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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **July 26, 2021**

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- Higher inflation, rising interest rates, and a less accommodative Federal Reserve could lead to short-term market volatility, but we expect the bull market to remain intact.
- Given the macro and earnings backdrop, we would view any pullback as buyable. We continue to prefer equities over fixed income, U.S. equities over international equities, and cyclical sectors over defensive sectors.

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- Technical factors played a large part in the current U.S. Treasury rally. For example, supply and demand were unusually tight as the Federal Reserve bought up all net issuance.
- But that does not mean that fundamental factors were absent. More recently, COVID-19 Delta variant fears for U.S. and global growth also pushed yields lower. How can we tell? Other markets provide corroboration — weaker equities and a stronger dollar are confirming signs.

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- 2020 was a strange sales year for cars and trucks.
- Electric vehicle sales surged to record highs in 2020.

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- With the backdrop of historically low interest rates, rich stock market valuations, and a healing economy, we believe qualified investors should consider incorporating certain alternative investment strategies into their portfolios, both to diversify and to potentially generate favorable portfolio outcomes.
- Private capital strategies with sector specialties and flexible capital solutions may identify unique opportunities. They have traditionally offered investors downside support with potential returns through debt and dividends while still navigating the recovery through long-term capital appreciation.

Equities Spotlight

Chris Haverland, CFA
Global Equity Strategist

Inflation, rates, and tapering, oh my!

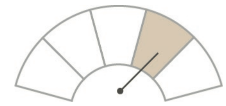
Global equity markets have surged higher this year on reopening optimism, eye-popping economic and earnings growth, and supportive monetary and fiscal policies. Despite recent concerns over peak growth and the Delta variant of COVID-19, we expect 2021 U.S. economic growth to be the highest in decades and S&P 500 Index earnings to reach record levels. Also, we believe the Federal Reserve (Fed) will remain accommodative through 2022 and that additional fiscal stimulus from the U.S. government is likely. Although bumps can be expected along the way, we believe these conditions should support equity prices over the next 12 months.

Historically, when the S&P 500 Index has had a strong first half of the year, the second half has been positive, albeit at a more moderate pace. Of course, past performance is not a guarantee of future results. Even so, volatility could pick up should seasonal weakness become a factor late in the summer, the world contends with coronavirus variants, and several looming policy decisions could be announced. Despite rolling corrections in many areas of the stock market, the S&P 500 Index has yet to experience a 5% pullback this year (history shows an average of three per year). If the market corrects, we would view it as an opportunity to fill out equity positions that may be below strategic or tactical targets.

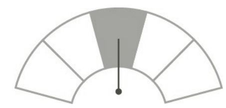
While there are numerous reasons for potential equity market weakness, several suggested causes may be more hype than reality. Some investors believe higher inflation is bad for the markets. Others view rising interest rates and less accommodative monetary policies as a death knell. While these factors can impact markets, the reaction has usually been temporary in nature. Sector and style leadership can change in these environments, but stocks have often outperformed bonds early in the cycle.

Higher inflation

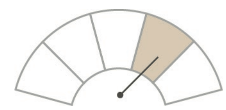
Recent U.S. inflation readings have soared and are expected to remain above average through 2022. While the Fed believes this spike is transitory, there are some components that could stick around for a while. Higher inflation can eat into asset price returns; however, a handful of assets historically have performed well during inflationary environments. Since 2000, commodities have been a top performer when inflation has been above average, while bonds have been a poor performer. Some may be surprised to learn that stocks have exhibited strong performance in these same periods with small caps, emerging markets, and cyclical sectors outperforming.



