WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee — December 28, 2020

Global economy spotlight

Gary Schlossberg
Global Strategist

How the economy supported this year's tech rally

The hallmark of an extraordinary year for the economy and the asset markets has been the role of traditional and non-traditional relationships in shaping performance. Nowhere is that more apparent than in the stock market, where low and declining interest rates and ample liquidity have powered a near 20% return[1] in the U.S. despite a double-digit decline in corporate profits.

Housing and "big-ticket" consumer goods have been the main engines of the economy's rebound from the deepest one-quarter slump since the 1930's depression. However, business investment has weighed in with unusually early support in helping reverse over 80% of the economy's decline by October. Much of that support has come from powerful growth of spending on high-tech equipment and software. Adding to high-tech's critical role in this growth recovery has been impressive growth of such purchases by households — powered by lifestyle changes created by the pandemic.

Support from computers and other high-tech equipment providing the infrastructure for the burst of online shopping, at-home entertainment, and other activities has reinforced our favorable view toward the sector, much as the supported activities have underpinned our similar view of social media and companies leading the way in the market's consumer discretionary segment. The stock market's rally is already extending into more economically sensitive sectors, like materials and industrials, as prospects for a post-pandemic recovery take hold. However, we believe the secular strength in technology, social media, and online shopping, reinforced by the pandemic, will keep online activity — and the infrastructure supporting it — at the forefront of market performance as well.

Behind housing's unexpectedly strong support to economic growth…

Housing's "boom"-like recovery has been surprising, given the unsettling effect of the economy's pandemic-related freefall last spring. Highly-visible support from ultra-low mortgage rates has been reinforced by a migration to the suburbs and beyond by work-at-home employees looking for more space than cramped urban accommodations. Postal change-of-address data shows an increase of 600,000 between February and July 2020 from the same period one year earlier (to nearly 16 million households). Over half were temporary address changes, and some were renters. Nonetheless, material support — likely provided by migrations early in the pandemic — has continued with recurring lockdowns of the economy.

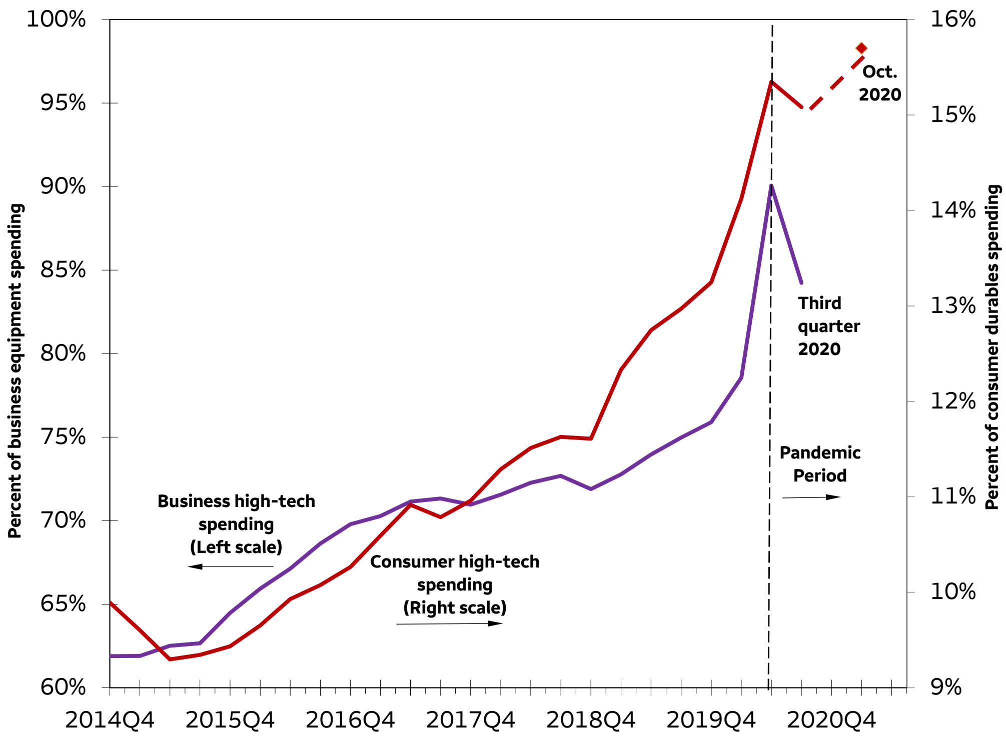
Housing plays an important role in the early stages of a growth cycle, directly and through its out-sized ripple effect on other parts of the economy, including spending by households on appliances and other home furnishings. This and other "big-ticket" spending on autos and other goods have been given an added lift by social distancing, sheltering in place, and income freed up by the pullback in travel and other services spending.

