WELLS FARGO ADVISORS

Stay the course

2014 Economic and Market OUTLOOK

A special publication from our Investment Strategy Committee

Economy

Will the U.S. economy continue to grow?

Our Chief Macro Strategist gives his forecasts for GDP, unemployment, and inflation.

U.S. equities

Where does the stock market go from here?

Our Chief Equity Strategist looks at what may be ahead for earnings and stock prices.

U.S. fixed income

How will interest rates impact bonds?

Our Chief Fixed Income Strategist looks at how the Fed may act and how interest rates may affect fixed income portfolios.

International

What are the growth prospects for foreign markets?

Our Chief International Strategist gives his analysis on foreign developed and emerging economies.

Please see page 15 for important disclaimers.

Forecasts and recommendations in this report are produced by analysts and strategists on Wells Fargo Advisors' Investment Strategy Committee.

Economic and market forecast

As of November 29, 2013, unless otherwise noted

Economy		2012 year end	2013 latest	2014 year-end forecast
Inflation-adjusted GDP	*rolling four quarters*	2.0%	1.6% [1]	2.4%
Inflation-adjusted GDP	*latest quarter percent change annual rate*		2.8% [1]	
Unemployment	*end of period/latest*	8.5%	7.3% [2]	6.7%
CPI inflation	*12-month average*	3.2%	1.5% [3]	2.0%
Federal deficit	*rolling 12-months*	$1.2 tril.	$0.7 tril. [2]	$0.5 tril.
Existing home sales (SAAR*)	*end of period/latest*	4.4 mil.	5.1 mil. [3]	5.8 mil.
Total vehicle sales (SAAR*)	*end of period/latest*	13.5 mil.	15.2 mil. [3]	16.5 mil.

U.S. equity		2012 year end	2013 latest	2014 year-end forecast
S&P 500 index	*latest (as of 11/29/13)*	1,426.19	1,805.81	1,850-1,900
S&P operating earnings	*trailing four quarters*	$104.58/shr.	$108.42/shr. [3]	$113.50/shr.
S&P 500 price/earnings	*trailing four quarters operating earnings*	13.64	16.66	16.52

U.S. fixed income		2012 year end	2013 latest	2014 year-end forecast
Target federal funds rate	*latest (as of 11/29/13)*	0.12%	0.08%	0.12%
10-year Treasury yield	*latest (as of 11/29/13)*	1.76%	2.74%	3.50%
30-year Treasury yield	*latest (as of 11/29/13)*	2.95%	3.81%	4.50%

International, commodities and currency		2012 year end	2013 latest	2014 year-end forecast
MSCI EAFE index	*latest (as of 11/29/13)*	1,604.00	1,888.91	1,950-2,000
MSCI Emerging Markets index	*latest (as of 11/29/13)*	1,055.20	1,018.28	1,050-1,100
Oil (per barrel)	*latest (as of 11/29/13)*	$91.82	$92.72	$101.00-$105.00
Gold (per troy ounce)	*latest (as of 11/29/13)*	$1,675.35	$1,253.49	$1,200-$1,300
U.S. dollars per euro	*latest (as of 11/29/13)*	$1.32	$1.36	$1.27-$1.32

*SAAR = Seasonally adjusted annual rate 1 = Data as of third-quarter 2013 2 = Data as of October 2013 3 = Data as of November 2013 **Source:** Bloomberg, Wells Fargo Advisors

Recommended tactical portfolio weightings

As of December 3, 2013

Asset classes

Overweight†	Evenweight†	Underweight†
Cash alternatives	Dollar	Commodities
	Emerging-market stocks	International developed fixed income
	High-yield securities	
	Intermediate-term IG‡ bonds	
	International developed stocks	
	International emerging market fixed income	
	Long-term IG‡ bonds	
	REITs	
	Short-term IG‡ bonds	
	U.S. large-cap stocks	
	U.S. mid-cap stocks	
	U.S. small-cap stocks	

†See "sector weightings" definition on page 14.

‡IG - Investment grade - Treasuries, agency securities, mortgage-backed securities, corporate bonds, and municipal bonds.

Source: Bloomberg, Wells Fargo Advisors

Please see page 15 for important disclaimers.

Stay the course

Over the past couple of years, investors were generally cautious and uncertain about economic and market prospects. We thought investors were too defensive, and in 2012 we suggested they should be "preparing for better days" and then followed that in 2013 by stating that it was "a time for action." Now, after improving economic conditions and strong stock market gains, many investors may be wondering what to do in 2014. First, we believe they need to rebalance their portfolios given the recent significant dispersion in returns from various asset classes. Second, we think the year ahead will be good, but challenging because many problems linger. Nevertheless, we remain long-term positive on the economy and the stock market. Valuations appear reasonable – no longer cheap, but not at levels that are excessive either. Therefore, we recommend that investors "stay the course" in 2014.

We expect U.S. economic conditions will continue to improve with moderate economic growth leading to decreasing unemployment and rising consumer confidence. Consequently, we believe that the U.S. stock market is likely to gain further next year, although equities are unlikely to repeat the strong gains of this past year.

Looking ahead, the U.S. stock market will celebrate the five-year anniversary of its 2009 financial crisis low in March 2014. Many investors may be worried that this bull market is aging fast and could end soon. Of course, anything is possible, but we believe the U.S. economy is still in an early stage of a longer-term expansion. The stock market hit new record highs in 2013, but the housing market, consumer confidence, and business capital spending have considerable room to expand before hitting their long-term potential. As a result, we think the stock market could advance for several more years before the current bull market ends.

Uncertainty over federal government budget policies and Federal Reserve monetary policies could lead to periods of market volatility in 2014. In addition, high unemployment and concerns about health care costs and mid-term elections could dampen spending and economic growth. But at this time, we do not expect these challenges to derail the economic expansion. Therefore, we remain positive even after the big market gains in 2013.

Why we think investors should stay the course

1. The United States is leading the global recovery.
2. Housing, confidence, and capital spending are still in an early stage of recovery.
3. Reduced household debt burdens and low interest rates are good for the economy, corporate earnings, and financial assets.