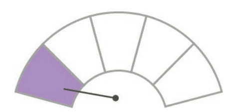
Favorable
U.S. Large Cap Equities



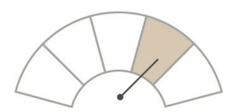
Neutral
U.S. Mid Cap Equities



Favorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities



Favorable
Emerging Market Equities

While higher commodity prices, labor shortages, and supply chain issues have increased expenses for many firms, gross margins are at record highs.[1] Companies are using operating leverage created during the COVID-19 recession to expand profitability in spite of higher input costs. Additionally, some firms have been successful in passing on higher costs to customers. It remains to be seen whether the stickier forms of inflation will detract from profitability in the coming quarters, but according to Bloomberg, consensus forecasts show S&P 500 Index margins reaching all-time highs over the next twelve months.

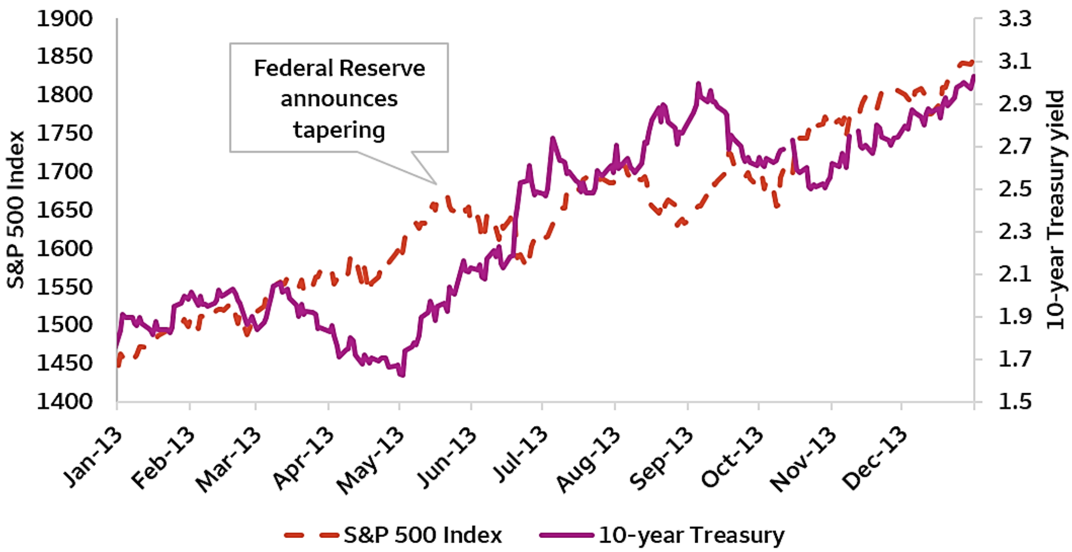
[1] Bloomberg, S&P; July 23, 2021

Interest rates and a less accommodative Fed

Despite the recent downtick in long-term interest rates, we are forecasting higher levels by year end. We expect the federal funds rate to remain unchanged through the end of 2022; however, the Fed is likely to begin tapering its bond-buying program in the coming quarters. While higher long-term rates can put downward pressure on price-to-earnings multiples, the level at which it becomes a problem for equities is well beyond our forecasts. We reviewed the past seven rising-rate environments since 1990 and found equities performed extremely well — the S&P 500 Index was positive in six out of seven periods with an average return of 29%.

With the Fed unlikely to adjust rates in the near term, all eyes are on its bond-buying program. As an initial step to unwinding highly accommodative polices, we believe the Fed is likely to announce reduced bond purchases later this year (which could put upward pressure on longer-term yields). A similar event occurred in 2013, called the taper tantrum, which led to a near doubling of the 10-year Treasury yield. While there was a modest 6% pullback in the S&P 500 Index post-announcement, the benchmark was up approximately 30% for the year.

2013 taper tantrum led to higher interest rates and stock prices



Sources: Wells Fargo Investment Institute and Bloomberg, July 21, 2021. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Investment implications

Higher inflation, rising long-term interest rates, and a less dovish Fed could potentially cause the market to pause. However, equities have historically performed well through these events, even if there was some initial selling pressure. Given the macro and earnings backdrop, we would view any pullback as buyable. We continue to prefer equities over fixed income, U.S. equities over international equities, and cyclical sectors over defensive sectors.

