WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **December 13, 2021**

Fixed Income spotlight

The Federal Reserve in 2022

Most central banks around the world have remained supportive of their economies throughout 2021. However, we expect next year to be one of transition for central banks as they balance between supportive policies and inflation threats. The Federal Reserve (Fed) will continue to play a key role in the global economy as it wrangles to tighten financial conditions and sustain the U.S. recovery. We believe there are three major themes that will influence the Fed in 2022.

1) Accelerating the tapering of bond purchases

In early December, Fed Chairman Jerome Powell made some remarks about the current state of the highly accommodative policy still in place. However, renewed concerns about the level of inflation in the economy and the continued improvement in the labor market caused the chair to express his view that accelerating the tapering of bond purchases seemed appropriate. Keep in mind that when the tapering announcement was made in early November, the Fed communicated that it was going to leave itself the flexibility to modify the amounts and timing of tapering to better align with the progress being made in the economy.

We feel confident that the Fed will most likely make some changes to the tapering amounts and that it will relay this message in the upcoming meeting on December 15. This puts tapering to finish a bit ahead of what we originally anticipated (late June versus late March 2022 now).

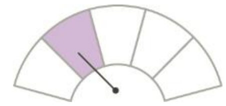
Also, there is a possibility the Fed could begin discussing balance sheet reduction next year, but this is not our base case. For now, we expect the Fed's balance sheet to remain elevated as Treasury issuance begins to decline. This elevation will accommodate the increased desire for liquidity and bank reserves from primary dealers and banks. The Fed should continue to conduct term and overnight repurchase agreement operations to help ensure that the supply of reserves remains ample and to mitigate potential disruptions in the ultra-short-term sector and money markets.

2) Providing guidance on the conditions needed to raise policy rates

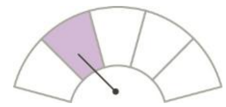
We expect that the Fed will begin drafting and communicating its litmus test on the conditions needed to begin raising policy interest rates sometime in the first half of 2022. Financial markets have been a little aggressive over the past few weeks, pricing in at least two rate hikes in 2022 and three rate hikes in 2023 as of this writing. Our base case, for now, is that the Fed will only increase the federal funds target rate once in 2022 and, most likely, after it has finished purchasing assets.

We are also projecting a deceleration in U.S gross domestic product growth and inflation in the second half of the year. This should allow the Fed to take a slower approach to raising policy interest rates; however, if inflation levels continue to advance at a strong pace or if the U.S. economy heats up more than expected, we believe there could be additional rate increases in 2022.

Luis Alvarado
Investment Strategy Analyst

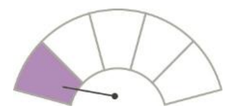


Unfavorable
U.S. Taxable Investment Grade Fixed Income

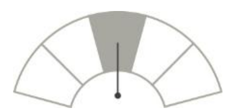


Unfavorable
U.S. Short Term Taxable Fixed Income

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

3) Composition of the Federal Open Market Committee (FOMC)

Another factor that is supporting our view of fewer interest rate hikes next year is the changing composition of the voting members inside the FOMC. Two very important and influential seats are rotating out (Richard Clarida, vice chair, and Randal Quarles, vice chair of banking supervision), and one other vacant seat that remains to be filled. This will allow President Joe Biden to nominate and potentially fill at least three seats. The consensus view is that the nominees will have a very dovish view of monetary policy, prioritizing robust job market recovery over inflationary concerns.

FOMC composition in 2022

				Fed spectrometer
2022 FOMC	**1**	Jerome H. Powell	Board of Governors, Chair	Dove
	2	Michelle W. Bowman	Board of Governors	Dove
	3	Lael Brainard	Board of Governors	Dove
	4	*Open seat (was Richard H. Clarida)*	Board of Governors	*Expected dove
	5	*Open seat (was Randall Quarles)*	Board of Governors	*Expected dove
	6	Christopher J. Waller	Board of Governors	Neutral
	7	*Open seat*	Board of Governors	*Expected dove
	8	John C. Williams	New York, Vice Chair	Dove
	9	James Bullard	St. Louis	Hawk
	10	Esther L. George	Kansas City	Hawk
	11	Loretta J. Mester	Cleveland	Neutral
	12	Kenneth C. Montgomery	Boston, first Vice President	Neutral
Alternate members	**13**	Naureen Hassan	New York, first Vice President	
	14	Charles L. Evans	Chicago	
	15	Patrick Harker	Philadelphia	
	16	Meredith Black, interim President	Dallas	
	17	Neel Kashkari	Minneapolis	

Sources: Bloomberg and Wells Fargo Investment Institute, December 8, 2021. The Fed spectrometer is a subjective assessment on how each member will vote (keeping monetary policy loose = dove; tightening monetary policy = hawk; or neutral). *Wells Fargo Investment Institute expects dovish members to be picked by President Biden.