Economy 4

We look for moderate economic growth to continue in 2014 and for inflation to remain low. In this moderate-growth, low-inflation environment, companies are likely to expand operations and hire more workers.

U.S. equities 6

The stock market is expected to trend higher next year, but equity returns in 2014 are unlikely to match the strong gains of 2013. Investors should anticipate increased volatility.

U.S. fixed income 8

We expect the Fed will taper bond purchases in 2014, but the timeline is the biggest variable. We expect economic data will allow the Fed to reduce purchases slowly.

International 10

International markets still look attractive over the next 10-15 years. However, in 2014 we expect global economic growth and earnings to improve only modestly over their 2013 performances.

Conclusion 12

Investors should focus on the long-term trends and have a diversified portfolio to ride out any short-term volatility.

Please see page 15 for important disclaimers.

Stay invested; growth prospects remain favorable

Gary Thayer
Chief Macro Strategist

2014 year-end **forecasts**

2.4 %
inflation-adjusted GDP
Rolling four quarters

6.7 % unemployment
End of year

2.0 % CPI inflation
12-month average

Source: Wells Fargo Advisors

During the past four years, the U.S. economy has been crawling out of the deep hole it fell into during the 2008-2009 financial crisis. Economic conditions are slowly improving, but the economy is still operating far below its potential. As a result, the unemployment rate is painfully high, and consumer confidence is still well below its prerecession peak.

The good news is our outlook for the economy remains positive. Consequently, we look for further economic improvement in 2014. In particular, we believe inflation-adjusted gross domestic product (GDP) is likely to average 2.4% in 2014 while consumer price inflation should remain low and average only 2.0%.

In this moderate growth, low-inflation environment, we expect businesses to expand operations and hire more workers, pushing the unemployment rate down to 6.7% by the end of 2014. If this proves accurate, the unemployment rate would still end the year well above the 5.0% to 6.0% range often associated with full employment in a healthy economy. Nevertheless, we believe consumer confidence is likely to trend higher next year as the jobless rate decreases. But of course, sentiment is unlikely to return to its prerecession peak until the unemployment rate declines closer to its full-employment range.

Deleveraging creates potential long-term benefits

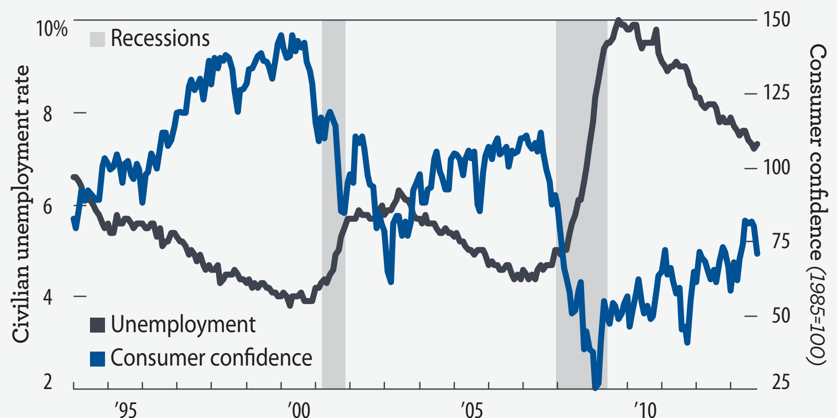
After more than four years of economic recovery, many investors may be wondering if the current expansion is likely to end soon or continue well into the future. At this point, several important economic indicators, including credit conditions and household debt burdens, suggest the U.S. economy is still in the early stage of a potentially long economic expansion.

One reason the current economic expansion has been slow is because households have been reducing their debts and increasing their savings during the past few years. As a result, the percent of household after-tax income that's needed to service those debts declined recently to its lowest level in 30 years.

This reduced use of credit typically hinders economic growth at first but sets the stage for a sustainable economic expansion once debt burdens are reduced. The previous two times that the household debt service burden declined to approximately its current level was in the early 1980s and the early 1990s. In both of those periods, the U.S. economy was still in an early stage of a long economic expansion that lasted several more years.

Declining unemployment boosts consumer confidence

Consumer confidence is slowly trending higher and is likely to support further consumer spending in 2014 if unemployment continues its downtrend as we expect.

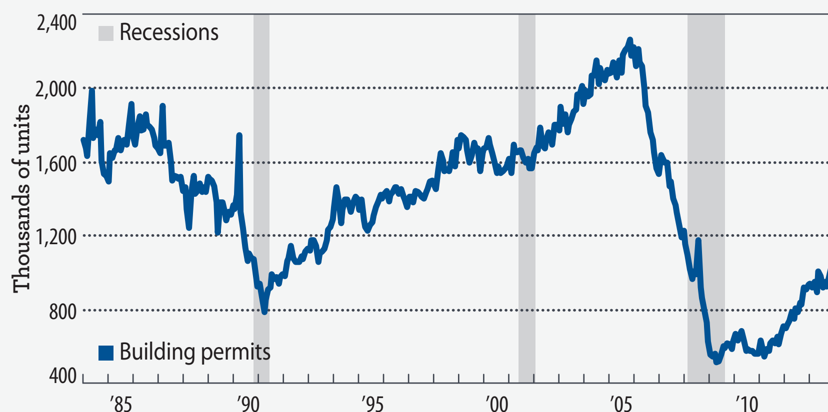


Source: Bureau of Labor Statistics, Conference Board, Haver Analytics, and Wells Fargo Advisors

Please see page 15 for important disclaimers.

Housing recovery just starting

Building permits are at the highest levels in more than five years, but are only starting to recover.



Sources: Census Bureau, Haver Analytics, and Wells Fargo Advisors

The economic recovery in the United States is disappointingly slow compared to other business cycles. Nevertheless, the United States is doing better than many other countries, and the U.S. economy is leading the global economic recovery. As a result, the value of the U.S. dollar has increased versus many emerging-market currencies and some developed-market currencies.

The U.S. housing market is likely to benefit from reduced debt burdens and favorable credit conditions. Housing activity remains well below its prerecession peak and has considerable room to increase, providing a positive contribution to U.S. economic growth.

Of course, past performance does not guarantee the same results. Nevertheless, the decrease in household debts during the past few years along with low interest rates have set the stage for potentially healthier economic growth during the next few years.