Fixed Income

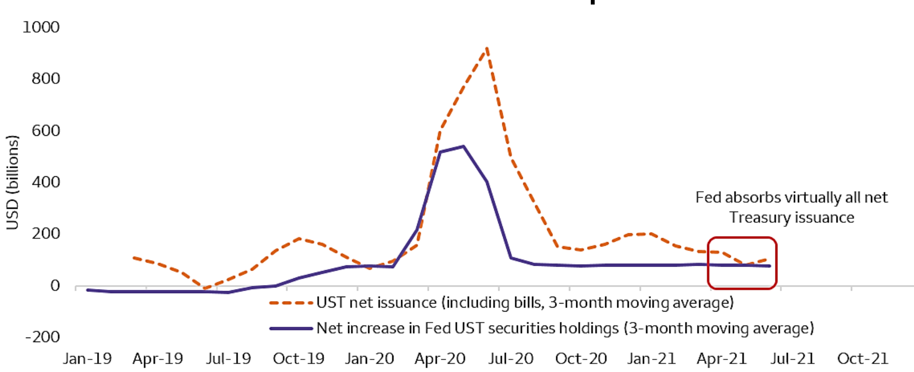
Is the U.S. bond rally technical or fundamental?

From the peak of 10-year U.S. Treasury note yields near 1.75% at the end of March through the breaking of the 200-day moving average around 1.25% in mid-July, the question has been asked: are the factors driving the U.S. Treasury rally mainly technical in nature, or is the drop in yields signaling something more fundamental, presaging a renewed downturn in the economic outlook? We believe the simple answer is: both.

That technicals played a large role in the early part of the rally is undoubtedly the case. What appeared at first mysterious — falling Treasury yields as inflation prints soared and equities extended gains — could be explained, at least in part, by a dramatic tightening of the supply-demand situation for U.S. Treasury securities. The chart shows that in the second quarter, Fed purchases of $80 billion per month were sufficient to soak up all net issuance of Treasury securities (including bills). This was due to the sharp reduction in the Treasury General Account (a kind of COVID-19 cash hoard, or war chest) that both reduced the Treasury's need to issue bills, notes, and bonds and at the same time boosted demand by increasing bank reserves — that is, cash in the money market.

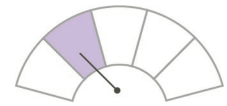
However, it would be wrong to suggest that the move is purely technical. More fundamentally, growing concerns about the COVID-19 Delta variant have helped push yields lower, and the tight supply-demand backdrop merely means yields are likely lower than they otherwise would be. Why do we believe this? Unlike earlier in the second quarter, other market moves now confirm that doubts over the real economy are paramount. These include the increased volatility in equity markets of course, but also the perceived "safe-haven" flows driving the latest rise in the dollar — and the Japanese yen — which have often accompanied growing fears for the real economy.

The Fed absorbed all net issuance in the second quarter

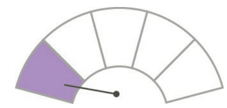


Sources SIFMA, U.S. Department of the Treasury, U.S. Federal Reserve, Bloomberg, and Wells Fargo Investment Institute. Latest data as of June 2021. USD = U.S. dollar. UST = U.S. Treasury.

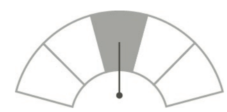
Peter Wilson
Global Fixed Income Strategist



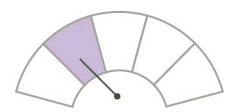
Unfavorable
U.S. Taxable Investment Grade Fixed Income



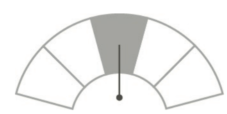
Most unfavorable
U.S. Short Term Taxable Fixed Income



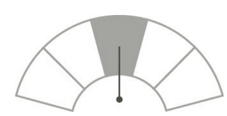
Neutral
U.S. Intermediate Term Taxable Fixed Income



