bear market, sector leadership typically changes. Because inflation tends to rise near the end of a bull market, natural inflation-hedged sectors like Materials may perform well. During a bear market, the sectors that tend to hold their value best are those that are more defensive in nature. These include Utilities, Consumer Staples, Energy, and Health Care. The demand for these sectors' products and services isn't as closely tied to the economic cycle, as these products and services often provide basic necessities for consumers.

Sectors that tend to perform well near the end of a bull market

Sectors that are closely tied to the economic cycle tend to perform well at the peak of a bull market, which often accompanies economic recovery. More defensive sectors tend to outperform at the beginning of a bear market, which often anticipates a recession.

Bull market			Bear market
Early	Mid	Late to peak	
• Consumer Staples • Health Care • Financials	• Consumer Discretionary • Industrials	• Industrials • Energy • Materials	• Consumer Staples • Health Care • Utilities • Energy

Source: Wells Fargo Investment Institute, April 2018. **Past performance is no guarantee of future results.**

Consider active management

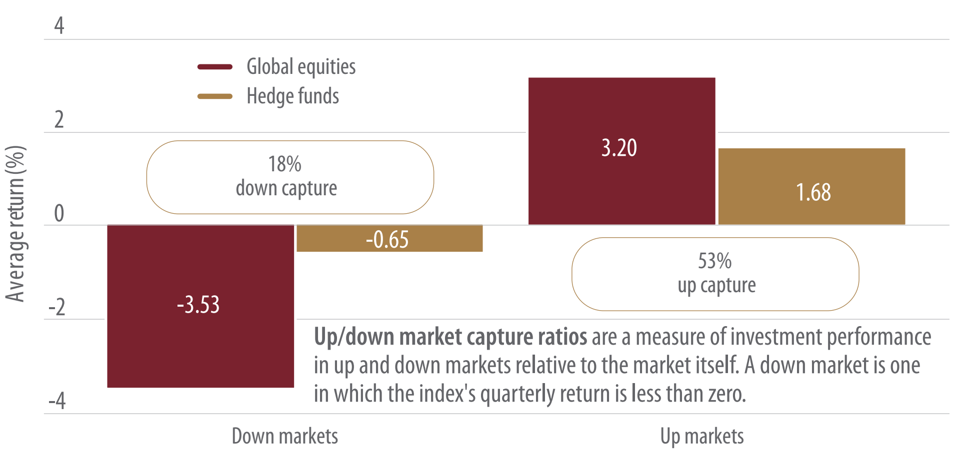
In the latter stages of bull markets, markets often display greater volatility, and individual stock performance tends to diverge within a given index. Such an environment may favor active management. Indeed, our research shows that about half of all mutual funds in Morningstar Inc.'s database outperformed their benchmarks in 2017, making it the best year for active management since 2012. Relative performance was especially strong for U.S. large-cap value, international equity, and U.S. fixed-income funds.[1] We believe that a blended approach—including a mix of active and passive strategies—may be suitable for many portfolios, depending on an investor's risk profile and return objectives.

Maintain exposure to fixed income and alternative investments

Even though it may be tempting to increase equity exposure in a strong market, asset classes such as fixed income and alternative investments (for qualified investors) can help counter potential equity volatility. In particular, we believe that hedge funds could benefit in 2018 from an improved environment for active management.

Hedge funds can help investors win by not losing

Since 1990, hedge funds have held up better than global equity indices in down markets, capturing just 18% of the losses equities sustained; in up markets, hedge funds have captured 53% of positive equity returns.



Sources: Morningstar Direct and Wells Fargo Investment Institute, December 1, 1990, to March 31, 2018. Performance results are for illustrative purposes only. Index returns represent general market results; assume the reinvestment of dividends and other distributions; and do not reflect the impact of any fees, expenses, or taxes applicable to an actual investment. Unlike most asset class indices, HFR index returns reflect deductions for fees and expenses. Because the HFR indices are calculated based on information that is voluntarily provided, actual returns may be higher or lower than those reported. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** Hedge funds are represented by the HFRI Fund Weighted Composite Index. Global equities are represented by the MSCI World Index. Please see page 15 of this report for the definitions of the indices and for the risks associated with the asset class.

Alternative investments, such as hedge funds, are not suitable for all investors and are open only to accredited or qualified investors within the meaning of U.S. securities laws.

1. **Source**: Wells Fargo Investment Institute, "Active Management Rebounds in 2017; Prospects Remain Positive for 2018," January 25, 2018

Key takeaways

- Data suggest that the bull market is approaching its end, yet the final years of bull markets have tended to deliver strong performance. In our opinion, investors should consider maintaining full equity exposure.
- Investors might consider adding exposure to developed and emerging international equity markets if they have not already done so. We believe these markets may not be as far along in their economic and stock market cycles as the U.S. is.
- Stock selection tends to become more important in the latter stages of bull markets, which could favor active management.
- Investors also might focus on sectors that are more cyclical in nature such as Industrials and Consumer Discretionary.

Action list

Rising volatility may indicate that a bull market is nearing its end. At the same time, our research shows that the final stages of a protracted market rally can be lucrative and an early exit can be detrimental to an investor's long-term returns. We therefore believe investors should maintain full equity allocations and instead of selling equities should consider these five strategies to help prepare their portfolios for the next bear market.

1. ***Revisit asset allocation.*** Consider adjusting the asset allocation based on the answers to these questions: Is the current allocation appropriate for the investor's time horizon, risk tolerance, and other circumstances? How did the current allocation perform during the Great Recession and afterward? Would there be commitment to the long-term plan even if equity markets were to fall by 20% or more in the coming years?

