WELLS FARGO | ASSET MANAGEMENT

Market insights

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Are high-growth stocks turning the corner?

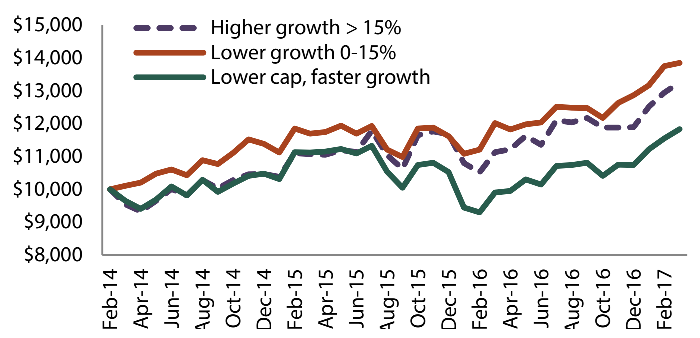
Challenging environment over last three years for higher-growth stocks

Since the spring of 2014, investors have often favored higher-dividend-paying stocks over higher-growth stocks. Dividend income has been a substitute for the exceptionally weak yields available in traditional fixed income markets. Macro and geopolitical concerns also contributed to risk-off periods when investors showed a preference for perceived safe-havens, such as low beta, "safety" stocks, and generally shunned higher-growth stocks (especially evident from early March through early May 2014 and the first 6 weeks of 2016). Although relatively brief, these periods have taken a toll on relative performance of higher-growth stocks.

Figure 1 shows the performance among higher- and lower-growth stocks since the spring of 2014 to date. The performance of the higher-growth segment has moderately trailed that of the lower-growth segment. The most significant weakness was exhibited by higher-growth stocks outside the mega-cap growth space, illustrated as the lower cap, faster growth series. This segment has often been fruitful ground for identifying the most innovative companies across a variety of sectors. However, investors shied away from both their lower yields and lack of perceived safety.

Figure 1: Since spring 2014, higher-growth stocks lagging considerably, especially in lower market cap (<$75B market cap)

March 2014 - March 2017



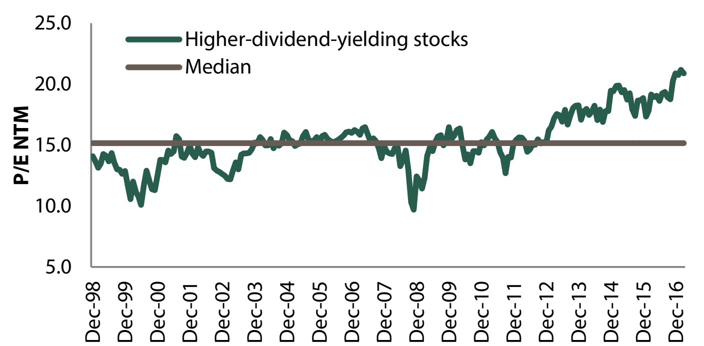
Source: FactSet. Growth = Blended expected earnings growth (1-2 year and 3-5 year expected growth). Higher growth is greater than 15%. Lower growth is 0-15%. Lower market cap is lower than $75 billion.

Has the scarcity of yield affected valuations for lower growth, higher dividend-yielding stocks?

The change in relative valuations among these sub-groups was even more extreme. Higher-dividend-yield stocks (largely found in the lower-growth segment) advanced to multi-decade high valuations (P/E NTM), as shown in Figure 2, despite generating only minimal earnings growth.

Figure 2: Higher-dividend-yielding stocks trading near multi-decade high valuations

P/E Next Twelve Months (NTM): 12/31/1998 - 3/31/2017



Source: FactSet. Higher-dividend-yielding stocks have greater than 2% yield.

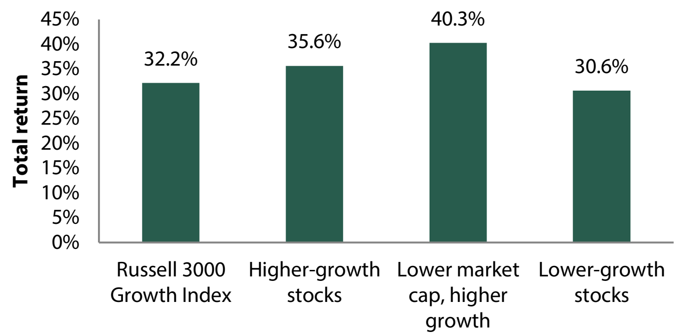
In contrast, higher-growth stocks as a group traded near multi-year-low relative valuations despite generating well over double-digit earnings growth. However, a turn in this dynamic may be underway.

Are investors beginning to reward higher-growth stocks?

Since the market bottomed on February 11, 2016, investors have more consistently rewarded positive growth fundamentals across the broad market cap spectrum (despite a challenging environment in the last seven weeks of 2016 during the post-election rally). The total returns of the various growth segments from this low through the first quarter of 2017 have witnessed a reversal of fortune, with higher-growth stocks, particularly those stocks outside the mega-cap space, outpacing the broader market.