[1] Dow Jones Total Stock Market Index, December 22, 2020.

…reinforced by tech-driven gains in business and consumer spending

Early-cycle support from business investment has been remarkable for what is typically a late-cycle sector, driven mainly by purchases of capacity-raising heavy machinery as operating rates approach a peak with the economy. The strength in this cycle, much like others in recent decades, has come from high-tech equipment and software. Cost control and improved data management supporting high-tech investment have been reinforced by the incentive during the pandemic to invest in building out infrastructure needed for greater online shopping and payments systems along with virtual and other activities. The result is a secular rise in technology's investment share ratcheting up to 84% of business-equipment spending in the third quarter of 2020 from a pre-pandemic 75% during the final quarter of 2019 (purple line in chart below).

The pandemic's added boost to high-tech spending



Sources: U.S. Commerce Department, Wells Fargo Investment Institute. December 21, 2020.

Reinforcing technology's contribution to this growth recovery has been the out-sized role of computers and other household high-tech equipment in driving big-ticket consumer spending. The 36% year-over-year increase in outlays for consumer high-tech goods through October was more than double the growth of consumer-durables spending, of which it's a part. That raised technology's share of big-ticket spending to nearly 16% in October from little more than 13% a year earlier (red line in chart above).

Consumer spending likely will migrate back toward a more traditional pattern, as we expect a vaccine-driven recovery by the latter part of 2021 to encourage a revival of dining out and other services spending. However, online shopping already was growing rapidly before the pandemic. New-found benefits likely will keep its share elevated, bolstering demand for supportive technology infrastructure both by business and by consumers engaged in more automated, tech-intensive transactions.

Equities

Chris Haverland, CFA
Global Asset Allocation Strategist

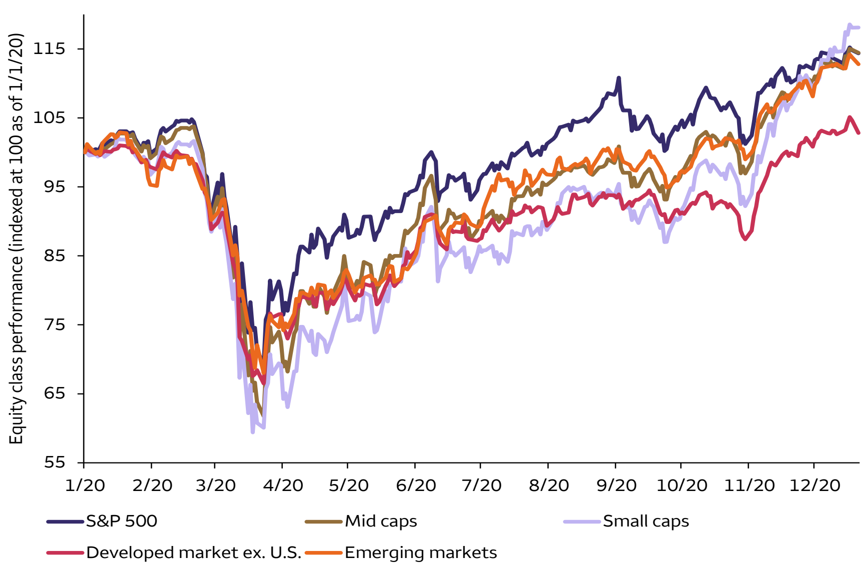
Despite volatility, equity markets reach record highs in 2020

2020 was a phenomenal year for the equity markets. In the span of 12 months, stock investors experienced the final stage of the longest bull market in history, the shortest bear market on record, and a tremendous rally marking the beginning of a new bull market. The markets had to contend with a crippling pandemic, an economic recession, and a contentious U.S. election. Policymakers added unprecedented stimulus that stabilized the economy and sparked a recovery in asset prices.