The markets still face many challenges

The U.S. stock market was very strong this past year as the economy expanded and corporate profits grew to new record highs. Unfortunately, the bond market suffered a temporary setback when the Federal Reserve signaled that it would wind down its bond purchase stimulus program, also known as quantitative easing, as the economy improved.

Looking ahead, the economy and the markets are likely to face many challenges in 2014. On the economic front, job growth is likely to be hurt by continued uncertainty over health care costs and concerns about potential tax increases that could be necessary to fund expanding government spending.

In addition, 2014 will be an important mid-term election year, which could highlight political differences and the ongoing dysfunction in Washington, D.C. Uncertainty over the federal government's fiscal policies and the Federal Reserve's monetary policies could lead to occasional market volatility and swings in consumer and business sentiment in the year ahead.

A good year after a great year

A year ago, investors were very defensive and worried about the state of the economy. As a result, investors were overly cautious. After a year of improving economic conditions and strong stock market gains, investors are now less defensive and more hopeful. The economy is likely to improve further in 2014, but the stock market is unlikely to experience a second consecutive year of exceptional gains. Instead, we believe investors should expect more normal stock market gains and occasional price weakness in fixed income securities as the Federal Reserve eventually tapers its bond purchase stimulus program.

The good news is weak foreign economic growth is likely to benefit the United States by keeping global inflationary pressures in check. As a result, 2014 is likely to be a good year for stock investors but not necessarily a great year for bond investors.

Please see page 15 for important disclaimers.

Look for more moderate growth

Stuart Freeman, CFA®
Chief Equity Strategist

2014 year-end forecasts

$113.50
S&P 500 earnings

1,850-1,900
S&P 500 index

Source: Wells Fargo Advisors

As we look toward 2014, we see a variety of factors that should lead to further earnings growth. First, the slow decline in initial unemployment claims suggests continuing slow job growth for the next six to nine months. Employment is likely to benefit from a broadening of expansion within later-cycle cyclical industries, leading to more income and more consumer spending. In addition, domestic demand should benefit as the United States should no longer feel the headwinds from the European recession of the past two years. Leading U.S. and European economic indicators generally point toward continued growth next year.

In 2014, we foresee the U.S., European, and Japanese economies simultaneously moving in a forward direction. In fact, the European Central Bank recently decreased its short-term interest rate in an effort to help further stimulate its early-stage cyclical growth. Simultaneous global growth could result in less volatile quarter-to-quarter earnings growth than domestic multinational companies experienced during the past several years. This could help fuel large-capitalization stocks more than smaller-capitalization stocks. We are projecting $113.50 per share for S&P 500 operating earnings next year versus $108 for 2013, which represents approximately 5% growth. We also believe that more revenue growth is likely to spread corporate fixed costs and benefit operating margins.

We expect the stock market to trend higher next year, but equity returns are unlikely to match the strong 2013 gains. Leading economic indicators and market breadth point toward more stock market appreciation in 2014. Furthermore, in our study of historically similar economic environments, we find today's environment is conducive to additional market returns in 2014 (but less than what we enjoyed during 2013). Of course, past performance is no guarantee of future results. We point out that a portion of 2013's strong market returns were borrowed from 2012, a year that included much uncertainty.

Should the next few quarters offer better international fundamentals than we currently expect, our S&P 500 operating earnings estimate could be conservative as opposed to aggressive. Similarly, modestly stronger operating earnings growth and continuing catch-up of investor confidence with consumer confidence could give this market a modestly higher price-to-earnings (P/E) valuation than we are currently using. We are now carrying a year-end target range of 1,850-1,900 for the S&P 500. This represents a 16.3x – 16.7x P/E range, whereas the median long term P/E valuation is 16.7x. The low-interest-rate and low-inflation environment give this multiple added support, in our opinion.

We expect cyclically sensitive sectors to outperform defensive sectors during much of 2014 but could see increased volatility in relative sector performance during the year. Manufacturing-related leading indicators are starting to suggest that industrial expansion is on its way.

2014 opportunities in U.S. equities

As of December 3, 2013

Overweight*	% of S&P 500	Guidance	Evenweight*	% of S&P 500	Guidance	Underweight*	% of S&P 500	Guidance
Consumer Discret.	12.3%	14.1%	Consumer Staples	10.3%	10.1%	Health Care	13.0%	11.5%
Industrials	10.9%	12.4%	Energy	10.5%	10.3%	Utilities	3.2%	0.0%
Info. Tech.	17.9%	19.4%	Financials	16.0%	16.3%			
			Materials	3.5%	3.5%			
			Telecom.	2.5%	2.4%			

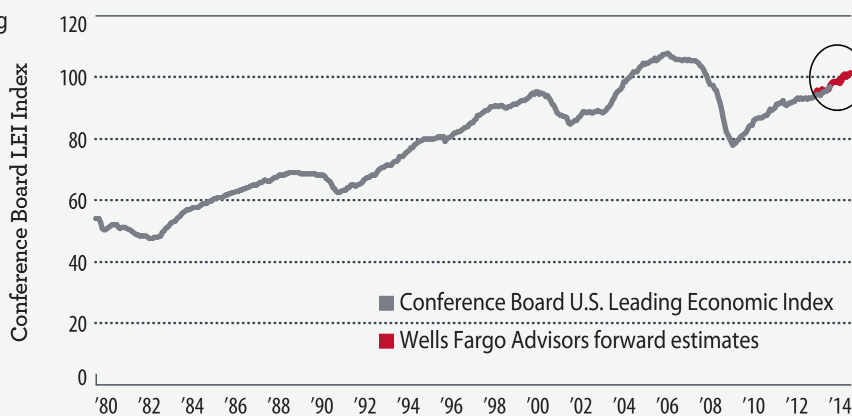
*See "sector weightings" definition on page 14.
Note: S&P 500 weightings as of December 2013. May not add to 100% due to rounding.

Source: Bloomberg, Wells Fargo Advisors

Please see page 15 for important disclaimers.

Economic indicators are positive

The uptrend in the Leading Economic Index (LEI) and our forward-looking projections support our expectations that this cyclical recovery still has more upside and that investors should anticipate higher levels for the S&P 500.



