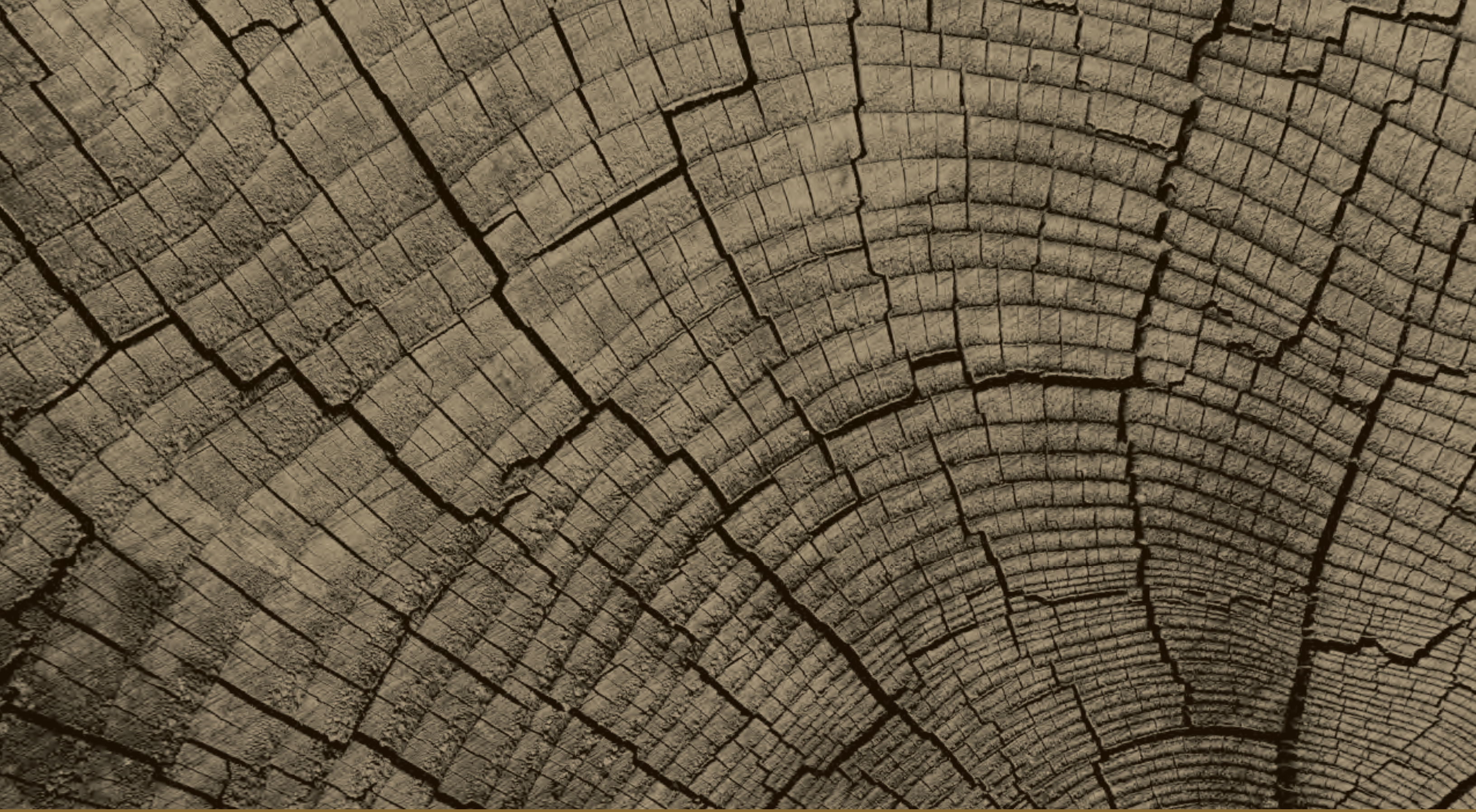
WELLS FARGO
Investment Institute

How Bull Markets End

Investment strategies to prepare for the next downturn

October **2019**



"The investor of today does not profit from yesterday's growth."

—Warren Buffett

What's inside

Investment and Insurance Products: NOT FDIC Insured • NO Bank Guarantee • MAY Lose Value

A record recovery and bull run

As of October 2019, the U.S. economic expansion is 126 months old, marking its longest expansion in U.S. recorded history since the mid-19th century. The S&P 500 Index simultaneously has sustained the longest bull market on record, gaining nearly 350% on a total return basis. The sheer length of these two runs has heightened investors' anxiety—surely, they presume, the good times must soon end.