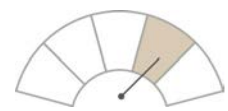
U.S. large-cap equities led performance for most of the year as investors preferred higher-quality companies amid the turmoil. Despite being down more than 30% peak-to-trough in the first quarter, the S&P 500 Index achieved an all-time high in December. The rally broadened in the fourth quarter as market participants became more comfortable with the economic rebound, multiple vaccines showed promise, and the elections were mostly complete. With the recovery firming, areas that tend to be more sensitive to the economy (i.e. emerging markets, U.S. small-caps, and cyclical sectors) began to outperform.

Growth stocks — led by the Information Technology sector — trounced value stocks for the year. The growth and quality theme was evident in sector leadership with Information Technology, Consumer Discretionary, and Communication Services handily outperforming the S&P 500 Index and most other sectors. Energy, Financials, and Real Estate ended the year in the red. While we don't expect 2021 to be as eventful as 2020, we do expect the equity markets to continue trending higher. We maintain our favorable view on U.S. large- and mid-cap equities.

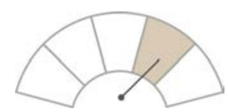
Key equity market performance in 2020



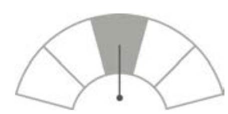
Sources: Wells Fargo Investment Institute and Bloomberg. Daily data from January 1, 2020 to December 21, 2020. Large caps = S&P 500 Index. Mid caps = Russell Midcap Index. Small caps = Russell 2000 Index. Developed market ex. U.S. = MSCI EAFE Index. Emerging markets = MSCI Emerging Markets Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**



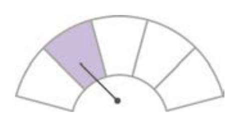
Favorable
U.S. Large Cap Equities



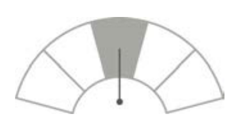
Favorable
U.S. Mid Cap Equities



Neutral
U.S. Small Cap Equities



Unfavorable
Developed Market Ex-U.S. Equities



Neutral
Emerging Market Equities

Fixed Income

Peter Wilson
Global Fixed Income Strategist

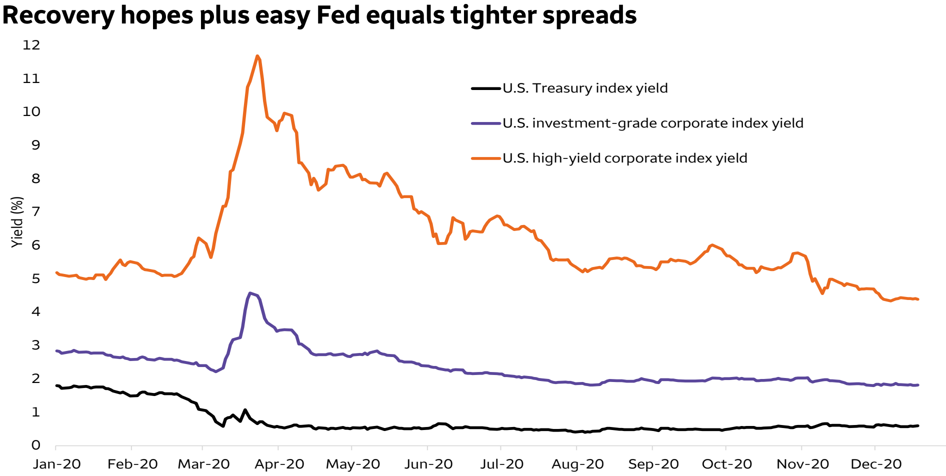
Fixed Income in 2020: Lower, tighter, flatter

A roller-coaster first quarter gradually calmed over the rest of 2020, as aggressive monetary and fiscal policy interventions first stabilized the credit market sell-off, then kept U.S. Treasury yields lower and supported a steady tightening in spreads. Much-needed good news on effective vaccines maintained the favorable tone for riskier fixed-income sectors into the holiday season.

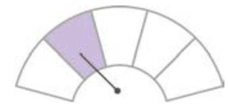
Between February 20 (first reports of COVID-19 spreading outside Asia) and late March, investment-grade (IG) corporate spreads widened by 276 basis points (bp) and high-yield (HY) spreads ballooned by 751bp.[2] March 23 marked the turning point, when the U.S. Federal Reserve (Fed) — which had already slashed rates by 150bp to effectively zero — announced open-ended purchases of Treasury securities and created two programs to support IG credit markets. A safety net for HY markets was created on April 9, and an array of Fed support programs — in co-ordination with the $2 trillion-plus fiscal support contained in the CARES Act — cemented this market stability[3].

