WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **September 21, 2020**

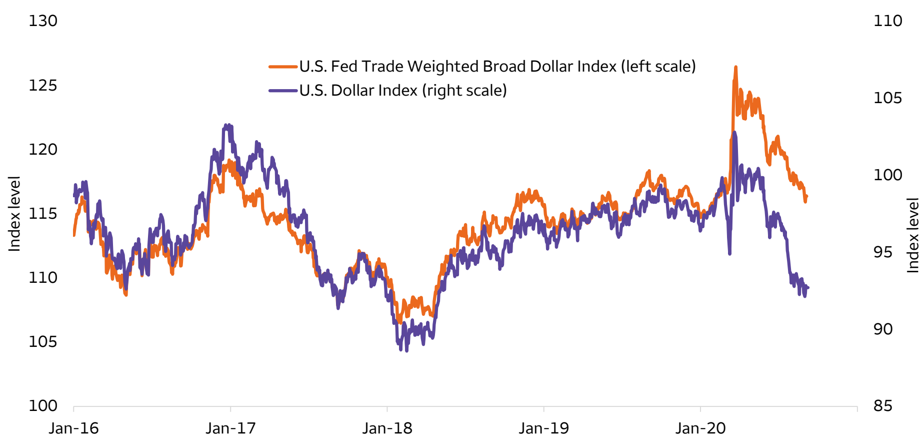
Fixed Income spotlight

Weaker dollar in 2021 — but against what?

There has been much discussion this year of the trend change in foreign-exchange markets, from U.S. dollar strength to weakness. Yet, this weakness has been apparent mainly in the DXY, which has declined from its highs near 103 to 2-year lows around 92-93. The chart illustrates the relatively narrow nature of the dollar's 2020 fall. While the DXY is at 2-year lows, the Federal Reserve's (Fed) Trade-Weighted Nominal Broad Dollar Index (a wider measure of dollar value against all major trading partners) remains slightly above the 2018-2019 trading ranges.

As the euro represents 58% of the DXY, we can say that the euro's appreciation — from lows near 1.08 to 1.20 in early September — has been the principal driver of the weak dollar in 2020. Other DXY constituents, like the yen, are scarcely stronger. And while the British pound has had periods of strength, it has weakened recently as Brexit risks have resurfaced.

Despite DXY weakness, the Federal Reserve Trade Weighted Broad Dollar Index is little changed from 2019's levels

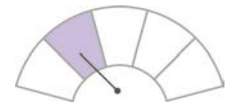


Sources: Bloomberg, Wells Fargo Investment Institute, latest data as of September 14, 2020. **Past performance is no guarantee of future results.** See disclosures for index definitions.

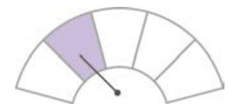
Structural supports for the dollar have weakened

There have been good reasons for euro strength this year. Although COVID-19 caseloads have been rising recently in many eurozone countries, investors viewed the region's initial response to the first wave of infections positively, and it raised hopes of a stronger 2021 economic recovery. The COVID-19 emergency also led to greater solidarity between national policymakers, and this bore fruit in the 750 billion euro ($890 billion) Recovery and Resilience Facility, involving mutualized debt issuance and transfers between nations.

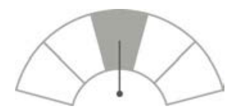
Peter Wilson
Global Fixed Income Strategist



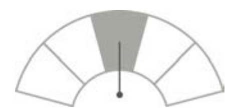
Unfavorable
U.S. Taxable Investment Grade Fixed Income



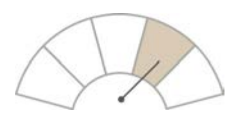
Unfavorable
U.S. Short Term Taxable Fixed Income



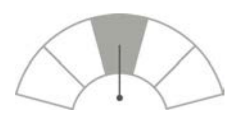
Neutral
U.S. Intermediate Term Taxable Fixed Income



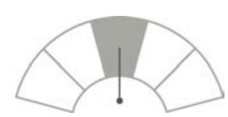
Neutral
U.S. Long Term Taxable Fixed Income



Favorable
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

Yet, we believe that it would be wrong to see 2020's dollar weakness as solely a euro/dollar phenomenon. The COVID-19 crisis and the U.S. policy response have removed or weakened several factors that were strong dollar supports last year. For example, the Fed's recent policy changes have opened avenues for a weaker dollar. Lower short-term rates and bond yields have slashed the U.S. securities rate advantage that existed until early 2020. In parallel with this, lower short-rate differentials have cut overseas hedging costs to zero in many cases. This has made it cheaper to sell dollars in forward-exchange markets and neutralized any potential dollar boost from inflows into longer-maturity bonds driven by a steeper yield curve or higher U.S. credit-market yields.

