WELLS FARGO
Investment Institute

Investment Strategy

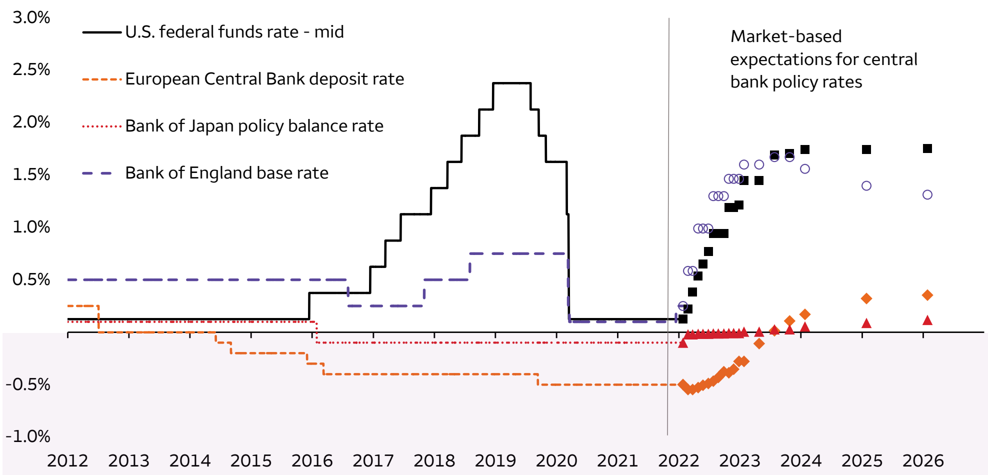
Weekly guidance from our Investment Strategy Committee **January 31, 2022**

Fixed Income spotlight

How far, how fast?

Back in November of last year, we wrote that accelerating inflation would likely lead to growing policy divergence between developed country central banks, with some countries, like the U.S., expected to raise rates in the coming year, and others — most notably Japan — seen keeping policy rates unchanged for the foreseeable future.[1] This remains broadly the situation in early 2022, but these expectations have developed faster than many expected. The chart below shows policy rate expectations for the U.S., the eurozone, the U.K., and Japan as of January 26.

How the market sees this rate-rise cycle

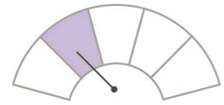


Sources: Bloomberg and Wells Fargo Investment Institute, latest data as of January 26, 2022. Interest rate expectations are derived from the Overnight Index Swaps (OIS) market. An OIS is a fixed to floating interest rate swap where the floating leg is computed using a published overnight index rate, and these swap rates are commonly used (as here) to indicate market expectations of central-bank policy rates.

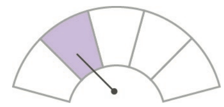
Are Federal Reserve expectations optimistic?

Looking at the chart, we would make several observations. First, the curve of federal funds rate expectations clearly shows the market having built in more than 100 basis points (1%) of rate increases in 2022. (As of the time of writing, the most common market call seems to be for four 25-basis-point hikes starting as soon as March.) However, note that the same is not expected for 2023; the expectations curve flattens out with a federal funds rate around 1.75%. This is sometimes known as the "terminal rate" — the rate at which the hiking cycle peaks. This is significantly below the median "long-term" rate expectation as expressed by Federal Reserve (Fed) members in the dot plots released quarterly by the Fed, which have been stable at 2.5%. It also implies that the Fed will finish hiking with the federal funds rate still in negative territory in real (inflation-adjusted) terms (assuming long-run inflation back to the target of 2.0%).

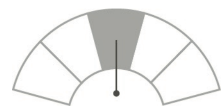
Peter Wilson
Global Fixed Income Strategist



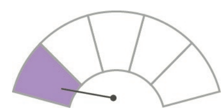
Unfavorable
U.S. Taxable Investment Grade Fixed Income



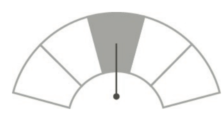
Unfavorable
U.S. Short Term Taxable Fixed Income



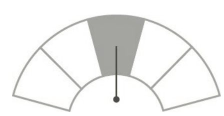
Neutral
U.S. Intermediate Term Taxable Fixed Income



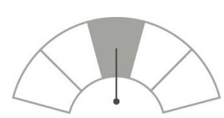
Most unfavorable
U.S. Long Term Taxable Fixed Income



Neutral
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

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[1] See "Inflation and monetary divergence – twin themes for 2022" *Investment Strategy*, November 29, 2021.