Although bear markets are a normal part of the market cycle, they are difficult to time. After all, an equity market decline does not necessarily predict a bear market or an economic recession. Instead, we favor planning for the next downturn, to avoid a fear-based reaction that can undermine an investor's long-term financial goals.

In this report, we begin by exploring the relationship between equity bear markets and economic recessions. We also consider how this cycle may differ from past ones and point out potential warning signs for investors to watch in the economy and in the equity markets. We conclude by highlighting the potential implications for investors, especially how to prepare for an eventual bear market or the next recession.

Bull market

A prolonged trend of rising equity prices without a decline of 20% or more

Bear market

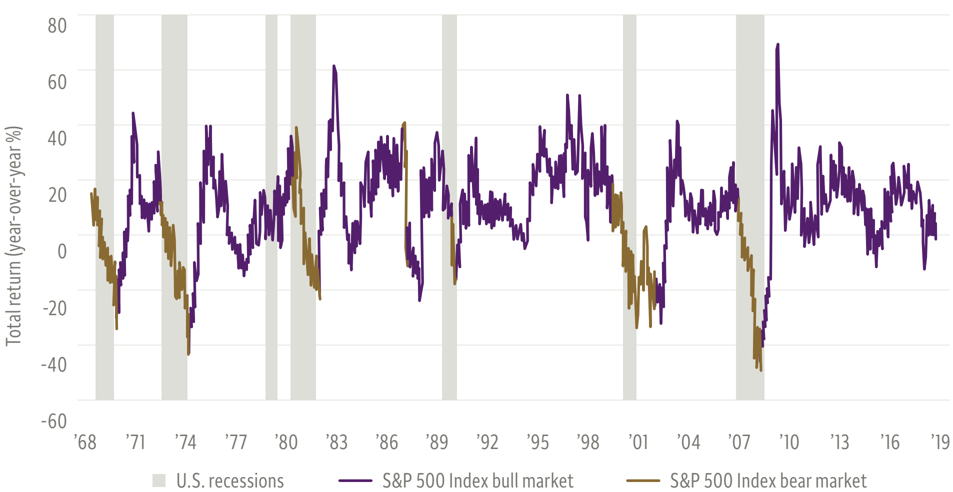
A decline of at least 20% from the highest closing price to the lowest

Recession

A significant decline in economic activity (gross domestic product) that lasts for more than a few months

Sustained market downturns tend to accompany recessions

Because investors value equities partly based on future earnings, a slowing economy and threat of lower earnings often result in an equity market sell-off. However, not every equity market decline develops into a bear market.



Sources: Bloomberg and Wells Fargo Investment Institute, as of September 30, 2019. Market is represented by the S&P 500 Index, a market-capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market. For illustrative purposes only. Index returns do not represent investment performance or the results of actual trading. Index returns reflect general market results; assume the reinvestment of dividends and other distributions; and do not reflect deductions for fees, expenses, or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Key questions we answer in this report

- What is the relationship between bear markets and recessions?
- Which indicators are we watching?
- Why is this cycle different from previous ones?
- How should investors position portfolios for the next downturn?

Bear markets and recessions

Recession versus depression

While a recession and a depression both are contractions in economic growth, a depression has a deeper impact on the markets and the economy.

Great Depression (1929–1933)

- U.S. GDP plunged 30%
- Unemployment spiked from 4% to 25%
- S&P 500 Index declined 86%

Great Recession (2007-2009)

- U.S. GDP fell 4%
- Unemployment rose from 4% to 10%
- S&P 500 Index declined 57%

Of the past seven bear markets, six were accompanied by a recession. The last bear market coincided with the worst recession since the Great Depression—the 2007–2009 Great Recession, which comprised six quarters of negative gross domestic product (GDP) growth and left an indelible mark on investors. Since its low point in March 2009, the market has risen by nearly 350%.[1] It has dropped more than 20% intraday twice since 2009 but has yet to experience a bear market by our definition.[2]

Putting bear markets in context

While bear markets have not always accompanied a recession, they have tended to begin before recessions—but not always.