The dollar is now less prone to upward squeezes since the Fed's aggressive liquidity response to the COVID-19 market shock has tranquilized fears of future dollar shortages. Further, the Fed's late-August introduction of its average inflation targeting policy should tend to lower U.S. real yields and raise inflation expectations relative to the rest of the world. Both of these factors likely have contributed to a weaker dollar.

Implications for 2021

In summary, we find that 2020 has seen a reversal in dollar sentiment, with the balance of factors now pointing to a lower dollar. We believe that this dollar-negative environment will extend into 2021, and we expect further dollar depreciation. However, since we see the euro/dollar exchange rate as the line of least resistance for this weaker dollar sentiment, we don't expect a very broad-based dollar collapse or a large cyclical decline as in 1985-1993 or 2002-2008. We expect a 2021 year-end range of 1.21–1.29 dollars per euro. This suggests further euro appreciation of approximately 4%–5% from current levels, and it is consistent with a DXY ranging between the mid-80s and low 90s. We expect only mild yen appreciation, and we believe that Brexit-related trade dislocations could push the pound lower against the dollar next year.

Finally, the dollar continues to hold attractions for investors. It should remain the largest and most important reserve currency for global central banks, and the dollar's existing preeminence in commercial trade and finance should erode only very gradually. Further, investors and traders looking to sell the dollar must consider what they will buy against it. The list of attractive foreign-exchange purchase candidates may be shorter than it was previously. Despite the dollar's decline on a DXY basis, it is holding up well against many EM currencies. (The Chinese yuan is a notable exception.) Although the dollar's fall may relieve some pressure on EM currencies, we do not expect EM currencies to stage a broad, sustained recovery (outside of Asia). Emerging economies face headwinds that predate the coronavirus crisis, including slow global demand growth and an end to the buoyant global trade recovery that supported much of their strong performance following the 2008-2009 global financial crisis.

Equities

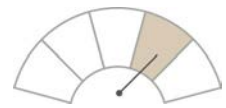
Chao, Ma, Ph.D., CFA, FRM
Global Portfolio and Investment Strategist

Looking toward a post-pandemic world

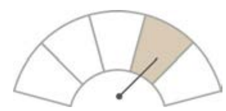
2020 has been quite a journey for the stock market — with its roller-coaster-like volatility starting this spring. As we look toward a post-pandemic paradigm, a logical question is how the stock market may look once we find a COVID-19 vaccine.

Once a vaccine finally is found, we believe that the pandemic will cease to be a major stock-market risk factor. Yes, vaccinations may take time. But the news generally should be a global-equity tailwind. Yet, the impact may not be the same for all stocks. We expect the industries that were most impacted by the pandemic, including travel, leisure, and department stores, should benefit the most from vaccine news. We believe that previous dynamics observed on days when positive COVID-19 vaccine trial data was released provide a good guidepost (see chart). A COVID-19 vaccine also could pave the way for a substantial recovery for these industries. Similarly, small-cap and value stocks may have an opportunity to catch up.

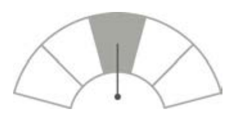
Looking through these shorter-term dynamics, we also believe that some of the trends which the pandemic accelerated potentially will continue. These could include the virtual-experience economy and investments in technology, innovation, and health care, along with supply chain reshoring. Companies that have succeeded relatively more during the pandemic may have the potential to retain their leadership over the long run. Our recent U.S. small-cap equity upgrade to neutral recognizes this equity class' shorter-term economic and earnings improvement tailwind, while we maintain our preference for U.S. large-cap equities and the Information Technology, Consumer Discretionary, Communication Services, and Health Care sectors.



