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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **January 11, 2021**

Equities spotlight: Five "Rs" that could drive equity markets in 2021.......2

- We expect the global economy to continue its recovery in 2021 and for the S&P 500 Index earnings per share (EPS) and price levels to reach record highs.
- We believe there are many potential catalysts for these milestones, including reflation, reaccelerating earnings, redeployment of cash, resumption of global trade, and repositioning.

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- Federal Reserve (Fed) rhetoric in early 2021 continues to stress that rates should remain low for an extended period – meaning years. So far, the market seems happy to concur with that view.
- Market expectations show developed market (DM) policy rates stuck at ultra-low levels or rising only very modestly over a three-year horizon. Emerging market (EM) rates are seen rising more, something that may be supportive of EM currencies over the period.

Real Assets: USD – What if we are wrong?..5

- We believe that commodities still have upside, and the U.S. dollar (USD) still has downside.
- Should we be wrong on the USD, the commodity rally may slow some, but we still think that it survives.

Alternatives: Light at the end of the tunnel for commercial mortgage backed securities..6

- Commercial real estate delinquency trends are showing early signs of stabilization.
- We expect Relative Value hedge funds to be active in the commercial mortgage-backed (CMBS) market this year, seeking to isolate winners from losers and identify post-pandemic trends.

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Equities spotlight

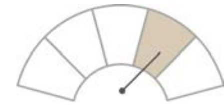
Chris Haverland, CFA
Global Asset Allocation Strategist

Five "Rs" that could drive equity markets in 2021

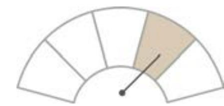
We believe the economic momentum that began in the second half of 2020 will continue in 2021. Although all may not be back to normal by year-end, we expect the S&P 500 Index EPS and price levels to both reach record highs. There are many potential catalysts for these milestones and below we discuss some of the key equity market drivers for 2021: reflation, reaccelerating earnings, redeployment of cash, resumption of global trade, and repositioning.

Reflation – Policymakers around the world took aggressive actions in 2020 to combat the pandemic-induced recession. These fiscal and monetary policies provided unprecedented liquidity to the global economy that is leading to a weaker U.S. dollar, a steeper yield curve, and the reflation of asset prices. We look for the Federal Reserve's accommodative stance to last at least through 2021, which should support risk assets — especially equities. In addition, a Democratic-controlled Congress is likely to boost fiscal spending, a key ingredient for reflation. Equity classes and sectors that tend to be more sensitive to the economy may benefit the from a "reflation trade." Those include U.S. small-cap and emerging market equities and cyclical sectors, such as Financials, Industrials, and Materials.

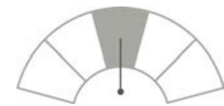
Reacceleration of earnings – Corporate earnings plunged in 2020 as the economy contracted and many businesses were deeply affected by the pandemic lockdowns. While revenues shrank, many companies reduced expenses, creating enormous operating leverage that should boost earnings once the economy recovers. We believe much of this prudent cost management is likely to be realized in 2021, with S&P 500 Index EPS expected to grow by more than 30%. The rebound in earnings will be most pronounced in cyclical sectors such as Industrials, Consumer Discretionary, Materials, and Financials. While 2020 equity market returns were driven mainly by price-to-earnings multiple expansion, 2021 performance likely will be driven by robust earnings growth (see chart below).