Recession vs. bear market	S&P 500 Index		Bear market led recession by
November 29, 1968–May 26, 1970	-36%	Bear market	12 months
December 1969–November 1970	-7%	Recession	
January 11, 1973–October 3, 1974	-48%	Bear market	10 months
November 1973–March 1975	-23%	Recession	
January 1980–July 1980	13%	Recession	
November 28, 1980–August 12, 1982	-27%	Bear market	7 months
July 1981–November 1982	6%	Recession	
August 25, 1987–December 4, 1987	-34%	Bear market	
July 16, 1990–October 11, 1990	-20%	Bear market	0 months
July 1990–March 1991	5%	Recession	
March 24, 2000–October 9, 2002	-49%	Bear market	11 months
March 2001–November 2001	-8%	Recession	
October 9, 2007–March 9, 2009	-57%	Bear market	2 months
December 2007–June 2009	-38%	Recession	

Sources: Bloomberg, Morningstar Direct, and Wells Fargo Investment Institute, as of September 30, 2019

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1. Bloomberg, October 21, 2019
2. A decline of at least 20% from the highest closing price to the lowest.

Asset-class performance

The months leading up to an economic contraction often are marked by heightened market volatility. The prospect of an eventual recession might tempt investors to exit the market entirely, but attempting to time the equity market can be costly. Large-cap equities often outperform many asset classes in the 12 months preceding a recession. From July 1, 1978, to September 30, 2019, the asset classes in the chart below show positive returns 12 to 24 months ahead of a recession. However, as the recession grew nearer, the range of returns became more volatile. Commodity prices often rose prior to a downturn during this period. Precious metals prices may climb ahead of a recession as investors seek perceived "safe-haven" assets.

We suggest actively managing portfolios throughout a market downturn—rather than attempting to enter and exit the market to time upswings and downswings. Surprisingly, history shows that missing the 10 best days in the S&P 500 Index over the past 30 years would have significantly reduced return potential. Of those 10 best days, 8 occurred during the Great Recession and the remaining 2 were during S&P 500 Index bear markets.

The cost of market timing

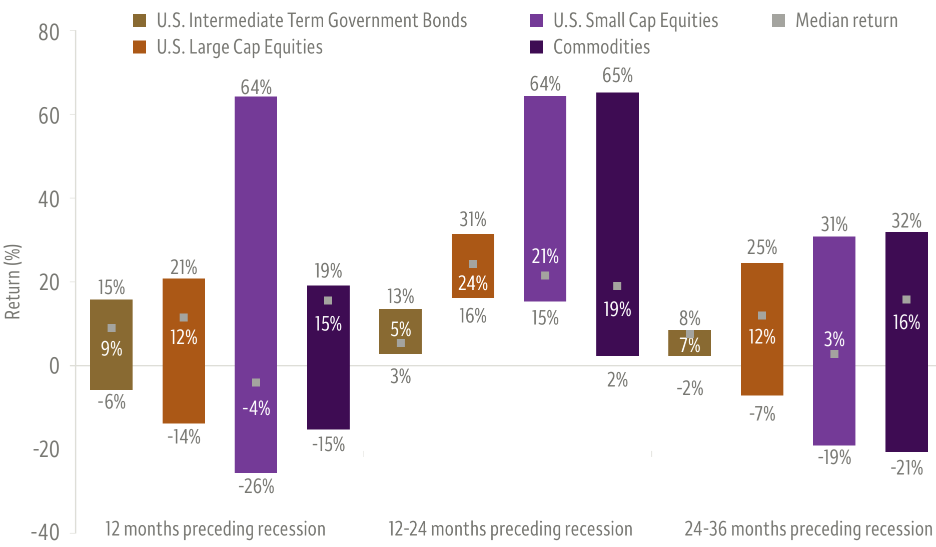
Value of $1 million invested in the S&P 500 Index, January 1, 1989, through December 31, 2018

- Invested all days: $7.2 million
- Missed best 10 days: $3.9 million

Sources: Bloomberg and Wells Fargo Investment Institute

Asset-class performance can be strong leading into recessions

We favor maintaining equity exposure in the latter stages of an economic cycle because market returns historically have been strong in the months prior to a recession.



Sources: Bloomberg, Morningstar Direct, and Wells Fargo Investment Institute. Data from July 1978 to September 2019 to incorporate returns starting 36 months before the July 1981–November 1982 recession.

U.S. Intermediate Term Government Bonds are represented by the IA SBBI U.S. Intermediate Term Government Bond Index, a custom index designed to measure the performance of intermediate-term U.S. government bonds. U.S. Large Cap Equities are represented by the IA SBBI U.S. Large Cap Stock Index, a custom index designed to measure the performance of large-capitalization U.S. stocks. U.S. Small Cap Equities are represented by the IA SBBI U.S. Small Stock Index, a custom index designed to measure the performance of small-capitalization U.S. stocks. Commodities are represented by the Bloomberg Commodity Index, a broadly diversified index composed of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity. **Past performance is not a guarantee of future results.** An index is unmanaged and not available for direct investment. Please see the end of the report for the risks associated with each asset class.