Past performance is not an indication of future results.

Source: Factset, Conference Board, and Wells Fargo Advisors

Overall, we foresee more moderate stock market upside for 2014, but with more volatility (relative to the low-volatility environment we enjoyed during the first half of 2013). Early in 2013, investors were moving out of a period of high uncertainty. With some of those issues cleared, equity inflows created one of the strongest and broadest market advances in 20 years.

Expect a rougher ride

Overall, we foresee more moderate stock market upside for 2014 along with more volatility (particularly relative to the low-volatility environment we enjoyed during the first half of 2013). Early in 2013, investors were moving out of a period of high uncertainty. With some of those issues cleared, equity inflows created one of the strongest and broadest market advances in 20 years. However, as we enter 2014, the S&P 500 index has already had a strong move. We are now facing a few more clouds. Budget wrangling will start up again in Washington, D.C., early in the year. In addition, there remains some uncertainty surrounding the Fed. Investors will ponder when the Fed might start tapering next year, how quickly they will finish it, and how the transition to a new Fed chairperson will fare. Of course, noise over the rollout of the Affordable Care Act and the approach of the mid-term elections will add opportunities for volatility, as well.

Look to cyclical sectors

We expect cyclically sensitive sectors will outperform defensive sectors during much of 2014 but could see some rotation in relative sector performance during the year. A year ago, nervous investors acquired equities, seeking yields on many defensive companies that offered generous dividend payouts. As those valuations moved higher, investors became a little less risk averse and started to accumulate companies whose earnings growth rates should benefit from continuing domestic and international expansion. Today, some manufacturing-related leading indicators are starting to suggest that industrial expansion is on its way.

Several months ago, we raised our weighting for the industrial sector from Evenweight to Overweight for the first time in this cycle. Continuing domestic growth with simultaneous international expansion should push capacity utilization levels to and beyond the 80% mark. At that point, we believe companies will feel the need to invest in their businesses and increase capital spending. We have also increased our weighting on Financials to Evenweight from Underweight.

Our Overweights currently include the Consumer Discretionary, Industrials, and Information Technology sectors. We suggest investors Underweight the Health Care and Utility industries. These weightings are consistent with our view that the more cyclical stocks will outperform in 2014.

Please see page 15 for important disclaimers.

Watch allocations, and remember why you own bonds

Brian Rehling, CFA®
Chief Fixed Income Strategist

2014 year-end forecasts

0.12%
target federal funds rate

3.50%
10-year Treasury yield

4.50%
30-year Treasury yield

Source: Wells Fargo Advisors

Going into 2014, the single most important unanswered question facing bond investors is exactly how the Fed will wean the economy off its bond purchasing stimulus (quantitative easing) program. The purchases have become a staple of monetary policy since they began in late 2008. The bond market often reacts significantly to indications that purchases may increase or decrease.

The bond market is also facing a number of uncertainties beyond "tapering" (the term commonly used for the weaning process); many are likely to be resolved as we head through 2014. Most notably, we expect we will have some federal budget and debt-ceiling uncertainty, at least through the mid-term elections. Some semblance of stability should give the Fed more confidence in the fiscal outlook when considering the timing of reducing bond purchases. In addition, Janet Yellen is likely to be confirmed and will take over as the chairperson of the Federal Open Market Committee (FOMC) in late January. Her confirmation will likely allow the Fed to better formulate and articulate a quantitative easing exit strategy.

We expect the Fed will taper purchases in 2014, but the speed at which purchases will be scaled back is the biggest variable. The central bank has clearly stated that any reduction in purchases will be data dependent. Our expectation is that GDP will grow at a moderate 2.4% rate in 2014 while the unemployment rate will slowly fall to 6.7%, remaining above the Fed's stated 6.5% threshold for keeping rates low. The bottom line: The data should allow the Fed to take it slow.

We expect the Fed will leave short-term rates unchanged in 2014 and beyond. As a result, the pressure on longer-term rates is likely to be limited. We do see long-term rates moving modestly higher in 2014 as the Fed scales back its bond purchases. In response, we have set our 2014 10-year Treasury year-end interest rate target at 3.50% and our 30-year Treasury target at 4.50%, a modest move higher from current levels. Such a move would likely result in below-average, but still positive, total returns for most fixed income investors. Total return comprises two factors – price movement and yield (interest income).

2014 opportunities in U.S. fixed income

As of December 3, 2013

Overweight	Slight overweight	Evenweight	Slight underweight	Underweight	Duration
		Agency securities			Slightly short*
		Corporate bonds			
		Mortgage-backed securities			
		Municipal bonds			
		Preferred securities			
		Treasury Inflation-Protected Securities			
		U.S. Treasuries			

See page 14 for "duration" definition.

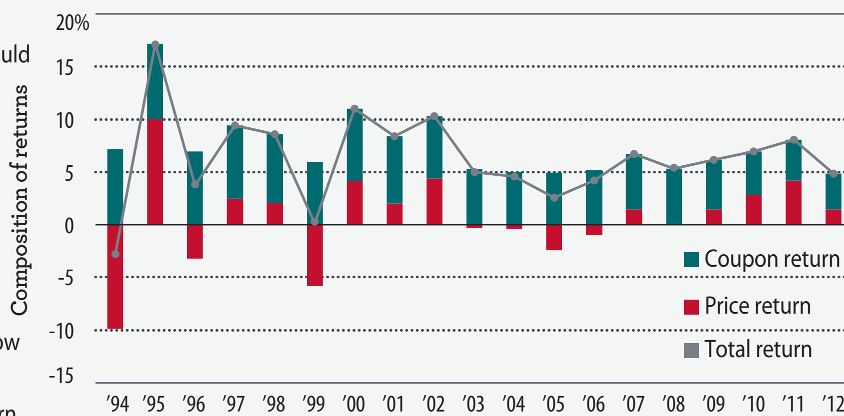
Source: Wells Fargo Advisors

**We recommend a duration slightly short of an investor's target duration. If an investor does not have a target duration, then we recommend a duration of approximately 5.00 years in taxable portfolios, and 7.50 years for tax-exempt portfolios.*

Please see page 15 for important disclaimers.