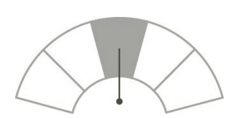
Unfavorable
U.S. Long Term Taxable Fixed Income



Neutral
High Yield Taxable Fixed Income



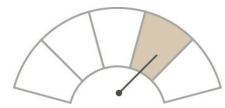
Neutral
Developed Market Ex.-U.S. Fixed Income



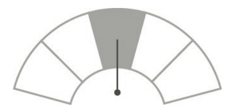
Neutral
Emerging Market Fixed Income

Real Assets

John LaForge
Head of Real Asset Strategy



Favorable
Commodities



Neutral
Private Real Estate

"Show me a man who claims he is objective and I'll show you a man with illusions." — Henry R. Luce

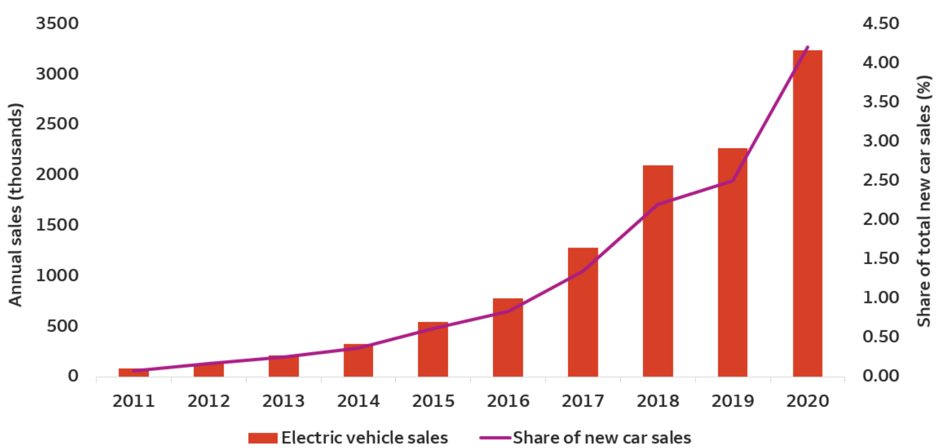
Electric made a dent in 2020

2020 was a strange year from many angles, the stock and commodity markets being obvious examples. During the throws of the April-May home lockdowns, few could have predicted near-record stock prices by year-end. Oil was similarly strange in that prices went negative (-$37.40 per barrel on April 17, 2020) for the first time in its 161-year history.

Another interesting twist to 2020 was what happened with car and truck sales. It started with home lockdowns, which kept consumers and workers at home. Great deals were to be had for willing buyers, but they did not last long. By summer's end, car parts were lacking, which stymied new car production. With little new inventory to pick over, consumers pushed heavily into the used car market, and it remains that way today. Over the past year, the average used car price has climbed more than 40%! If you have a spare car handy, it may be time to unload it.

Electric vehicle sales also turned in a surprising 2020. Electric vehicle sales surged even though overall new global car production slowed. To see more electric vehicles sold in a world increasingly concerned with global warming was not particularly surprising. The surprise was the magnitude of the sales jump. At the end of 2019, electric vehicle sales represented 2.5% of total new car sales globally. By the end of 2020, this jumped to a record 4.0%! For those looking for evidence that the green movement is making strides, look no further than the surge in electric vehicle sales.

Global electric vehicle sales (absolute and share of total new vehicle sales)



Sources: EV-Volumes and Wells Fargo Investment Institute. Yearly data: 2011–2020. Annual data: 2011–2020.