However, even voting members with a more dovish tilt might support a more cautious normalization of monetary policy on concern of getting too far behind the curve. Hence, we believe it is still premature to assume whether a dovish tilt at the FOMC will dramatically alter the pace of tightening. We expect more insight on this topic at the December 15 FOMC meeting. We will get an updated summary of economic projections and dot plots, which should guide market participants on where the doves stand in regards to raising interest rates in 2022.

Overall, in 2022, we believe the Fed will attempt to display a balancing act between keeping the recovery going, tackling uncertainties any new variants of coronavirus could pose to the labor market, and dealing with an economy that has been running hot with inflation for several months. We expect the Fed to be more proactive in the first half of the year, but to be on hold as the mid-term election period draws near (as long as inflation subsides in the second half). The Fed's proactive stance while the economy slows should put some additional upward pressure on short-, intermediate-, and long-term U.S. interest rates. In turn, we expect modestly higher rates to support equity valuations and low double-digit U.S. equity returns in 2022.

Equities

Ken Johnson, CFA
Investment Strategy Analyst

Analyst earnings estimates may be too conservative

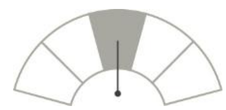
No two market cycles are the same. This truth is exemplified when you look at today's market environment. The illustration below shows how earnings expectations move from cycle to cycle. The closer the spread between forward and actual earnings is to zero, the better analysts did at predicting actual earnings.

What we find is that, on average, analysts have done a decent job predicting earnings, but there have been two big exceptions. The first is during recessions, and the second is immediately after a recession. During a recession, analysts have tended to overshoot — no surprise here, since it is nearly impossible to predict when a recession will occur. Immediately after a recession (early cycle), estimates tended to undershoot as they adjusted to the economic boom. As the cycle matures, analyst accuracy in forecasting earnings tended to improve.

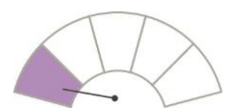
We have seen a similar trend this cycle, but the magnitude of underestimating earnings is the largest ever recorded. Global COVID-19 uncertainty and supply chain disruptions have left analysts more pessimistic than normal. In our opinion, analysts are overweighting these potential risks, specifically in sectors such as Industrials, Financials, and Information Technology, all of which we have a favorable outlook. We believe a steepening yield curve, resurgence of share repurchases, a continuation of technology spending, and elevated new goods orders all provide a tailwind to earnings. We anticipate 2022 will be a year of record S&P 500 Index earnings. Our estimate is $235, roughly $9 higher than Bloomberg consensus.

Most favorable
U.S. Large Cap Equities

Favorable
U.S. Mid Cap Equities



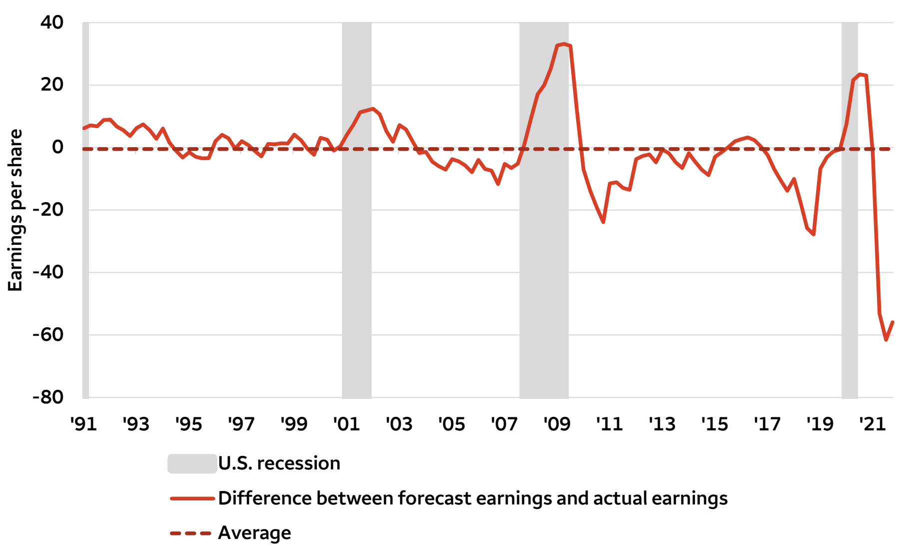
Neutral
U.S. Small Cap Equities



Most unfavorable
Developed Market
Ex-U.S. Equities

Neutral
Emerging Market Equities

S&P 500 Index consensus earnings estimates well under actuals



Sources: Wells Fargo Investment Institute and Bloomberg, December 8, 2021. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