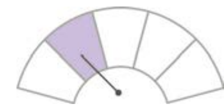
Favorable
U.S. Large Cap Equities



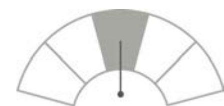
Favorable
U.S. Mid Cap Equities



Neutral
U.S. Small Cap Equities

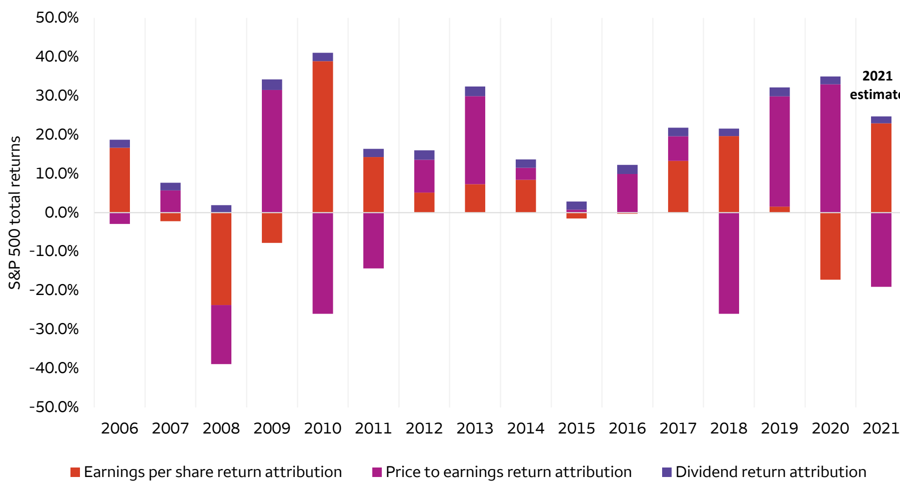


Unfavorable
Developed Market Ex-U.S. Equities



Neutral
Emerging Market Equities

Stock performance for 2021 may ride on earnings rebound



Sources: Bloomberg, Wells Fargo Investment Institute, January 5, 2021. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change. Attribution breaks down the source of returns.

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Redeployment of cash – Institutional and retail investors have more than $4 trillion invested in money market funds, nearly $700 billion more than pre-pandemic levels.[1] With rates expected to remain relatively low in 2021, investors seeking income and growth may consider re-investing some of that money in the equity markets. Corporations also accumulated a significant amount of cash during the recession, with cash as a percentage of assets at the highest level since 1960. If the economic recovery takes hold and sentiment improves as we expect, we believe there could be a wave of merger and acquisition activity and a renewed focus on capital expenditures. In addition, we believe excess cash could fuel increased dividend payments and the reinstitution of stock buyback programs.

Resumption of global trade – We expect the Biden administration to have a somewhat less aggressive approach to trade policy and the use of tariffs. In our view, relaxing some of the restraints from the past few years could benefit corporations as well as investors. Working with our trading partners to develop mutually beneficial agreements could result in a more stable, investor-friendly environment for multinationals. This may provide a tailwind to U.S. large-cap equities with 40% of S&P 500 Index revenues coming from foreign countries. At the sector level, Materials, Information Technology, and Consumer Staples have the highest foreign revenue exposure. Although not a given in 2021, any normalization of trade policies in the coming quarters likely would be positive for S&P 500 Index earnings, potentially adding to the expected cyclical rebound.

Repositioning – Growth has outperformed value for more than a decade, and 2020 was no different.[2] Nonetheless, value (in particular cyclicals) historically has tended to perform well in the early stages of a bull market. We saw flashes of this in the fourth quarter, and we believe there will likely be a further broadening of the rally in 2021. In the past few months, we have upgraded U.S. small-cap equities, emerging market equities, and the Materials and Industrials sectors, all of which have benefited from wider participation. From a value perspective, we have a favorable view on the Health Care sector (top weighting in the S&P 500 Value index) and recommend a full allocation to Financials, Consumer Staples and Industrials (second, third, and fourth highest weightings in the S&P 500 Value Index). While our sector positioning has leaned toward growth for some time, in 2021 we favor a more balanced approach to style investing with continued emphasis on quality.

[1] Strategas as of December 9, 2020.
[2] As measured by the Russell 1000 Growth Index compared to Russell 1000 Value Index.