Risk factors for a potential downturn

Recessions are not easy to predict, but we believe the specific headwinds of this cycle provide investors with warning signs to monitor.

Yield curve

The yield curve is a reference to a graphical representation of yields across bond maturities. An inverted yield curve occurs when short-maturity bonds have higher yields than longer-term bonds.

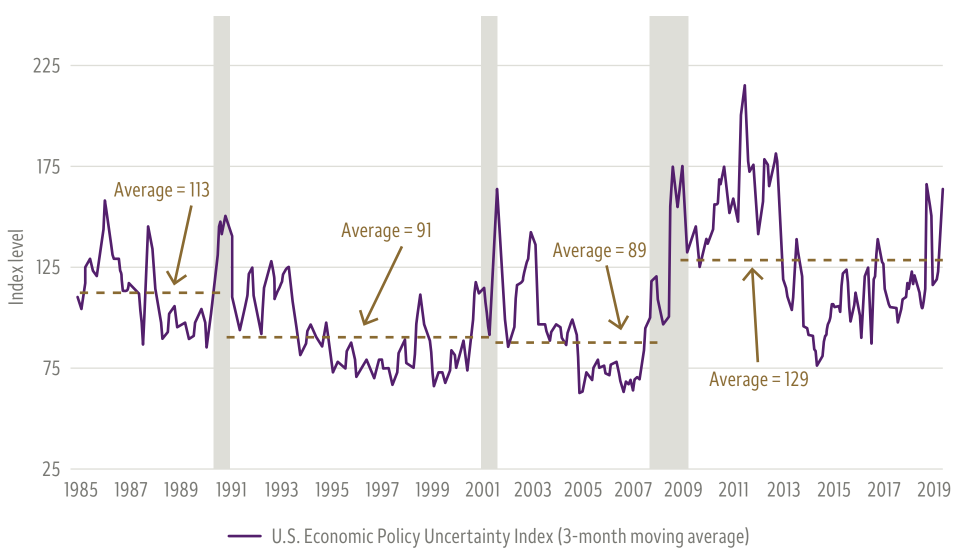
HIGH RISK FACTORS

Yield-curve inversion: Investors normally demand higher interest rates to hold long-term debt securities rather than short-term debt securities because these instruments tie up money for a longer period of time. In 2019, rapidly growing investor demand for longer-term bonds drove their yields lower than those of some shorter-term bonds. This is a yield-curve inversion, and it can push the rates that banks earn on long-term loans lower than the short-term rates that they pay on deposits. In this way, an inversion undercuts bank profits and intensifies the pressure on the economy. Yield-curve inversions are often one of the more predictive indicators of recessions.

U.S. and international political disruption: Geopolitical uncertainties—such as the U.S.-China trade dispute, the growing U.S. political divide, Brexit, and tensions in the Middle East and North Korea—may disrupt the global economy. For example, prolonged negotiations for a revised trade deal between the U.S. and China have been contributing to heightened market volatility. Sustained geopolitical uncertainty could continue to dampen sentiment, potentially triggering a sustained economic downturn.

Economic policy uncertainty has been elevated throughout the current cycle

The U.S. Economic Policy Uncertainty Index average in this cycle is higher than in the previous three expansions.



Sources: Baker, Bloom, and Davis; Bloomberg; and Wells Fargo Investment Institute, as of August 31, 2019. The U.S. Economic Policy Uncertainty Index, produced by Baker, Bloom, and Davis, measures changes in news coverage about policy-related economic uncertainty, tax code expiration data, and economic forecaster disagreements.