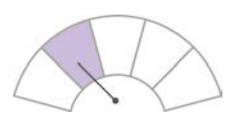
Favorable
U.S. Large Cap Equities



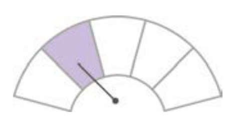
Favorable
U.S. Mid Cap Equities



Neutral
U.S. Small Cap Equities

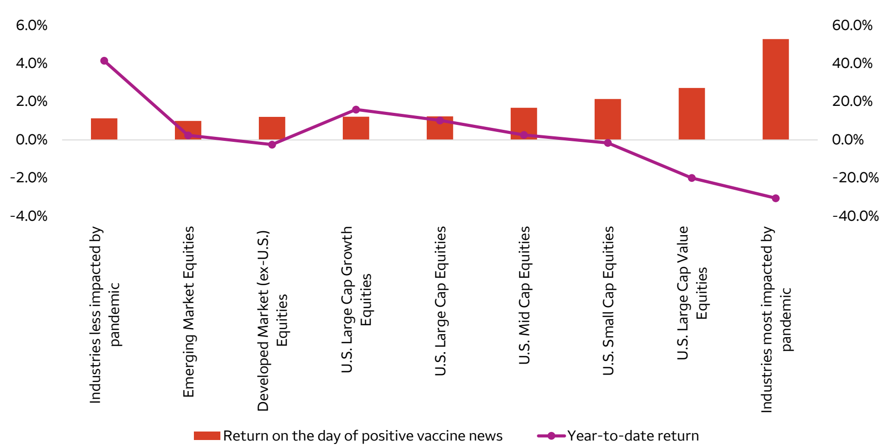


Unfavorable
Developed Market Ex-U.S. Equities



Unfavorable
Emerging Market Equities

Stock returns on the day of positive COVID-19 vaccine news



Sources: Wells Fargo Investment Institute, Morningstar, September 16, 2020. See disclosures for index definitions. Chart reflects our view that S&P 500 industries that are less impacted by the pandemic include internet retail, air freight and logistics, application software, homebuilding, and home improvement retail. It also reflects our view that S&P 500 industries most impacted by the pandemic include airlines, hotels, resorts, cruise, casinos and gaming, apparel accessory and luxury goods, and department stores. **Past performance is no guarantee of future results**

Real Assets

Austin Pickle, CFA
Investment Strategy Analyst

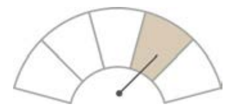
"Success is not final, failure is not fatal: it is the courage to continue that counts."
— Winston S. Churchill

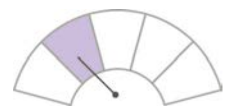
Is it time to "bottom fish" Office, Retail, and Lodging REITs?

Our least-favored REIT subsectors — Office, Retail, and Lodging — have underperformed the REIT benchmark by 22%, 30%, and 50%, respectively, since we initiated our unfavorable guidance (through September 15).[1] This significant underperformance has prompted the question: "is it time to bottom fish?" Our answer is "not today."

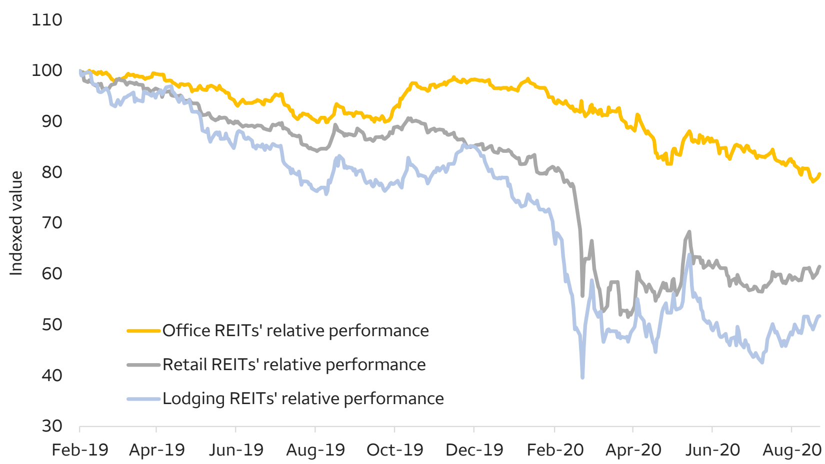
We are always ready to change our guidance if the weight of the evidence argues to do so. But, in our view, the evidence does not support bottom fishing in this space. We are still confident in our view that these subsectors will underperform over our tactical time frame (6-18 months). Each still has serious questions. When will the pain in brick and mortar retail end? When will leisure and business travel rebound to pre-pandemic levels? How quickly will the job market recover? How many of us will end up working from home full- or part-time? These questions have the potential to materially impact Retail, Lodging, and Office REITs for years to come.