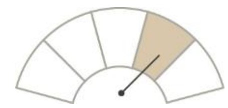
Real Assets

John LaForge
Head of Global Real Asset Strategy

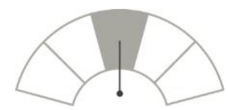
"There are no shortcuts to any place worth going." — Beverly Sills

Commodities — Expecting a strong 2022

Last week we released our 2022 Outlook, and in it we detailed our thoughts for Commodities' performance next year. The bottom line is that we are expecting another good year. The midpoint of our 2022 Bloomberg Commodity Index (BCOM) target is 15% higher than last Wednesday's closing price. If hit, this would be the third straight year of double-digit gains for the BCOM.



Favorable
Commodities

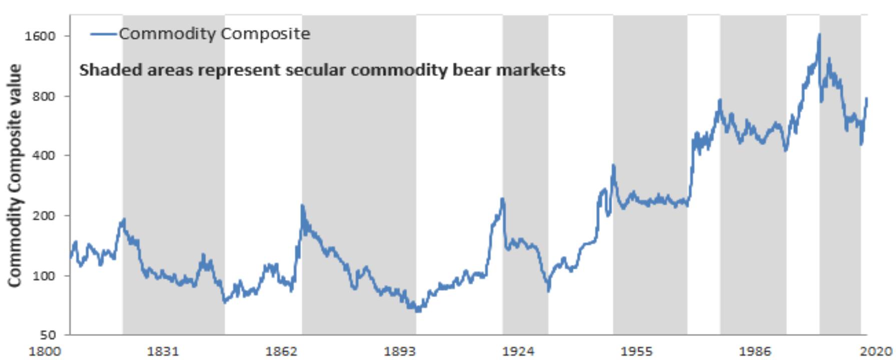


Neutral
Private Real Estate

Our positive 2022 stance is underpinned by our belief that Commodities began a new bull super cycle in March 2020. Super cycles are multi-year boom (bull) and bust (bear) periods during which commodity prices have typically moved together as a family. Bull super cycles are shaded white in the chart below while the bear super cycles are shaded gray. Using data going back to the year 1791, bull cycles last on average 17.5 years with an average 247% gain (see table below). Our current bull cycle has gained 63% and is only 1.7 years old. It appears that we still have time and gains left before the current bull super cycle runs out of steam.

To gain exposure to the Commodities bull super cycle, we recommend a broad basket of commodities. Bull super cycles have been known to lift most commodity prices. For those looking to pick select areas we favor Energy and Precious Metals over Agriculture and Industrial Metals to begin 2022.

Commodities bear market super cycles



Commodities bull super cycles

	Percentage gain	Length (years)
1791–1814	132.5%	23.5
1843–1864	208.2%	21.6
1896–1920	269.7%	24.0
1933–1951	331.5%	18.3
1971–1980	249.5%	9.1
1999–2008	291.8%	9.0
2020–today	62.5%	1.7
Average bull (without current)	**247.2%**	**17.6**

Sources: Bloomberg, "Prices" by G.F. Warren and F.A. Pearson, Bureau of Labor Statistics, Bureau of Economic Research, and Wells Fargo Investment Institute. Returns are based off of the Commodity Composite. Monthly data for bear market super cycles chart: January 31, 1800–February 26, 2021. Return and length calculation for current bull is between 3/18/2020 and 12/9/2021. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.**

Alternatives

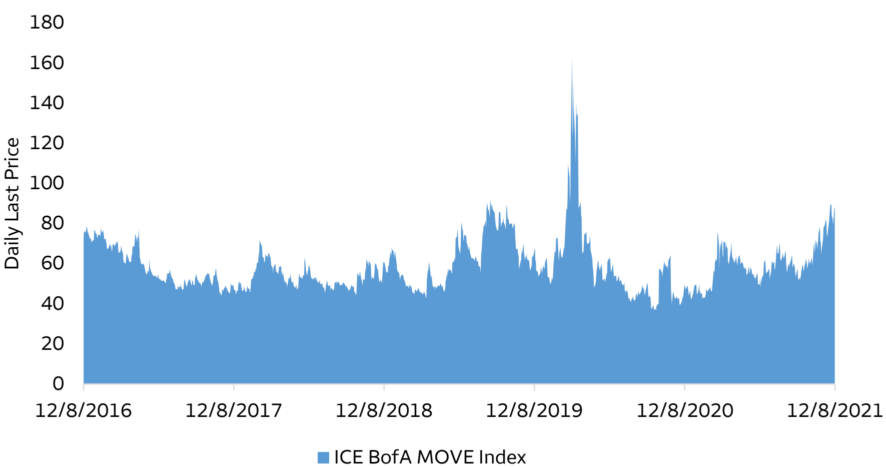
James Sweetman
Senior Global Alternative Investment Strategist