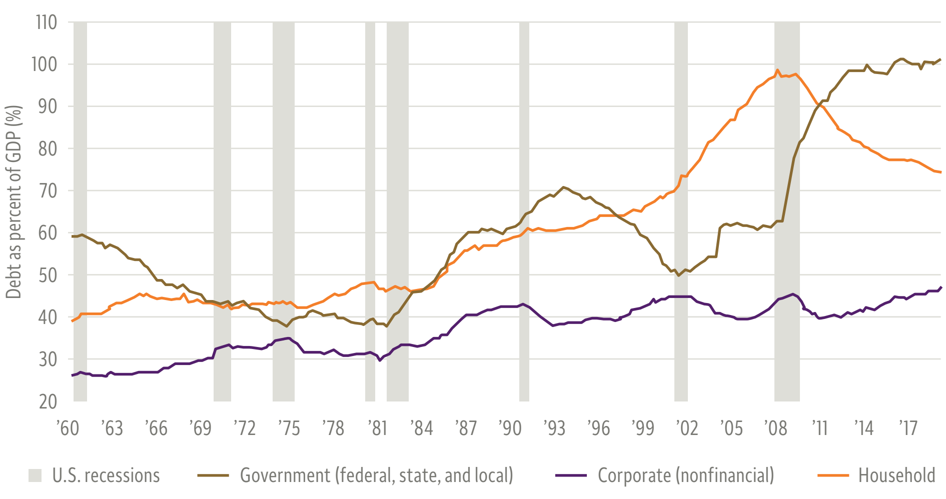
MODERATE RISK FACTORS

High-yield corporate debt spreads: Increasingly higher yields for non-investment-grade bonds relative to U.S. Treasury securities of comparable maturities may signal stress for lower-quality debt. Currently, only a few sectors of the high-yield corporate market—particularly the Energy sector—are experiencing these higher spreads. Spreads may eventually widen and the widening may extend across sectors, leading to a surge in delinquencies and defaults. In general, high-yield spreads are wider now than earlier in the cycle but do not appear to be precariously high. The risk of potential credit stress leads us to favor companies with strong cash flows and low cash/debt ratios even more than in prior cycles.

Debt levels: During this expansion, absolute debt levels have risen, yet signs of stress are not evident at this time. Household debt/GDP ratios remain elevated compared with historical levels but are lower than they were before the Great Recession. Mortgage debt accounts for the largest portion of household debt, and it remains well below the peak debt/GDP ratio seen at the beginning of the last recession. Corporate debt has grown since 2014. U.S. corporations have taken advantage of low interest rates to issue debt and buy back equity shares, potentially augmenting earnings per share and adjusting capital structures.

Households have reduced debt levels since the Great Recession, while corporate debt has grown larger

Given the large effect of consumer spending on the U.S. economy, we believe that excessive household debt would pose a greater economic risk than rising corporate debt.



Sources: Bloomberg, Federal Reserve, and Wells Fargo Investment Institute, as of June 30, 2019

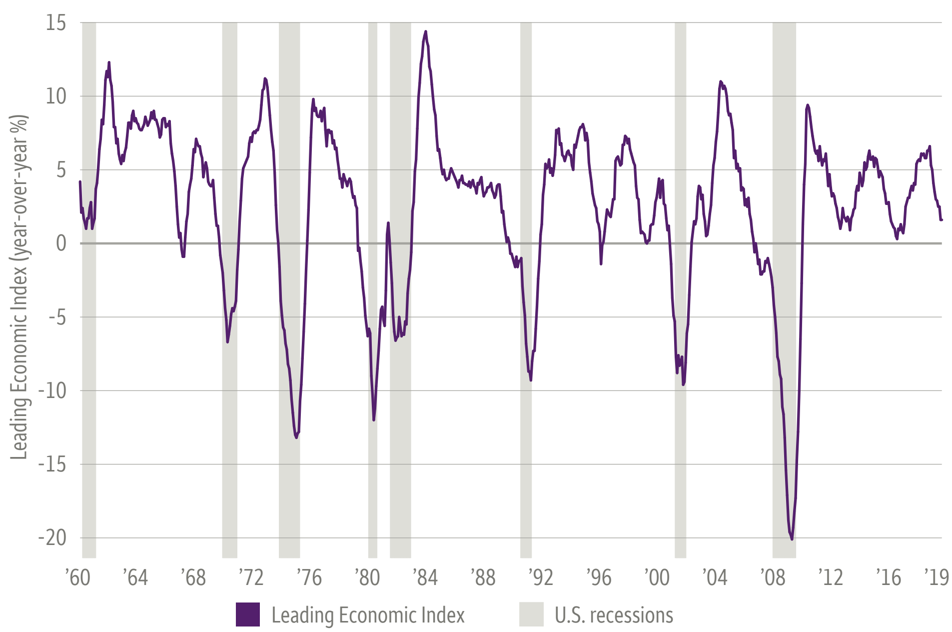
MODERATE RISK FACTORS (CONTINUED)

Federal Reserve (Fed) policy: We see a significant risk for two potential policy mistakes. First, the Fed may fail to cut interest rates sufficiently for a slowing economy that faces heightened political uncertainty. And second, there is a risk that the Fed exhausts effective monetary tools to fight the next recession.