It is important to remember that we believe investing is a relative game — is my $1 better invested here or there? For REIT investors, we still believe that $1 is better invested in our favorite subsectors: Industrial, Infrastructure, and Data Center REITs. The evidence may change down the road — as the above questions may be answered, price dislocations could occur, or new trends could emerge. But for now, we say "leave your poles at home." For more details on our REIT subsector ratings, please see our *Real Assets Quarterly Guidance* report.


Favorable
Commodities


Unfavorable
Private Real Estate

Office, Retail, and Lodging REIT relative performance



Sources: Bloomberg, Wells Fargo Investment Institute. Daily data: February 26, 2019 – September 16, 2020. Relative performance is measured as the FTSE NAREIT Subsector Index divided by the FTSE NAREIT All Equity REITs Index. Indexed to 100 as of the start date. **Past performance is no guarantee of future results**

[1] This performance is measured by the total return of the FTSE NAREIT subindexes, with the benchmark being the FTSE NAREIT All Equity REITs Index. Our Office REIT and Lodging REIT unfavorable ratings were initiated on February 26, 2019. Our Retail REIT unfavorable guidance was initiated on July 25, 2019.

Alternatives

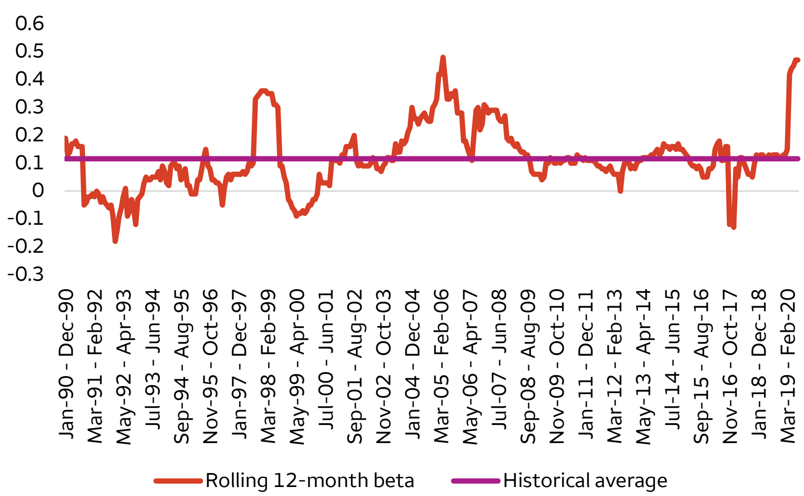
Evaluating the Merger Arbitrage strategy in 2020

The Merger Arbitrage strategy historically has exhibited low beta (sensitivity) to global equity markets.[2] From January 1990 through July 2020, the average rolling 12-month beta to global equities has been just 0.12.[3] Yet, for the 12 months ended on July 31, its equity market beta was 0.47 — as the coronavirus pandemic drove a historic equity market sell-off and pushed Merger Arbitrage spreads to all-time highs.[4]

Market participants have attributed the aggressive spread widening to large, multi-strategy hedge funds that used their Merger Arbitrage allocations to raise cash during the market decline, raising selling pressure.

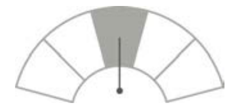
While this strategy's performance was disappointing during March's pandemic-fueled market downturn — as it captured approximately 70% of global equities' downside — we believe that this was a short-term, technically driven outlier that isn't indicative of the strategy's long-term diversification benefits.[5] With fixed-income yields near all-time lows and equity markets near all-time highs, we believe that Merger Arbitrage can generate meaningful returns that are not dependent on broader markets' direction, but rather on merger and acquisition (M&A) deals closing successfully. Currently, we believe that the average merger spread level above 5% presents an attractive alternative for qualified investors.[6]

An abrupt spike in equity market sensitivity: Merger Arbitrage strategy beta to global equities

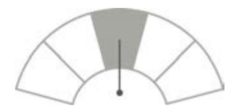


Sources: Markov Processes International (MPI) and Hedge Fund Research (HFR), Wells Fargo Investment Institute, September 2020. Chart compares the Merger Arbitrage Strategy's rolling 12-month beta to the MSCI All Country World Index of global equities from January 1990 through July 2020.