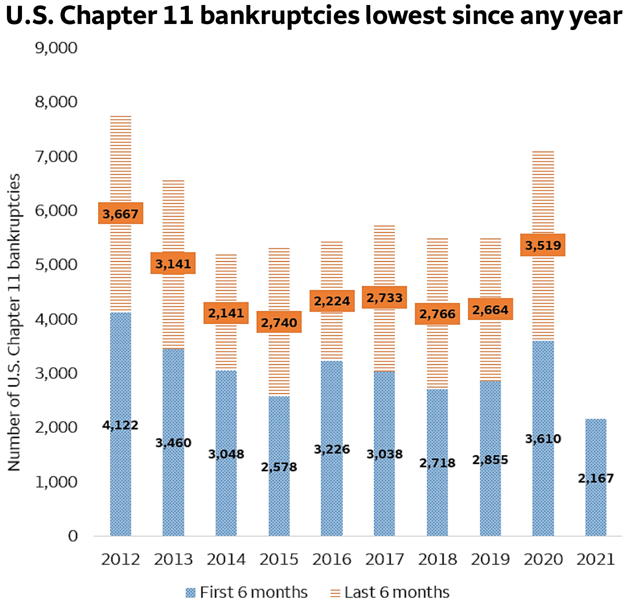
Alternatives

Dislocation opportunities in private capital investments

Not surprisingly, to say the coronavirus pandemic has been hard on businesses is an understatement. Despite this, while the past year has been tumultuous for many reasons, there were actually fewer U.S. Chapter 11 bankruptcies through the first six months of 2021 than any year going back to 2012 (see chart below). In fact, according to statistics, 2,167 Chapter 11 bankruptcy cases were filed in the U.S. by June 2021, which is 40% lower than the number of cases filed by that time in 2020 and 24% lower than first six months of 2019. This was largely related to government initiatives that supported financially vulnerable businesses, delaying bankruptcy for many. In short, the U.S. government's unprecedented levels of global stimulus provided in response to the coronavirus pandemic allowed many businesses to survive 2020 and now 2021.

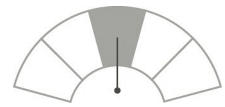
With the broader recovery in the markets since the second quarter of 2020, companies followed two different paths. Companies and sectors with stable balance sheets, equity sponsorship, and more diversified sales have been resilient through coronavirus-related business disruptions. On the flip side, there is a separate category of companies whose businesses have been more severely impacted by COVID-19 given travel restrictions and social distancing. However, unless Congress acts before its recess in August, a number of stimulus packages will end heading into year-end. While it is nearly impossible to determine precisely how the end of government stimulus programs will affect companies, we believe the uncertainty will be most acute around certain cyclical, coronavirus-impacted sectors. Heading into this period, we believe qualified investors may benefit from flexible, opportunistic providers of capital that can invest in equities, credit, or hybrid capital structures as strategic or rescue capital can provide companies creative, flexible capital solutions capable of bridging the gap to a recovery.

U.S. Chapter 11 bankruptcies lowest since any year back to 2012

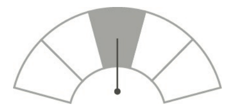


Source: Epiq AACER, Wells Fargo Investment Institute, July 2021.

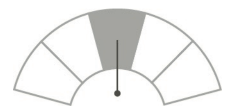
James Sweetman
Senior Global Alternative Investment Strategist



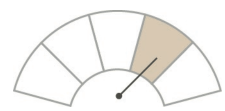
Neutral
Private Equity



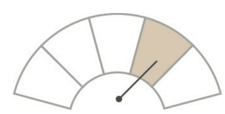
Neutral
Hedge Funds – Macro



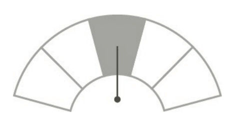
Neutral
Hedge Funds – Event Driven



Favorable
Private Debt



Favorable
Hedge Funds – Equity Hedge



Neutral
Hedge Funds – Relative Value

Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not appropriate for all investors and are only open to "accredited" or "qualified" investors within the meaning of U.S. securities laws.

Risk Considerations

Forecasts are based on certain assumptions and on views of market and economic conditions which are subject to change.

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. **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- and mid-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. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. 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. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is appropriate 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, private equity, private debt and private real estate fund 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.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market.

An index is unmanaged and not available for direct investment.

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