The Conference Board Leading Economic Index® (LEI): This index of 10 market and economic indicators can be used as a barometer of early signs of slowing growth. Historically, the 12-month change in the LEI has dipped below zero (with few false alarms) prior to a recession in seven of the past eight economic cycles. The LEI is slowing, as it did twice earlier in this expansion (in 2012-2013 and 2016). However, during those earlier slowdowns, the headwinds were less concerning to us than they are today. This suggests the risk of a recession is rising, along with the potential for a bear market over the next 12 to 24 months.

Leading economic indicators are approaching levels that often have signaled prior recessions

A sharp decline in the LEI on a year-over-year basis tends to signal a turning point in the U.S. economy within three to six months.



Sources: Bloomberg, The Conference Board, and Wells Fargo Investment Institute, as of August 31, 2019

Traits of a bull-market peak

During the latter stages of a bull market, the sentiment of "it's different this time" and investor overconfidence can lead to inflated market prices and, in some cases, excessively high asset prices (bubbles). The aftermath of asset bubbles has adverse effects on the markets and the economy, depending, in part, on who owns the affected assets and whether that ownership is debt-financed. The table below lists common factors that can lead to excesses over time.

Despite some signs of optimism, the overall picture is mixed. We read this evidence as consistent with a late cycle but not yet the end of the cycle.

Asset bubbles

When assets become grossly overvalued, driven by investor exuberance rather than by intrinsic or fundamental value

Examples include:

- U.S. housing market of the 2000s
- Technology and certain emerging market stocks in the 1990s

Some factors that suggest a bull-market peak may be near

Factor	Currently indicating a peak?	What we are seeing today
Heavy inflows into equity mutual funds	No	Equity mutual funds have seen persistent outflows in the past year
Rising real (inflation-adjusted) interest rates	No	Real U.S. interest rates are declining
Credit spreads widen sharply	No	Credit spreads remain contained
Exuberant investor sentiment	No	Sentiment shows some caution
Rapid growth in corporate mergers and acquisitions	Yes	Merger and acquisition activity has been rising since 2016
IPO activity is strong[3]	Yes	IPO issues have more than doubled from 2018 to 2019
Decelerating corporate earnings	Yes	Positive but slower earnings growth
Equity market leadership shifts to defensive sectors	Yes	In the past 12 months, the leading sectors have been Utilities, Consumer Staples, and Communication Services. The worst performers have been Energy, Materials, and Financials.

Source: Wells Fargo Investment Institute, September 30, 2019

3. An IPO is an initial public offering of equity by a company.

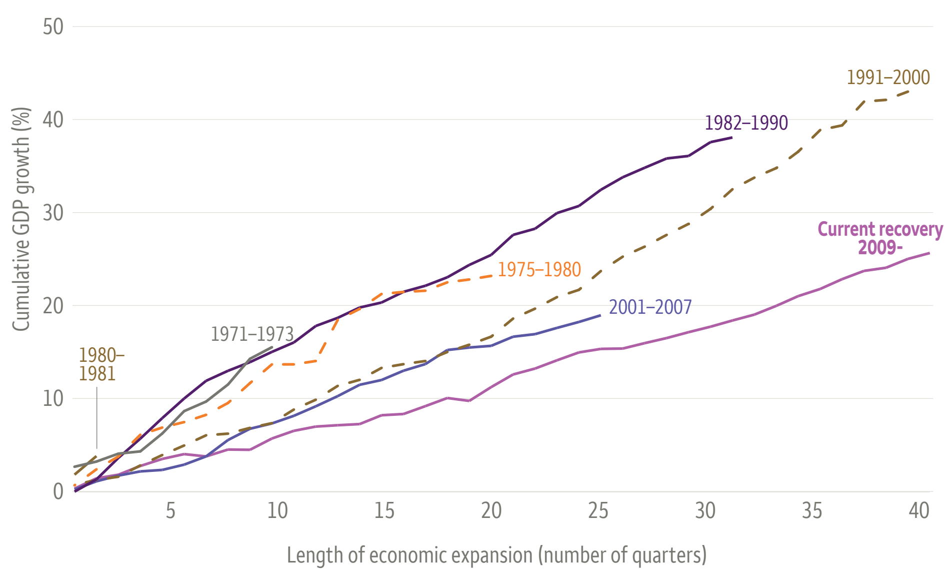
Why this cycle is different

History often can guide investors, but each market cycle is unique—and this matters for managing portfolios. This U.S. economic expansion has been extraordinarily long because consumer caution has constrained spending and prevented household debt from rising to prior peaks (as a percent of GDP). Much of this caution can be attributed to the psychological impact that the Great Recession had on households. Correspondingly, low inflation has allowed exceptionally stimulative central bank policies and low interest rates throughout the expansion.