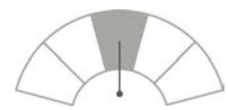
Ryan, McWalter, CAIA
Global Alternative Investment Strategist



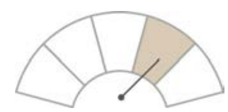
Neutral
Private Equity



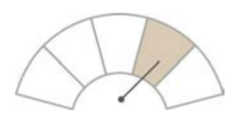
Neutral
Hedge Funds – Macro



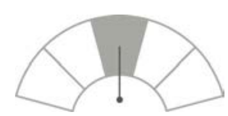
Neutral
Hedge Funds – Event Driven



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

[2] Beta is a measure of market sensitivity. A beta near or above 1 indicates a higher degree of market sensitivity (and vice versa for a lower beta).
[3] This compares the HFRI Event Driven Merger Arbitrage Index and the MSCI All Country World Index.
[4] Ibid.
[5] Ibid.
[6] Bloomberg: Deals involving North American target companies with spreads between zero and 30%.

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. There is no guarantee that **value stocks** will increase in value or that their intrinsic values will eventually be recognized by the overall market. The value type of investing tends to shift in and out of favor. **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.

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. **Communication Services** companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. 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. 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. **Real estate** investments have special risks, including possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market.

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 or in best interest 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.

The **Federal Reserve's Trade-Weighted Nominal Broad Dollar Index** is a weighted average of the foreign exchange value of the U.S. dollar against the currencies of a broad group of major U.S. trading partners.

FTSE NAREIT All Equity REITs Index is designed to track the performance of REITs representing equity interests in (as opposed to mortgages on) properties. It represents all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets, other than mortgages secured by real property that also meet minimum size and liquidity criteria.

FTSE NAREIT Retail Index is a free float adjusted market cap weighted index that includes all tax qualified retail REITs listed in the NYSE, AMEX, and NASDAQ National Market. Total return accounts for dividends reinvested in the index.

FTSE NAREIT Lodging Index is a free float adjusted market cap weighted index that includes all tax qualified lodging/resorts REITs listed in the NYSE, AMEX, and NASDAQ National Market. Total return accounts for dividends reinvested in the index.

FTSE NAREIT Office Index is a free float adjusted market cap weighted index that includes all tax qualified office REITs listed in the NYSE, AMEX, and NASDAQ National Market. Total return accounts for dividends reinvested in the index.

HFRI Event Driven: Merger Arbitrage Index: Merger Arbitrage strategies which employ an investment process primarily focused on opportunities in equity and equity related instruments of companies which are currently engaged in a corporate transaction. Merger Arbitrage involves primarily announced transactions, typically with limited or no exposure to situations which pre-, post-date or situations in which no formal announcement is expected to occur. Opportunities are frequently presented in cross border, collared and international transactions which incorporate multiple geographic regulatory institutions, with typically involve minimal exposure to corporate credits. Merger arbitrage strategies typically have over 75% of positions in announced transactions over a given market cycle.

The **MSCI All Country World Index (MSCI ACWI)** is an international equity index, which tracks stocks from 23 developed and 26 emerging markets countries. This global index consists of the MSCI World (global index for developed countries) and the MSCI Emerging Markets (global index for emerging markets countries).

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.

Index definitions for page 4 chart:

Emerging Market Equities (U.S. dollar)/(Local). **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of 23 emerging markets.

Developed Market Ex-U.S. Equities (U.S. dollar)/(Local). **MSCI EAFE Index** is a free float-adjusted market capitalization index that is designed to measure the equity market performance of 21 developed markets, excluding the U.S. and Canada.

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U.S. Large Cap Equities. **S&P 500 Index** is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation and financial companies.

U.S. Large Cap Equities (Growth). **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.

U.S. Mid Cap Equities. **Russell Midcap Index** measures the performance of the mid-cap segment of the U.S. equity universe.

U.S. Small Cap Equities. **Russell 2000 Index** measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

U.S. Large Cap Equities (Value). **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.

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