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Fixed Income

Peter Wilson
Global Fixed Income Strategist

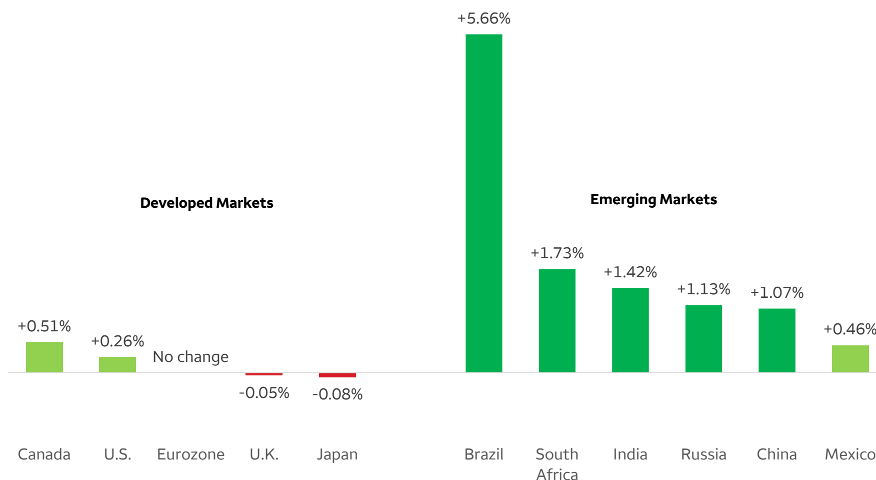
Where will central bank rates be in three years?

U.S. Federal Reserve (Fed) speakers in early January reinforced the policy of "flexible average inflation targeting" first announced in August last year. Chicago Fed President Charles Evans stated, *"It likely will take years to get average inflation up to 2 percent, which means monetary policy will be accommodative for a long time. This translates into low-for-long policy rates…"*[3]

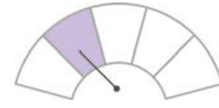
So far, the bond market is prepared to take these words at face value, and money-market participants do not anticipate that the Fed will raise rates before late 2023 at the earliest. The Overnight Index Swaps (OIS) market sees the effective federal funds rate in January 2024 at 0.39% — just 0.26% higher than today's rate — implying just one full 0.25% rate hike even three years from now[4]. The picture is the same in other developed markets; central bank policy rates in the eurozone, the U.K., and Japan are seen stuck at today's ultra-low or negative levels — or maybe even edging lower still (see chart).

Similar OIS expectations for emerging market central banks see more upside for policy interest rates. The chart shows rises of more than 1.0% for several major EM countries and much bigger rises in some cases, such as Brazil, where severe downturns have left rates very depressed. We do not expect the very modestly higher expected rates for the Fed to give much support to the U.S. dollar against other DM currencies, but we do believe that if the global recovery develops as anticipated, higher rates will be one factor contributing to a better performance from EM currencies than we have seen recently.

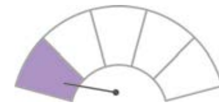
Higher rate hopes may boost EM currencies



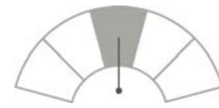
Sources: Bloomberg, Wells Fargo Investment Institute. Latest data as of January 7, 2021. These forward-looking policy rates are derived from the Overnight Index Swaps (OIS) market. An OIS is a fixed/floating interest rate swap where the floating leg is computed using a published overnight index rate, in this case the overnight rate corresponding to the relevant central bank policy rate.



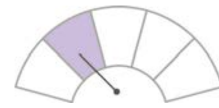
Unfavorable
U.S. Taxable Investment Grade Fixed Income



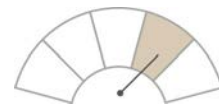
Most unfavorable
U.S. Short Term Taxable Fixed Income



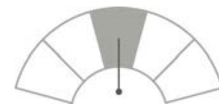
Neutral
U.S. Intermediate Term Taxable Fixed Income



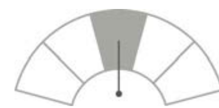
Unfavorable
U.S. Long Term Taxable Fixed Income



Favorable
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

[3] Speech to the American Economics Association, January 4, 2021.
[4] Data as of January 7, 2021.

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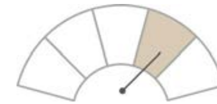
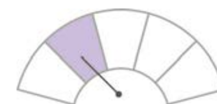
Real Assets

John LaForge
Head of Real Asset Strategy



Favorable
Commodities



Unfavorable
Private Real Estate

"Don't wait. The time will never be just right." — Napoleon Hill

USD – What if we are wrong?