Total return performance

During the next few years, we believe an investor should anticipate an average annual total return (price return and interest) of 2% to 3% for a fixed income portfolio — a return that is likely to outpace the returns of cash allocations but is below the longer-term historical fixed income average return.



Past performance is not an indication of future results.

Source: Barclay's Aggregate Bond Index

Why own bonds?

If interest rates appear ready to increase, should investors sell their bonds? After all, as interest rates increase, bond prices tend to fall.

With the potential of negative price returns, investors in search of better opportunities may be considering significantly reducing or eliminating their fixed income allocations. There are several factors to consider before making such a move.

First, we strongly recommend that investors consider the total return picture as the most accurate judge of fixed income performance (see chart above). Investors who neglect yields and consider only price movement are missing half the picture. Second, we expect a well-diversified fixed income portfolio will continue to outperform cash alternative allocations over time. So moving from fixed income into cash alternatives would not appear to be a profitable long-term decision. Third, if you're considering moving into more aggressive securities, before you do so, consider the following three reasons fixed income positions are included in most asset allocation models.

Diversification. The future is often uncertain. While we may have a strong feeling of what tomorrow will look like, unforeseeable events often alter reality. Taking too large a bet on any one particular outcome normally increases your risk significantly. Investment strategies based on concentrated allocations are usually higher-risk.

Reduced volatility. One of the primary reasons to continue to own fixed income investments, even if interest rates increase, is the lower volatility these investments typically offer when compared to stocks. Bonds, when used properly as part of a diversified investment strategy, may help smooth out your portfolio's overall performance.

Liquidity. Most bonds have a maturity date when, if the issuer has not defaulted, principal is returned to the investor. If you are able to anticipate future cash needs, purchasing high-quality credit instruments with maturities near those occasions can be an effective way to stay invested in the markets while maintaining some assurance that funds will be available when you need them.

Why the concern about tapering?

Increases in the Fed's quantitative easing bond purchases have generally been viewed as positive news for bond investors because they've helped push yields lower and prices higher. However, now that the Fed appears poised to begin winding the program down, bond prices have fallen and yields have moved higher. Most notably, back in May and June, Fed speakers signaled the Fed's intention to begin to taper purchases during the fall of 2013. As a result, longer-term interest rates moved significantly higher, pushing down prices and resulting in flat-to-negative total returns for many fixed income investors in 2013.

Invest globally, and balance regional opportunities and risks

Paul Christopher, CFA®
Chief International Strategist

2014 year-end forecasts

1,950-2,000
MSCI EAFE equity index

1,050-1,100
MSCI Emerging-market equity index

\$101.00-\$105.00
Crude oil per barrel

\$1,200-\$1,300
Gold per troy ounce

\$1.27-\$1.32
euro exchange rate

Source: Wells Fargo Advisors

For 2014, we expect global economic growth and earnings to improve only modestly and with important regional differences. Economic activity and earnings are likely to grow, but we anticipate relatively more improvement among the U.S. and other developed economies and more risks among the emerging economies. In particular, there are risks to international markets, especially to emerging markets, if rising U.S. yields divert investment flows from international markets to U.S. markets. Some of those outflows occurred in 2013, but another round is possible, especially if U.S. yields were to rise sharply.

In addition, reforms undertaken in the largest emerging economies (notably India, Brazil, and China) could trigger rising unemployment and bankruptcies in those countries. Fortunately, the policymakers implementing these changes have options to help offset the negative impacts of reforms and maintain positive – if slower – economic and earnings growth. Consequently, we think any global market disruptions are unlikely to be severe or sustained and more likely to create opportunities for international investors to differentiate across emerging markets.

U.S. and other developed markets should outperform emerging markets and commodities. In our view, economic growth improvement in the United States and in the largest international economies will drive equity markets in these countries to outperform. Emerging economies should also post earnings gains, but structural reforms and continued weakening investment inflows from overseas investors pose risks to emerging equity markets. We still see important long-term advantages to holding international government debt exposure, but 2014 may again deliver only modest returns.

Currencies and commodities impacted

Potential regional growth differences have implications for currencies and commodities. Considering the advantages in better growth improvement and higher yields in the U.S. economy, we look for the U.S. dollar to gain on its main competitor currencies (including the euro, yen, pound sterling, and the dollar-block currencies of Canada and Australia). The dollar should turn in a more mixed performance against emerging-market currencies. In turn, dollar strength, along with sluggish world economic growth and risks in emerging economies, should offer relatively few opportunities in commodities, and we recommend reducing positions from long-term target allocations.

2014 opportunities in international and commodity investments

As of December 3, 2013

	Equities	Sovereign debt	Commodities
Developed markets			
Core*	MSCI EAFE index	S&P/Citigroup International Treasury Bond Ex-U.S. index	**Core** DBIQ Optimum Yield Diversified Commodity index
Satellites*	Belgium Japan Switzerland	Norway	**Satellites** None at this time
Emerging markets			
Core	MSCI Emerging Markets index	J.P. Morgan Emerging Markets Bond Index Global	
Satellites	Malaysia Taiwan	None at this time	

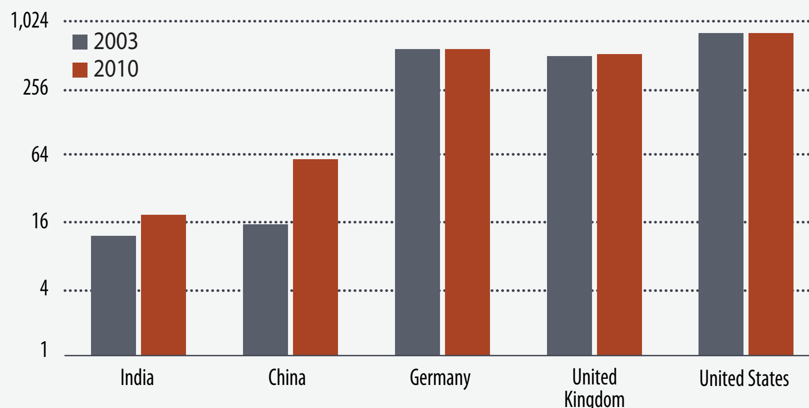
*See page 14 for definition.