The risk may be that the 2023-2024 section of this expectations curve may shift higher — either because annual inflation rates near 7% are slower to revert to more moderate rates than expected, or simply as time passes, the first rate hikes are seen, and the market's near-term horizon continues to expect four hikes in the coming year. In short, it may be optimistic to assume that this rate cycle peaks at a lower level than it peaked in 2016-2018.

European Central Bank risks more balanced

The U.K. policy rate curve may be similarly optimistic. As for expectations for the European Central Bank's (ECB) deposit rate, these have changed a little. After the ECB voted in December to end its COVID-19-era bond purchases (the Pandemic Emergency Purchase Program) in March, with no tapering, it became clear to many that the eurozone central bank was embarking on its own process of "normalization." The market expectations shown in the chart on the previous page suggest an ECB rates lift-off from levels of -0.5% as soon as late 2022, and rates moving into positive territory by late 2023. Risks to these expectations are perhaps more balanced: ECB President Lagarde has seemed to push back against early rate-rise calls, but on the other side, there have been calls from the governing council to move more aggressively to normalize interest rates. Only the Bank of Japan is seen as persisting in its policy — with rates seen close to zero for the whole of the five-year forecast horizon.

Investment implications

The chart and the observations are consistent with our fixed income and foreign exchange outlooks. We have increased our federal funds rate target to expect four rate hikes this year, and a funds rate of 1.00%-1.25% by year-end 2022. Our 10-year U.S. Treasury yield target is unchanged at 2.00%-2.50%. We expect the yield curve to modestly flatten, but to remain positively sloped. Even as the 2-year yield moves higher in line with federal funds rate expectations, unless economic growth slows sharply (which is not our outlook), then the 10-year yield should remain above the 2-year rate by year-end. Now that the Fed has prepared the market (in the January 5 Federal Open Market Committee minutes) to expect an early move to reduce its balance sheet, an increased supply of U.S. Treasury securities will be another factor keeping the yield curve less flat than it would otherwise have been — and pushing inversion further into the future.

For the U.S. dollar, we note that an increase in federal funds expectations in the 2023-2024 section of the curve could provide additional support, and prolong the U.S. Dollar Index (DXY) uptrend. However, if the ECB also moves more openly to normalize rates, this will be a significant shock to the market, and will likely boost the euro. Such a move might become clearer in the second half of the year, since before raising rates, the ECB would need to signal the end of ongoing bond buys through its Asset Purchase Program. This is supportive of our profile that sees additional U.S. dollar strength more possible early in the year, but with upside increasingly challenged as we move into year-end.

Equities

Chris Haverland, CFA
Global Equity Strategist

Anatomy of stock market corrections

After an extended period of low volatility, equity markets have experienced sizable swings in the past few weeks. Stock market optimism over strong economic and earnings growth and easy fiscal and monetary policies quickly turned to pessimism based on expectations of slowing growth and a less accommodative Fed. Regardless of the cause, the S&P 500 Index has corrected (at least a 10% decline) once a year (on average) since 1928. The last correction was nearly two years ago; however, during a secular bull market, the time between corrections can be longer than average.

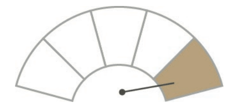
Since 1928, corrections have transitioned to bear markets (at least a 20% decline) less than 50% of the time. Our view is that the latest decline is a normal market correction that does not signal a recession or the end of this bull market. Historically, stock market corrections within bull markets have lasted three to four months. Although the S&P 500 Index remains in an uptrend, this correction has done some technical damage to markets that likely will take time to repair. Still, we continue to believe that economic growth and corporate earnings will be solid this year, and that the Fed will not be overly aggressive in dialing back monetary policy.

Stock market corrections can be viewed as an opportunity for investors who have excess cash to deploy. Fundamentals are unchanged over the past few weeks, and earnings expectations are still rising. Valuations have been reset, with forward price-to-earnings multiples receding close to 10-year historical averages. In addition, we are not seeing the warning signs of a deeper market sell-off — such as high-yield spreads surging or an inverted yield curve. Although the lows may not be in place yet and volatility likely will remain elevated in the near term, we would advise investors to take advantage of weakness by adding to high-quality U.S. Large and Mid Cap Equities.

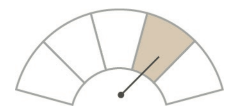
S&P 500 Index declines since 1928

	Pullback (5% decline)	Correction (10% decline)	Bear Market (20% decline)
Number of occurrences	319	99	26
Average occurrences per year	3.4	1.1	0.3
Average duration (days)	35	100	289
Average decline	-10.8%	-19.5%	-35.6%

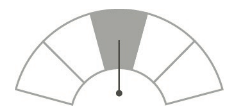
Sources: Ned Davis Research, Bloomberg, and Wells Fargo Investment Institute. January 26, 2022. Data from January 3, 1928 to January 25, 2022.