Figure 3: Improved results for higher-growth stocks since market bottom last year

Total returns: February 12, 2016 – March 31, 2017



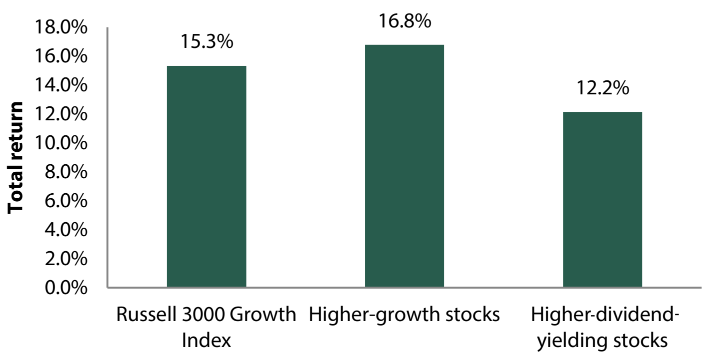
Source: FactSet.

How have recent changes in interest rates affected the performance of higher-growth versus higher-dividend-yielding stocks?

Beginning in July 2016, interest rate expectations began to climb after several years of declines. We believe this changing market dynamic has led to waning enthusiasm for dividend-paying safety stocks as rates show signs of stabilization. In essence, the scarcity of income/yield dynamic prevalent for much of the past several years has been alleviated more recently in the context of higher fixed income yields. We see the outperformance of higher-growth stocks over higher yielding stocks most clearly in this period, as shown in Figure 4.

Figure 4: Investors favoring growth over yield as interest rates rise

Total returns: July 1, 2016 - March 31, 2017



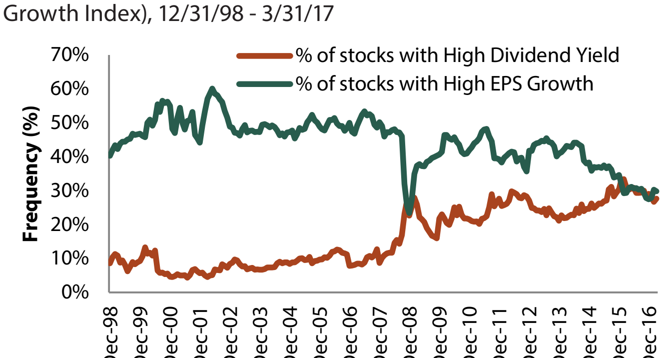
Source: FactSet.

Is the more recent trend toward favoring higher-growth stocks likely to continue?

We think supply and demand dynamics in a potentially stabilized, higher-rate environment could provide a catalyst for continued outperformance of higher-growth stocks relative to stocks with lower growth, higher dividend yield characteristics. Figure 5 shows that stocks with higher dividend yields have become a larger proportion of the total market, just as yields available in fixed income markets are beginning to improve. This is mirrored by a reduced supply of stocks exhibiting robust growth in an economic landscape characterized by moderate growth, which is still subdued by historical standards. It appears that these market dynamics may lead to a continuation of recent trends that favor "scarcity of growth" over yield.

Figure 5: Increasing supply of high yielding stocks, reduced supply of robust growers

(% of stocks with high yield or high growth characterstics in S&P 1500 Growth Index), 12/31/98 - 3/31/17

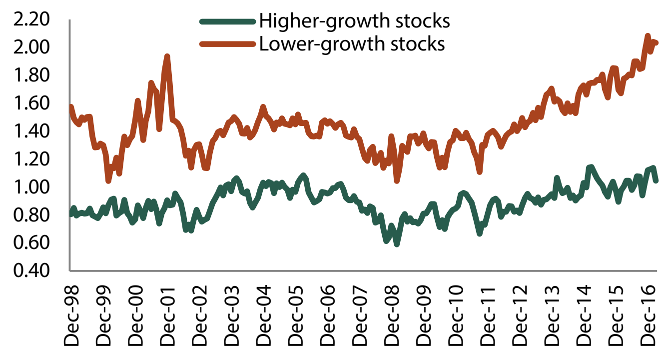


Source: FactSet.

Moreover, we think there is plenty of runway for relative valuations to rebalance. Figure 6 shows that higher-growth stocks continue to be attractive in context of the multiple paid for this growth, especially when evaluated relative to stocks with lower growth potential.

Figure 6: Faster-growth companies increasingly attractive in recent years relative to other stocks

PEG ratios: 12/31/1998 - 3/31/2017



Source: FactSet.

We believe these higher-growth stocks have an opportunity to begin to close the relative valuation gap, especially in an environment of modestly higher rates and fairly steady economic growth. Even if price multiples (i.e., PE, PEG) do not improve relative to the market, these stocks have a promising outlook simply driven by their earnings growth potential, which is much higher than the broad market.

Moreover, many of these higher-growth stocks have strong secular underpinnings. Industry specific examples include increased business demand for cloud services and data analytics. We also expect continued health in e-commerce and digital payments.

We believe the longer-term outlook for higher-growth stocks could improve considerably relative to the past three years. Ultimately, a greater influence from earnings fundamentals, rather than monetary policy and macro factors, could bode well for the higher-growth stock universe.

For figures 1, 3, and 4 the underlying universe of constituents is the Russell 3000 Growth. These charts illustrate more recent performance trends over the last 3 to 5 years.

For figures 2, 5, and 6 the underlying universe of constituents is the S&P 1500 Growth. The charts illustrate characteristics of the growth stock universe when looking over multiple decades.

For figures 2 and 6, the calculation assumes the median result.

Michael Thomas, External Investment Analyst at Wells Fargo Asset Management, developed this summary.

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