Source: Wells Fargo Advisors

Please see page 15 for important disclaimers.

Stronger growth among emerging economies in automobile ownership

Automobile ownership has grown rapidly in India and China over the past several years. However, auto ownership remains greater in the developed world. This leaves room for growth in emerging economies in the coming decades.



Automobile ownership per 1,000 people. Latest India data point is for 2009.

Sources: World Bank and Wells Fargo Advisors

Long-term prospects remain appealing

In a year in which we think U.S. markets will outperform, some investors may wonder, “Why hold international exposure?” International growth prospects still look attractive over the next 10 to 15 years. Young populations and improving living standards have raised tens of millions of people to middle-class incomes, and spending across Asia, Latin America, and parts of Africa has increased during the past 15 years. The chart above shows that the level of automobile ownership, a staple of the middle-class living standard, is greatest in the advanced economies. Yet, the *increase* in car ownership in China and India exceeded the increase in the developed economies. Simply put, there is more room for fast growth in the emerging economies as they catch up, and we expect this trend to extend in the coming two decades.

We also think international diversification is an increasingly compelling reason to consider allocating investment capital to international markets. The financial crisis of 2008-2009 sparked a synchronized disruption in international markets. As the crisis passes and people adjust, global economic growth tends to revert to local drivers. Other world economies can follow their own patterns, which could differ from the U.S. pattern. In the past 20 years, for example, Europe skipped over the U.S. recessions of 1990-91 and 2001, and Australia did not have a recession at all between 1991 and 2013.

As local economic and investment return drivers regain prominence, we expect correlations between markets to decline, thus making the benefit of a broadly diversified portfolio even more critical. Over the past 24 years, international diversification generated an annualized return equal to the S&P 500 index by itself but with less variability from year to year, although this historical performance is not guaranteed to repeat in the future.

Gold and silver may be losing luster

Gold and silver prices have retreated from their record highs of recent years, and we think investors should use any price rise as an opportunity to reduce their precious metals allocations to a small share of a broadly diversified commodity position. In our opinion, a stronger U.S. dollar, rising U.S. bond yields, and modest inflation constitute a potentially strongly negative combination for gold and silver prices.

Volatility could create longer-term opportunities

The U.S. stock market rallied sharply in 2013 with only minor setbacks along the way. History suggests that the market is likely to be more volatile in the year ahead. Riding out this potential volatility could be challenging for many investors who have enjoyed relatively steady market gains this past year. As a result, we recommend investors follow diversified asset allocations in an effort to dampen volatility risks and take advantage of any market opportunities that may develop in the year ahead.

A quick portfolio review could determine if recent market movements have caused portfolio holdings to exceed or fall short of recommended allocations. If asset weightings have diverged from recommended percentages, investors should rebalance their holdings back to recommended allocations to help ensure proper diversification, especially since market volatility could increase in 2014.

The big stock market gains this past year helped lift investor wealth in 2013. But investors should not assume that they can rebuild wealth solely through market gains. We also recommend that investors review their long-term financial goals and determine whether they need to increase savings in order to help ensure a better chance at meeting their future financial needs.

Finally, we believe that inflation is likely to remain low in the year ahead. However, investors should not assume that inflation will stay low indefinitely. Even modest inflation can add up to substantially higher prices over a long period of time. Therefore, investors who do not want to see their purchasing power decrease as consumer prices increase need to hold assets that are more likely to have returns that exceed the inflation rate. This may require taking on more market risk to reduce the risk of declining purchasing power caused by inflation.

Taking these simple steps should go a long way toward offsetting market uncertainties and keeping long-term goals in the forefront of investment decisions.

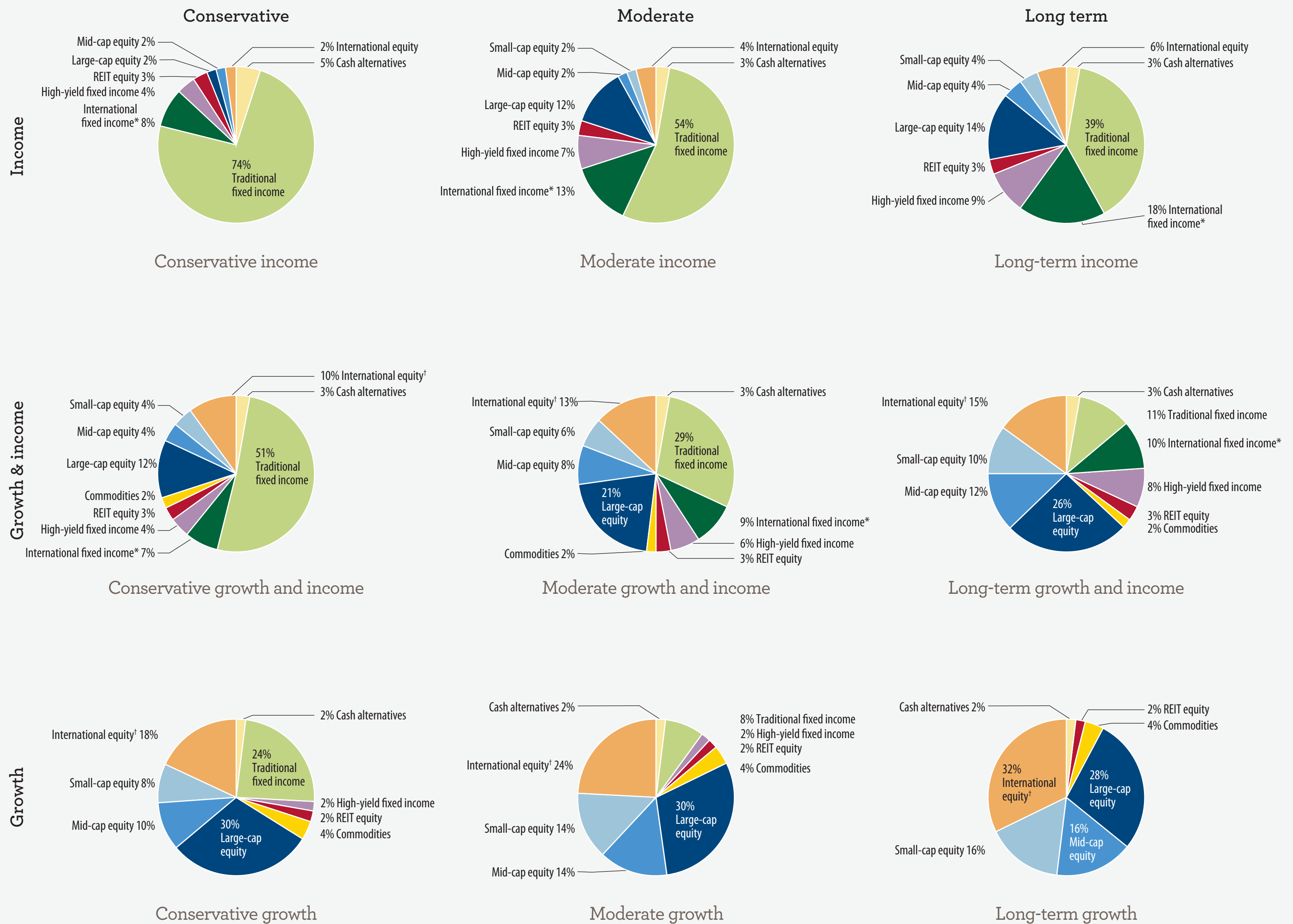
This past year the U.S. economy was able to weather many problems and grow at a moderate rate despite substantial headwinds. We believe that investors should stay the course and remain positive in 2014 to take advantage of further potential improvements in the economy and the markets.