2. ***Rebalance regularly.*** The allocations to equities, fixed income, real assets, and alternative investments (where appropriate) that correspond to an investment objective are designed to help manage risk while maintaining the potential for gains. It is important to ensure that allocations remain aligned with longer-term targets.

3. ***Broaden exposure to risk-mitigating assets.*** Where appropriate, qualified investors may want to consider adding alternative investments such as hedge funds to their portfolios. These asset classes can behave differently from traditional asset classes and may help buffer the effect that down markets can have on a portfolio's value.

4. ***Look for tactical opportunities late in the cycle.*** The volatility that often accompanies the end of a bull market may offer investors shorter-term opportunities, such as purchasing equities at temporarily lower prices. Tactically adjusting the allocations to certain asset classes may potentially enhance return or reduce volatility risk.

5. ***Be active but smart, particularly in international equities and hedge funds.*** Active managers may benefit most toward the end of a cycle when market participants start to differentiate between companies that are sustaining earnings growth and those that have just come along for the bull-market ride. We have observed this trend most notably in international markets and in hedge funds.

Conclusion

We believe the U.S. stock market is slowly approaching the end of what likely will be the longest bull market on record. Economic conditions remain strong. Late-cycle fiscal stimulus may boost corporate earnings in the coming years, but it also may awaken inflation. Historically, rising inflation has led to central bank tightening that resulted in more challenging equity and fixed-income market conditions. Investors should remain alert to the risks that are present in the latter stages of a bull market, including the temptation to significantly alter their long-term asset allocation. They also should be aware that attractive returns historically have been generated in the final years of the bull market and that maintaining an allocation to fixed income and hedge funds may help reduce volatility risk. Appropriate strategic and tactical asset allocations are important ways that investors can prepare for market downturns while participating in potential equity market upside.

About the authors

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Definitions for indices, pages 9 and 11:

The HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager funds that report to HFR Database. Constituent funds report monthly net-of-all-fees performance in U.S. dollars and have a minimum of $50 million under management or a 12-month track record of active performance.

The Ibbotson Associates Stocks, Bonds, Bills and Inflation Series (IA SBBI) U.S. Large Stock TR Index is a large-cap stock total return index based on the S&P Composite Index. This index is a readily available, carefully constructed, market-value-weighted benchmark of large-cap stock performance. The large-capitalization stock total return is provided by S&P Dow Jones Indices, which calculates the total return based on the daily reinvestment of dividends on the ex-dividend date.

The Ibbotson Associates Stocks, Bonds, Bills and Inflation Series (IA SBBI) U.S. Intermediate-Term Government Bonds TR Index consists of one-bond portfolios that are used to construct the intermediate-term government bond index. The bond chosen each year is the shortest noncallable bond with a maturity not less than five years, and it is *held* for the calendar year. Total returns of the intermediate-term government bonds for 1987 to 2014 are calculated from *The Wall Street Journal* prices, using the coupon accrual method. Returns for 1934 to 1986 are obtained from the Government Bond File at the Center for Research in Security Prices at the University of Chicago Booth School of Business.

The Ibbotson Associates Stocks, Bonds, Bills and Inflation Series (IA SBBI) U.S. Small Stock TR Index is based on the S&P Composite Index. This index is a readily available, carefully constructed, market-value-weighted benchmark of small-cap stock performance. The small-capitalization stock total return is provided by S&P Dow Jones Indices, which calculates the total return based on the daily reinvestment of dividends on the ex-dividend date.

The MSCI World Index is a free-float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of 23 developed market countries, including the United States.

Risk considerations:

All investing involves risks, including the possible loss of principal. There can be no assurance that any investment strategy, including active and passive strategies, will be successful and not incur loss. Investments fluctuate with changes in market and economic conditions and in different environments due to numerous factors, some of which may be unpredictable. Asset allocation, including strategic and tactical asset allocation, does not guarantee investment returns or eliminate risk of loss, including in a declining market.

Each asset class has its own risk and return characteristics, which should be evaluated carefully before making an investment decision. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. The risks associated with the representative asset classes discussed in this report include:

Stock markets, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks, including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Mid- and small-cap stocks** are generally more volatile, are subject to greater risks, and are less liquid than large-company stocks. **Bonds** are subject to market, interest rate, price, credit/default, call, liquidity, inflation, and other risks. Prices tend to be inversely affected by changes in interest rates.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. The **Energy sector** may be adversely affected by changes in worldwide energy prices, exploration and production spending, and government regulation and by changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. Risks associated with investing in **Industrials** include the possibility of a worsening in the global economy, acquisition integration risk, operational issues, failure to introduce to market new and innovative products, further weakening in the oil market, potential price wars due to any excesses industry capacity, and a sustained rise in the dollar relative to other currencies. **Materials** industries can be significantly affected by the volatility of commodity prices, the exchange rate between foreign currency and the dollar, export/import concerns, worldwide competition, procurement and manufacturing, and cost containment issues.

Hedge funds are not suitable for all investors. They are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. There is no assurance that any investment strategy pursued by a hedge fund will be successful or that the fund will achieve its intended objective. Investments in hedge funds entail significant risks, volatility, and capital loss, including the loss of the entire amount invested. They trade in diverse complex strategies that are affected in different ways and at different times by changing market conditions. Strategies may, at times, be out of market favor for considerable periods with adverse consequences for the fund and the investor.

Investment expertise and advice to help you succeed financially

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