Hedge funds deleveraging due to rising risks

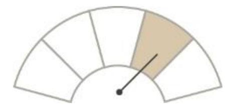
Market volatility, as measured by the CBOE Volatility Index, has doubled since the end of October as investors adjust to a changing landscape. The Omicron variant of COVID-19 has emerged, posing risks to growth, and the Federal Reserve has pivoted, sparking a reassessment of inflation and policy expectations. Amidst this increased uncertainty, hedge funds have ramped up the pace of their hedging activity and dramatically reduced gross and net leverage from mid-year highs. But despite lower leverage, early indications are that many hedge funds were caught off guard by news of the Omicron variant — they had bought reopening stocks and sold stay-at-home names. This is particularly true for Equity Hedge managers, who experienced their worst losses of the year and were down approximately 2.7%.[1]

But as the old saying goes, often times, crisis creates opportunity. Many hedge funds are in search of mispriced risks heading into 2022, whether they are predictions for accelerating inflation or rising interest rates. Uncertainty in the fixed-income rates markets has helped drive the ICE BofA MOVE Index (a widely watched gauge of Treasury volatility based on options) to levels last seen at the onset of the pandemic crisis and the second-highest levels in the past five years (see chart below). We believe this increased volatility may create compelling opportunities for Relative Value credit-oriented strategies, such as Long/Short Credit and Fixed-Income Arbitrage. We believe these strategies have the ability to generate gains in both long and short positions while providing diversification that compliments traditional fixed-income exposures in 2022.

Treasury volatility at highest levels since pandemic

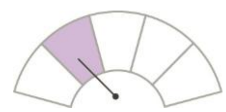


Sources: Bloomberg, Wells Fargo Investment Institute, December 2021. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.**

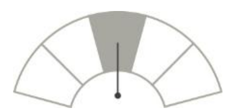


Favorable
Hedge Funds – Relative Value

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.

[1] Hedge Fund Research (HFR) – December 8, 2021.

Risk Considerations

Forecasts are not guaranteed and 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.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

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

An index is unmanaged and not available for direct investment.

Bloomberg Commodity Index is comprised of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity.

Chicago Board Options Exchange Volatility Index (VIX) reflects a market estimate of future volatility, based on the weighted average of the implied volatilities for a wide range of strikes.

ICE BofA MOVE Index is the Merrill Lynch Option Volatility Index, which is composed of over-the counter options for Treasury securities maturing in 2-30 years. It is a yield-curve-weighted index of the normalized implied volatility on 1-month Treasury options which are weighted on the 2, 5, 10, and 30 year contracts.

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.

Commodity Composite measures a basket of commodity prices as well as inflation. It blends the historical commodity index introduced by George F. Warren & Frank A. Pearson, former academics at Cornell, collected and published commodity price data in their book, Prices, and the producer price index for commodities (PPI-Commodities), and the National Bureau of Economic Research (NBER) Index of Wholesale Prices of 15 Commodities, the Reuters Continuous Commodity Index, and the Bloomberg Commodity Index Total Return. The index components and weightings, from Warren and Pearson's Prices, change over time but the 11 commodity groups used from 1786-1932 are: Farm Products, Foods, Hides and Leather products, Textile Products, Fuel and Lighting, Metals and Metal Products, Building Materials, Chemicals and drugs, Spirits (stopped tracking 1890), House furnishing Goods, and Miscellaneous. The PPI-Commodities is compiled by the Bureau of Labor Statistics and shows the average price change from the previous month for commodities such as energy, coal, crude oil and the steel scrap. The NBER Index of Wholesale Prices of 15 Commodities is a measure of price movements of 15 sensitive basic commodities whose markets are presumed to be among the first to be influenced by changes in economic conditions. The Reuters Continuous Commodity Index comprises 17 commodity futures that are continuously rebalanced: cocoa, coffee, copper, corn, cotton, crude oil, gold, heating oil, live cattle, Live hogs, natural gas, orange juice, platinum, silver, soybeans, sugar no. 11, and wheat.

The Commodity Composite connects the aforementioned components at the following years:

Warren and Pearson- Prices: 1720-1932, BLS PPI-Commodities: 1933-1946, NBER: 1946-1956, Reuters Continuous Commodity Index: 1956-1999, Bloomberg Commodity Index Total Return: 1999- current.

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