Please see page 15 for important disclaimers.

Have an overall plan before you act

To make the process of developing your overall investment strategy easier, Wells Fargo Advisors has crafted nine models for asset allocation (shown below) that cover a wide range of objectives from conservative income to a more aggressive allocation of long-term growth. Your Financial Advisor can work with you to choose an asset allocation (investment mix) specifically addressing your situation, financial goals, and risk tolerance.

Strategic asset-allocation models



* Includes emerging-market debt.
† Includes emerging-market equities.

Investment objectives

Income. Emphasis on achieving current income.

Growth and income. Balance in emphasis between potential capital appreciation and income.

Growth. Emphasis is on potential capital appreciation.

Risk tolerance

Conservative. The least risk for a given investment objective.

Moderate. A higher degree of risk for the potential to receive higher returns.

Long-term. The highest risk within a given investment objective.

Please see page 15 for important disclaimers.

Definitions

Commodities are basic goods used in commerce that are generally interchangeable with other commodities of the same type. Commodities are most often used as inputs in the production of other goods or services.

Consumer Price Index (CPI) is a measure of the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Core is a broad, well diversified position in commodities or international investments.

Current yield (frequently referred to as yield) is the annual income an investment provides divided by its current market price. For example, a bond selling at par ($1,000) paying $100 annually in interest would have a 10% yield. However, if the bond's market price fell to $900, its yield would increase to approximately 11%.

Cyclical stocks are typically those of companies that sell discretionary items that consumers can afford to buy more of in a booming economy and will cut back on during a recession. In other words, when the economy is doing well, cyclical investments tend to perform well. The opposite, of course, is true when the economy is doing poorly. Defensive investments, on the other hand, tend to be less affected by economic cycle changes.

DBIQ Optimum Yield Diversified Commodity index is a measurement of 14 commodities drawn from the energy, precious metals, industrial metals, and agriculture sectors.

Defensive stocks tend to be resistant to general stock market fluctuations. An investor may hold these stocks to help provide their stock portfolio with some price stability in a volatile market. Utility, gold and silver producer, and some consumer goods stocks are generally considered defensive. Cyclical stocks, on the other hand, tend to be more sensitive to general stock market fluctuations.

Duration can be used to estimate the percentage change in a bond's value that will result from a 1% change in interest rates. For example, a duration of four means that a 1% change in prevailing rates in a one-year period should shift the bond's price in the opposite direction by 4%. The longer (higher) the duration, the more the bond's price will fluctuate as interest rates rise and fall.

Emerging markets are financial markets in countries with developing economies. These markets are typically immature compared to those of the world's major financial centers but are becoming increasingly sophisticated and integrated into international markets; they provide potentially higher returns but are intensely volatile.

Gross domestic product (GDP) is the total value of the goods and services the economy produces during a year. Increasing GDP indicates growing economic activity. Decreasing GDP suggests the opposite.

High yield is noninvestment-grade fixed income securities (rated Ba1 or lower by Moody's and/or BB+ or lower by S&P). These investments are considered to be speculative and are subject to a higher degree of risk.

Intermediate-term fixed income includes instruments that mature in six to 12 years.

International investing involves putting money into financial markets in developed economies outside of the United States.

J.P. Morgan Emerging Markets Bond Index Global tracks total returns for U.S.-dollar-denominated debt instruments issued by emerging-market sovereign and quasi-sovereign entities.

Large-cap growth stocks have a market cap greater than $10 billion and a price-to-book ratio greater than 2.3.

Large-cap value stocks have a market cap greater than $10 billion and a price-to-book ratio less than or equal to 2.3.

Liquidity, in regard to the economy, is a reference to the money supply. The greater the liquidity, the larger the money supply.

Long-term fixed income includes instruments whose maturities are greater than 12 years.

Mid-cap growth stocks have a market cap between $2 billion – $10 billion and a price-to-book ratio greater than 2.3.

Mid-cap value stocks have a market cap between $2 billion – $10 billion and a price-to-book ratio less than or equal to 2.3.

MSCI EAFE (Europe, Australasia, and Far East) index compiled by Morgan Stanley Capital International (MSCI) is a value-weighted index of the equity performance of major foreign markets. In effect, it is a non-American world index of more than 1,000 stocks.

MSCI Emerging-market index was created by MSCI and designed to measure equity market performance in global emerging markets.

Quantitative easing is a Federal Reserve strategy for increasing the money supply (adding liquidity) to help keep interest rates low and stimulate economic activity. In general, it involves Fed purchases of bonds from banks, providing them with money to lend to businesses and consumers.

Real estate investment trusts (REITs) trade on the major exchanges and invest in real estate directly, either through properties or mortgages.