During this cycle investors have been rewarded for remaining invested in riskier assets, such as equities and longer-maturity and lower quality bonds. Investors with a U.S.-focus have also likely outperformed those with a more global focus. Looking forward, investors should not expect these trends to continue indefinitely. We favor a more proactive approach to selecting asset classes both at home and abroad.

How does the growth pace of the current recovery compare?

While the current recovery is the longest on record, the average pace of growth during this recovery has been 2.3%—significantly lower than the 4.0% average GDP growth rate the U.S. experienced during the past six recoveries.



Sources: Bloomberg, Bureau of Economic Analysis, and Wells Fargo Investment Institute, as of June 30, 2019

Economic drivers of a cycle

While global growth remains sluggish, headwinds continue to build. Slowing job growth, weakening capital expenditures, and significant political obstacles undercut global economic growth. In particular, China's managed economic slowdown and the U.S.-China trade dispute are weighing on manufacturing in the U.S. and abroad, dissuading corporate spending on plant and equipment. Interest rates near multigenerational lows, along with strong cash flows for some multinational firms, have produced a mix of defensive and cyclical equity market leaders so far this year.

Yet, stable global household spending growth arguably is keeping recession risk at bay. Recessions typically happen when economic imbalances become unsustainable and must be rebalanced. Recessions also can happen when inflation surprises and other shocks (for example, 9/11 or the oil-price spikes of the '70s) disrupt the economy. A major challenge for investors today is that the slowly slowing global economy may be increasingly susceptible to shocks, while low interest rates encourage additional debt growth. We believe that weaker-credit corporate debt may eventually pose risks to this recovery.

Factors currently affecting the global economy

Headwinds

- Weaker manufacturing
- Job creation slowing
- Mixed housing market
- Softening business confidence
- Political uncertainties
- Trade disputes
- Slowing international economies

Tailwinds

- Positive (but slowing) corporate earnings
- Wage growth outpacing inflation
- Low interest rates
- Steady household spending growth
- Accommodative Fed policy
- Chinese stimulus

Portfolio positioning for the next downturn

The specific traits and trends of this cycle suggest potential investment strategies. For example, we believe low interest rates should prevail in the coming years, and investors may need to adjust income-generating strategies. We favor a focus on quality companies, that is, those with strong cash flow and cash management. Rather than exiting the equity market late in the cycle, we recommend making the following portfolio adjustments.

Investing ahead of a downturn

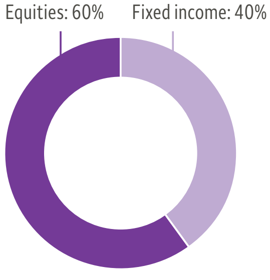
- **Diversify to help mitigate risks:** Consider broadening exposure to alternative investments, including hedge funds and private capital.*
- **Manage cash during periods of volatility:** Instead of holding large quantities of cash, deploy it selectively as markets pull back.
- **Rebalance portfolios:** This long economic expansion may have created a much higher equity exposure than originally desired in many portfolios. Rebalancing back to strategic targets can help prepare a portfolio for a market correction or economic downturn.
- **Know what you own:** Investor sentiment can outpace fundamental value late in a cycle. If expected returns look too good to be true, they probably are. *Know what you own* also means accounting for overlapping exposures or concentration risk. For example, some growth-oriented equity funds were not as diversified as they seemed in the late 1990s because growth-oriented equities as a group became overvalued.

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

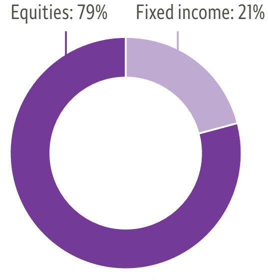
Using rebalancing to help manage risk

Suppose an investor desires a portfolio of 60% equity and 40% fixed income (below). Without rebalancing, equity market appreciation could result in the center portfolio, with a higher allocation to equities after 18 years and higher volatility compared with the target allocation. Using quarterly rebalancing maintained the target allocation of 60% equity and 40% fixed income (right) and achieved a similar expected total return—with lower expected volatility.