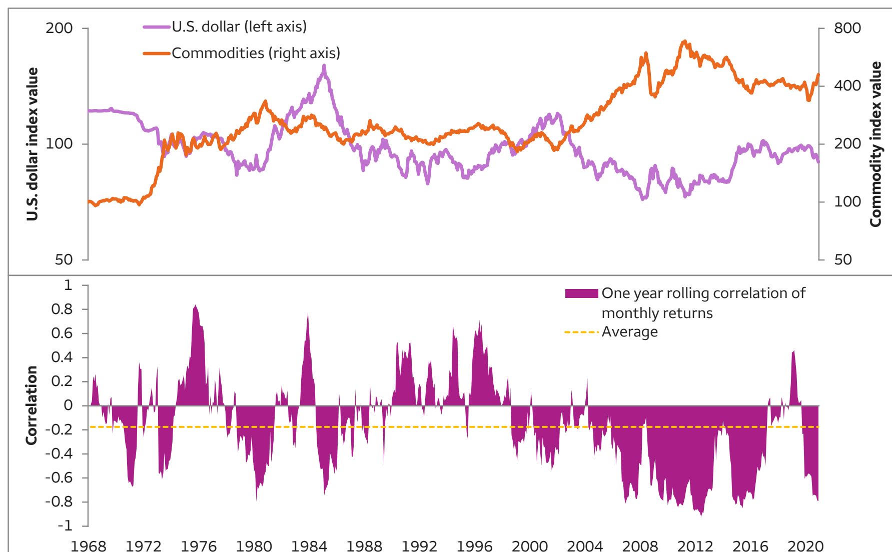
The U.S. dollar has dropped 13% since last March.[5] The drop has not been sudden — rather a slow grind. Over the same time period — not surprisingly — most commodity prices have been rising. Historically it has been common for commodity prices to run opposite the USD. The reason is that many global commodities are priced in USD. As the USD weakens, the currencies of other markets often strengthen, which gives these countries extra buying power. This extra buying power can influence commodity demand and commodity prices.

We've been calling for a weak USD and higher commodity prices. We upgraded commodities to favorable on March 12, 2020 – roughly one week before the USD began its 13% drop. Now, here we are in 2021 — still commodity bullish and USD bearish. But, what if we are wrong on the USD? Can commodities survive a strong USD?

We believe the answer is yes, commodities can survive USD strength. While the negative connection between commodities and the USD has been strong lately, this historically hasn't always been the case. The bottom panel in the chart highlights the commodity/USD correlation since 1968. Notice that the line is not always below zero (negative correlation). Commodities are also influenced by other factors (improved Chinese economic growth, low global real interest rates, healing commodity super-cycle)[6], which are generally commodity-positive today.

For 2021, we believe that commodities still have upside, and the USD still has downside. Should we be wrong on the USD, the commodity rally may slow some, but we still think that it survives.

U.S. dollar versus commodities



Sources: Bloomberg, Wells Fargo Investment Institute. Monthly data: January 31, 1968 – December 31, 2020. Top panel shown in log scale. Commodities are represented by the CCI Index. The U.S. dollar is represented by the U.S. Dollar Index (DXY).

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[5] As measured by the U.S. Dollar Index (DXY).

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

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Alternatives

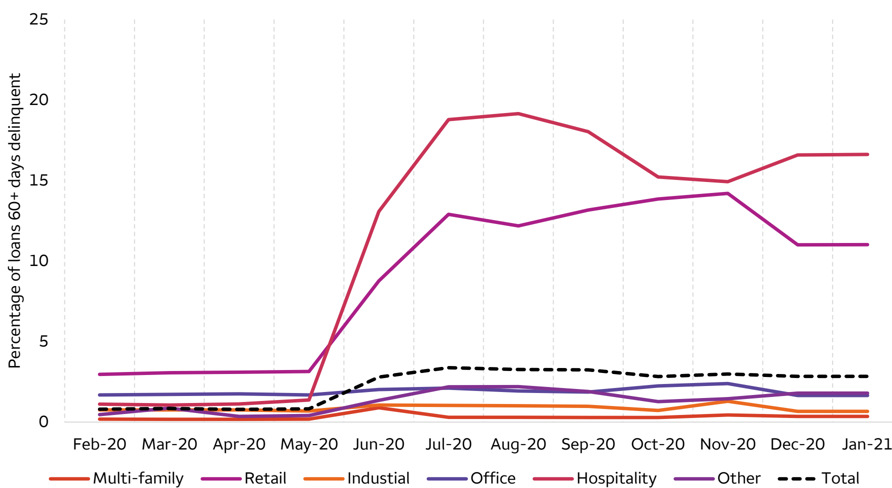
Justin Lenarcic
Senior Global Alternative Investment Strategist