Satellites are complementary commodity or international positions held alongside the core (see definition) with the objective of outperforming the core. Keep in mind that allocations to satellites may increase volatility.

Sector weightings are guidance stock market strategists use to indicate how they believe investors should allocate their stock portfolios. When a strategist's guidance is to overweight a sector, he or she believes it will perform well in the future and investors should allocate a larger percentage of their stock portfolios to that sector than its relative representation in the S&P 500 index. For example, if the Energy sector represents 11% of the S&P 500 index and a strategist's guidance is to overweight that sector, he or she is recommending that investors allocate more than 11% of their stock portfolios to the sector. If a strategist's guidance is to evenweight a sector, he or she believes investors' allocation to that sector should be in line with its representation in the S&P 500. If a strategist's guidance is to underweight a sector, he or she believes investors' allocation to that sector should be less than its representation in the S&P 500.

Short-term fixed income includes instruments that mature in one to six years.

Small-cap growth stocks have a market cap less than $2 billion and a price-to-book ratio greater than 2.3.

S&P/Citigroup International Treasury Bond Ex-U.S. index is designed to reflect the performance of bonds issued by non-U.S. developed-market countries.

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

Disclaimers

Some information contained in this report was prepared by or obtained from sources that Wells Fargo Advisors believes to be reliable. Any market prices are only indications of market values and are subject to change.

Wells Fargo Advisors may not offer direct investments into the products mentioned in this report.

Asset allocation and diversification do not guarantee a profit or protect against loss in a declining market.

An index is unmanaged and not available for direct investment.

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

Investments in currencies involve certain risks, including credit risk, interest rate fluctuations, fluctuations in currency exchange rates, derivative investment risk, and the effects of political and economic conditions. The use of currency transactions to seek to achieve gains in a portfolio could result in significant losses to the portfolio which could exceed the amount invested in the currency instruments.

Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

The prices of small- and mid-cap company stocks are generally more volatile than large-company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Investing in fixed-income securities involves certain risks, such as market risk if sold prior to maturity and credit risk, especially if investing in high-yield bonds, which have lower ratings and are subject to greater volatility. All fixed-income investments may be worth less than original cost upon redemption or maturity.

Income from municipal securities is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal alternative minimum tax (AMT).

High-yield bonds, also known as junk bonds, are subject to greater risk of loss of principal and interest, including default risk, than higher-rated bonds. The prices of these bonds may be volatile , and they are generally only suitable for aggressive investors.

Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment.

Mortgage-backed securities are subject to prepayment risks. Changes in prepayments may significantly affect yield, average life, and expected maturity.

There are special risks associated with investing in preferred securities. Preferred securities generally offer no voting rights with respect to the issuer. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable, which may negatively impact the return of the security. Preferred dividends are not guaranteed and are subject to deferral or elimination.

The interest rate for Treasury Inflation-Protected Securities (TIPS), which is set at auction, remains fixed throughout the term of the security. The principal amount of the security is adjusted for inflation, but the inflation-adjusted principal will not be paid until maturity although the adjustment will be subject to income tax in the year it was earned. Wells Fargo Advisors is not a tax advisor. TIPS have special tax consequences, generating phantom income on the "inflation compensation" component of the principal. A holder of TIPS may be required to report this income annually although no income related to "inflation compensation" is received until maturity.

There are special risks associated with an investment in real estate, including credit risk, interest rate fluctuations and the impact of varied economic conditions. Distributions from REIT investments are taxed at the owner's tax bracket.

While stocks generally have a greater potential return than government bonds and Treasury securities, they involve a higher degree of risk. Government bonds and Treasury bills, unlike stocks, are guaranteed as to payment of principal and interest by the U.S. government if held to maturity. Although Treasuries are considered free from credit risk, they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate inversely to a change in interest rates.

Investing in commodities is not suitable for all investors. Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. The prices of various commodities may fluctuate based on numerous factors, including changes in supply and demand relationships, weather and acts of nature, agricultural conditions, international trade conditions, fiscal, monetary and exchange control programs, domestic and foreign political and economic events and policies, and changes in interest rates or sectors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies which, may expose investors to additional risks, including futures roll yield risk.

An investment that is concentrated in a specific sector, industry, country, or commodity increases its vulnerability to any economic, political, currency, or regulatory development affecting the sector, industry, country, sector, or commodity, which may result in greater price volatility.

Investing in physical commodities, such as gold, silver, and other precious metals, exposes a portfolio to other risk considerations, such as potentially severe price fluctuations over short periods of time and storage costs that exceed the custodial and/or brokerage costs associated with a portfolio's other holdings.

There is no assurance that any of the target prices or other foward-looking statements mentioned will be attained. Any market prices are only indications of market values and are subject to change.

Stay informed

Our strategists will be following all the latest developments in the news to determine their potential impact on the U.S. and global economy, the markets, and political events overseas. Your financial professional can provide research and advice as well as review your current investment strategy and goals and help ensure that you are prepared to act if anything should change.

This publication is designed to provide accurate and authoritative information regarding the subject matter covered. It is made available with the understanding that Wells Fargo Advisors is not engaged in rendering legal, accounting or tax-preparation services. If tax or legal advice is required, the services of a competent professional should be sought. Wells Fargo Advisors' view is that investment decisions should be based on investment merit, not solely on tax considerations. However, the effects of taxes are a critical factor in achieving a desired after-tax return on your investment. The information provided is based on internal and external sources that are considered reliable; however, the accuracy of the information is not guaranteed. Specific questions on taxes as they relate to your situation should be directed to your tax advisor.

Wells Fargo Advisors is a broker/dealer affiliate of Wells Fargo & Company; other broker/dealer affiliates of Wells Fargo & Company may have differing opinions than those expressed in this report. Contact your Financial Advisor if you would like copies of additional reports.

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

Wells Fargo Advisors is the trade name used by two separate registered broker-dealers: Wells Fargo Advisors, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, non-bank affiliates of Wells Fargo & Company. First Clearing, LLC is a registered broker-dealer and non-bank affiliate of Wells Fargo & Company. © 2013 Wells Fargo Advisors, LLC. All rights reserved.

92567B-v1

1213-00230