Original allocation

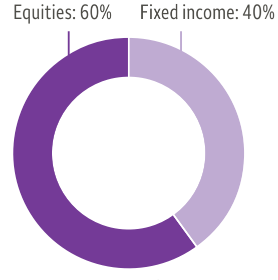


Allocation without rebalancing



Average annual return: 8.2%
Average volatility: 10.0%

Allocation with quarterly rebalancing



Average annual return: 8.2%
Average volatility: 8.8%

Sources: Morningstar Direct and Wells Fargo Investment Institute. January 1, 1990, to December 31, 2018. Bonds are represented by the Bloomberg Barclays U.S. Aggregate Bond Index, a broad-based measure of the investment-grade, U.S.-dollar-denominated, fixed-rate taxable bond market. Stocks are represented by the S&P 500 Index, a market-capitalization-weighted index generally considered representative of the U.S. stock market. Chart shown is hypothetical and intended for illustrative purposes only. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** Please see the end of the report for the risks associated with the asset classes.

Investors nearing retirement

- **Revisit a portfolio's strategic allocation:** As an investor approaches retirement, we suggest actively reducing portfolio risk. Some questions that may help guide the decision are:
    - Is the current allocation appropriate for my time horizon, risk tolerance, and other circumstances?
    - How did the current allocation perform during the Great Recession and afterward?
    - Would I remain committed to the long-term plan even if equity markets were to fall by 20% or more?
    - Will my income needs be met by fixed income alone? Should I consider other income-generating asset classes?
- **Use high-quality bonds for income and to help offset equity volatility:** As the expansion matures, investors might consider more selectivity in fixed-income holdings, by raising average credit quality and aligning portfolio duration (a measure of a bond's or bond portfolio's sensitivity to interest rates) with their individually selected benchmarks.
- **Make incremental changes:** Investors sometimes take large losses by waiting too long to adjust portfolios as the expansion matures. Consider incremental moves—such as from lower-quality to higher-quality bonds—as the expansion ages.

Bear markets and recessions are normal parts of any economic cycle. Investors who react emotionally or out of fear can severely impair their longer-term potential returns and financial goals. Instead, we favor a more proactive approach, taking control of the portfolio by thoughtfully and regularly considering where diverging valuation and price may create excessive risk.

Investors with a growth orientation

- **Proactively remain in the equity market:** Maintain equity exposure because the final years of recoveries historically have been positive. However, be prepared to adjust allocations tactically as risk and reward shift. Late cycle, we see clear disadvantages in U.S. small-capitalization companies. Larger-capitalization companies with good cash flow and low cash/debt ratios may perform better than other companies in a bear market.
- **Look for late-cycle investment opportunities:** Tactical strategies invariably look for attractive risk and reward, but risk and reward may shift more quickly later than earlier in the cycle. Tactically adjusting the allocations to certain asset classes may potentially enhance return or reduce volatility risk.
- **Keep an eye overseas:** U.S. markets outperformed for most of the current cycle, but economic and earnings growth may be stronger overseas in the coming years. Patient investors could benefit from maintaining international diversification.

Authors

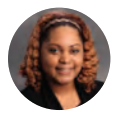
Darrell Cronk, CFA
President of Wells Fargo Investment Institute
Chief Investment Officer for
Wealth and Investment Management

Paul Christopher, CFA
Head of Global Market Strategy

Tracie McMillion, CFA
Head of Global Asset
Allocation Strategy

Michael Taylor, CFA
Investment Strategy Analyst

Michelle Wan, CFA
Investment Strategy Analyst



Veronica Willis
Investment Strategy Analyst

Risk considerations

All investing involve risks, including the possible loss of principal. There can be no assurance that any investment strategy will be successful. 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 risk and return characteristics. 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. Asset allocation and diversification are investment methods used to help manage risks. They do not guarantee investment returns or eliminate risk of loss.

The risks associated with the representative index 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. **Small-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. The **commodities markets** are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

Alternative investments, such as hedge funds and private capital, 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. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund and private capital investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

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Wells Fargo Investment Institute is home to more than 120 investment professionals focused on investment strategy, asset allocation, portfolio management, manager reviews, and alternative investments. Its mission is to deliver timely, actionable advice that can help investors achieve their financial goals.

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

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