Light at the end of the tunnel for commercial mortgage backed securities

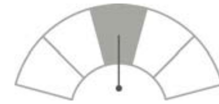
It's no surprise that several sectors within commercial real estate (CRE) are facing acute stress from the coronavirus pandemic. Pressure was already building within the retail sector this time last year, but the economic shutdown catapulted delinquencies in both retail and hospitality sectors to levels not seen since the 2008 global financial crisis. Though delinquency trends for these two strained sectors remain high — as seen below — they began to moderate in the fourth quarter. In fact, recent progress by Mall of America owners to restructure its $1.4 billion mortgage and cure its delinquency could even be a precursor to more retail-sector loan modifications in 2021. Importantly, other sectors such as multi-family, industrial, and even office have remained in a healthier position throughout the year.

We believe that commercial mortgage backed securities (CMBS) could be a compelling investment in 2021, and we expect more activity from Relative Value hedge funds looking to capitalize on depressed valuations. Assuming a continuation of the economic recovery coupled with vaccine distribution, we expect further improvement in the fundamental landscape for CMBS. Add in the relatively attractive yield, and it's easy to see the technical backdrop improve as demand outpaces supply. However, while there may be light at the end of the tunnel for CMBS, we believe there will be clear winners and losers across markets. That warrants caution and bodes well for an active — as opposed to passive — investment approach.

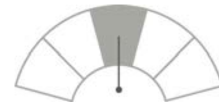
Commercial real estate delinquency trends appear to have stabilized



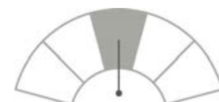
Sources: Bloomberg, Wells Fargo Investment Institute. Data as of January 5, 2021.



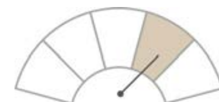
Neutral
Private Equity



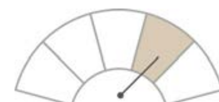
Neutral
Hedge Funds – Macro



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 suitable for all investors and are only open to "accredited" or "qualified" investors within the meaning of U.S. securities laws.

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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. 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. Risks associated with the **Consumer Discretionary** sector include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players; reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. **Consumer Staples** industries can be significantly affected by competitive pricing particularly with respect to the growth of low-cost emerging market production, government regulation, the performance of the overall economy, interest rates, and consumer confidence. Investing in the **Financial** services companies will subject a investment to adverse economic or regulatory occurrences affecting the sector. Some of the risks associated with investment in the **Health Care** sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio's performance. **Materials** industries can be significantly affected by the volatility of commodity prices, the exchange rate between foreign currency and the dollar, export/import concerns, worldwide competition, procurement and manufacturing and cost containment issues.

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 suitable 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.

Commercial Mortgage Backed Securities (CMBS) are a type of mortgage-backed security backed by commercial mortgages rather than residential real estate. CMBS tend to be more complex and volatile than residential mortgage-backed securities due to the unique nature of the underlying property assets.

Definitions

An index is unmanaged and not available for direct investment.

Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.

S&P 500 Industrials Index comprises those companies included in the S&P 500 that are classified as members of the GICS® industrials sector.

S&P 500 Value Index measures value stocks using three factors: ratios of book value, earnings and sales to price.

Thompson Reuters Equal Weight Commodity Index (CCI Index) comprises 17 commodity futures that are continuously rebalanced: Cocoa, Coffee Copper, Corn, Cotton, Crude Oil, Gold, Heating Oil, Live Cattle, Lean Hogs, Natural Gas, Orange juice, Platinum, Silver, Soybeans, Sugar No. 11, and Wheat.

U.S. Dollar Index (DXY) 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.

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