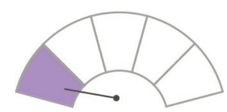
Most favorable
U.S. Large Cap Equities



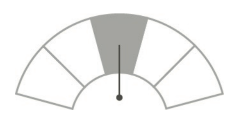
Favorable
U.S. Mid Cap Equities



Neutral
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities

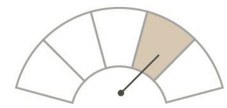


Neutral
Emerging Market Equities

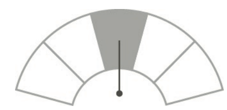
Real Assets

Austin Pickle, CFA
Investment Strategy Analyst

"The only thing we know about the future is that it is going to be different." — Peter Drucker



Favorable
Commodities



Neutral
Private Real Estate

Gold: 2021 forensics and 2022 forecast

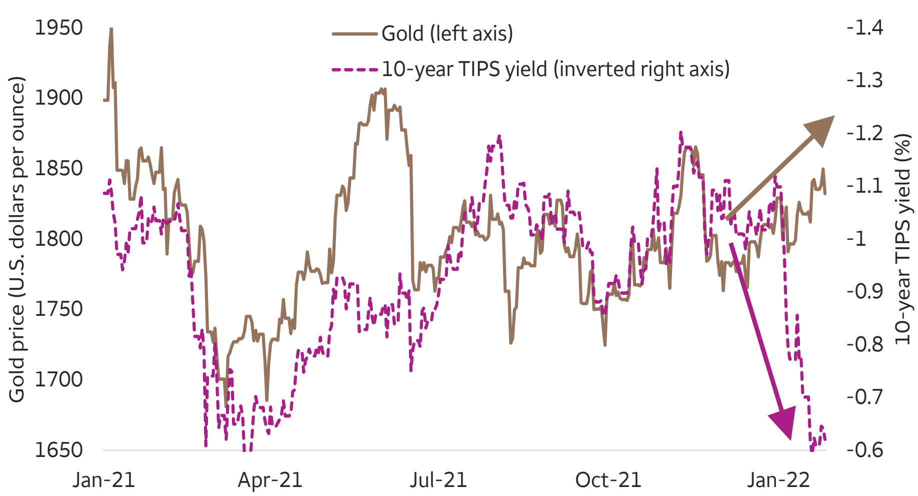
Gold was one of the worst-performing assets last year. Yet, this year could be an entirely different story for the yellow metal. What happened in 2021? And why do we think gold could snap out of its doldrums in 2022?

There were some sizable 2021 gold headwinds in play, with the more significant including a blistering risk-on rally with little volatility, a strengthening U.S. dollar, and real interest rates that found their bottom. One could also throw onto the pile inflation that was assumed to be transitory for much of the year, surging cryptocurrency prices, and increasingly optimistic investors and economic outlooks.

So why do we think 2022 could be the turnaround year for gold? First off, risk asset returns may be choppier with higher volatility this year, which could prompt a rotation back into the perceived safe haven — gold. The bull commodity super cycle should lend its support as well, as it is the tide that lifts all commodity boats.[2] And our range-bound U.S. dollar outlook suggests that the greenback will cease to be such a stiff headwind this year.

Risks remain, including the possibility of increasing interest rates. Yet, if gold were to breach the technically and psychologically important $1,900 level, we would expect 2022 to be a very good year for gold. Our 2022 year-end gold target is $2,000-$2,100 per ounce.

Gold versus 10-year TIPS



Sources: Bloomberg and Wells Fargo Investment Institute. Daily Data: January 1, 2021 to January 26, 2022. TIPS = Treasury Inflation-Protected Securities. **Past performance is no guarantee of future results.**

[2] Commodity prices tend to move in overall bull and bear cycles, some lasting decades. These are super cycles.

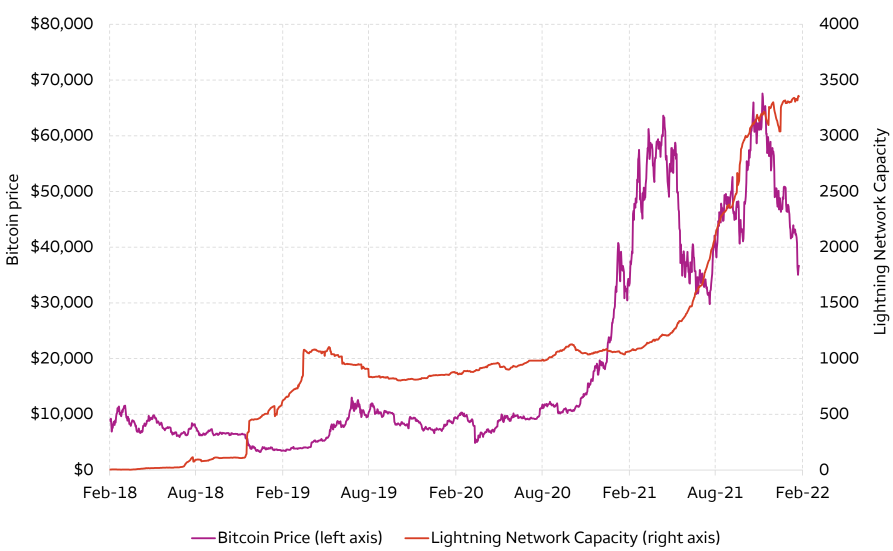
Alternatives

Bitcoin collapses, but adoption still growing

Bitcoin has once again experienced a remarkable correction, retracing to late-summer levels and declining roughly 50% from its November 2021 all-time high. This time, macro fears surrounding inflation and an accelerated rate hike — not to mention geopolitical fears of a potential Russian invasion of Ukraine — sparked a broader risk-off move that affected technology and growth in particular. We are reminded once again of the unpredictable and volatile nature of this asset.

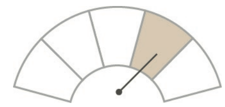
Despite the painful decline in price, it is important to focus on the broader "digitalization" theme. There are many metrics used to analyze bitcoin usage and adoption, but one of the more important ones is Lightning Network Capacity. The Lightning Network was designed to facilitate smaller, faster, and cheaper bitcoin transactions. In other words, it was designed to make the adoption of bitcoin more user-friendly. The capacity refers simply to the number of bitcoin — at any given time — that are tied up in transactions. As seen in the chart, Lighting Network Capacity continues to trend higher, and at the time of this writing was 3,351 bitcoin. This means at current bitcoin prices, users can send and receive nearly $123 million over the network. Of course this is a miniscule amount relative to the more traditional money channels, but it is nearly four times more than this time last year and nearly two times the capacity just six months ago. Adoption and utilization is still strong, which bodes well for the long-term rationalization of cryptocurrencies.

Despite the decline, metrics that gauge bitcoin "adoption" are trending higher

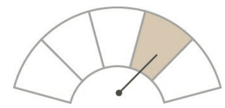


Sources: Glassnode and Wells Fargo Investment Institute. January 25, 2022

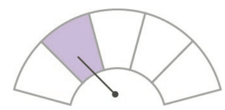
Justin Lenarcic
Senior Global Alternative Investment Strategist



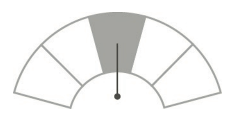
Favorable
Hedge Funds – Relative Value



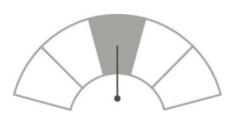
Favorable
Hedge Funds – Macro



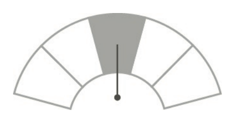
Unfavorable
Hedge Funds – Event Driven



Neutral
Hedge Funds – Equity Hedge



Neutral
Private Equity



Neutral
Private Debt

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

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. **Treasury Inflation-Protected Securities (TIPS)** are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond to fluctuate more than other fixed income securities. 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. 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.

Virtual or cryptocurrency is not a physical currency, nor is it legal tender. Bitcoin and other cryptocurrencies are a very speculative investment and involves a high degree of risk. Investors must have the financial ability, sophistication/experience and willingness to bear the risks of an investment, and a potential total loss of their investment. An investor could lose all or a substantial portion of his/her investment. Cryptocurrency has limited operating history or performance. Fees and expenses associated with a cryptocurrency investment may be substantial. Cryptocurrencies are sometimes exchanged for U.S. dollars or other currencies around the world, but they are not backed or supported by any government or central bank. Their value is completely derived by market forces of supply and demand, and they are more volatile than traditional fiat currencies.

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 US stock market.

U.S. Dollar Index (USDX) measures the value of the U.S. dollar relative to majority of its most significant trading partners. This index is similar to other trade-weighted indexes, which also use the exchange rates from the same major currencies.

An index is unmanaged and not available for direct investment.

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