As 2020 comes to a close, IG index yields are trading close to all-time lows below 2% (-102bp from end-2019 levels) and the HY index yield stands at 4.39% (-80bp from end-2019).[4] 10-year U.S. Treasury yields are trading near the top of a 0.5-1.0% trading range, having risen back from historical (intra-day) lows near 0.3%. But ultra-accommodative Fed policy has raised 10-year inflation expectations (breakevens) to almost 2.0%, which means that 10-year real (inflation-adjusted) yields remain below -1%. This relationship bears watching more closely in 2021.

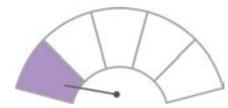
Recovery hopes plus easy Fed equals tighter spreads



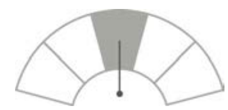
Sources: Bloomberg, Bloomberg Barclays Indices, Wells Fargo Investment Institute. Latest data as of December 18, 2020. U.S. Treasury index = Bloomberg Barclays U.S. Treasury Index. U.S. investment-grade corporate index = Bloomberg Barclays U.S. Corp Investment Grade Index. U.S. high-yield corporate index = Bloomberg Barclays U.S. Corporate High Yield Index. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. **Past performance is no guarantee of future results.**



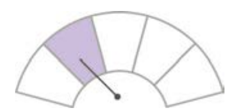
Unfavorable
U.S. Taxable Investment Grade Fixed Income



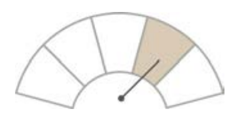
Most unfavorable
U.S. Short Term Taxable Fixed Income



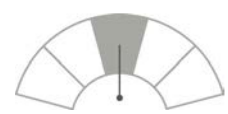
Neutral
U.S. Intermediate Term Taxable Fixed Income



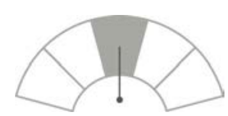
Unfavorable
U.S. Long Term Taxable Fixed Income



Favorable
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

[2] One basis point (1bp) equals one hundredth of one percent (0.01%).
[3] The Coronavirus Aid, Relief, and Economic Security (CARES) Act became law on March 27, 2020.
[4] Market data as of December 18, 2020.

Real Assets

Austin Pickle, CFA
Investment Strategy Analyst

"Life can only be understood backwards; but it must be lived forwards." — Soren Kierkegaard

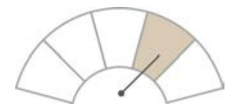
A look back at 2020

"Unprecedented" and "historic" are often used to describe 2020 — and rightfully so. The COVID-19 pandemic has profoundly impacted — and continues to impact — our daily lives, the economy, and financial markets. Real Assets did not escape the pandemic's influence.

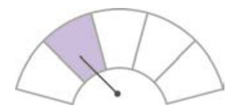
The widespread lockdowns earlier in the year brought the global economy to a virtual halt, which decimated commodity demand and prices. Perhaps no asset was impacted to a greater extent than oil — the benchmark West Texas Intermediate oil price reached a historic -$37.63 on April 20 (see chart below). Yes, you read that correctly — *negative* 37 dollars. Production cuts, broad monetary and fiscal support, and encouraging vaccine developments have prompted a significant surge off the lows in oil and — more broadly — commodity prices.

Gold was one asset that bucked the negative trend early in 2020. The financial and commodity market turmoil prompted investors to flock to gold — an asset trusted for thousands of years as a store of value and a perceived "safe haven". Gold started the year around $1,515 but surpassed its previous all-time high and touched $2,075 in August. The collapse in real long-term interest rates and aggressive accommodative policies were tailwinds. Gold's rally has since faltered as the market mood has transitioned from "risk off" to "risk on."

Work-from-home trends, mobility restrictions, unprecedented job losses, and social distancing measures decimated certain areas of the real estate market including Office, Retail, and Lodging REIT subsectors. Industrial, Data Centers, and Infrastructure REIT subsectors significantly outperformed in 2020.

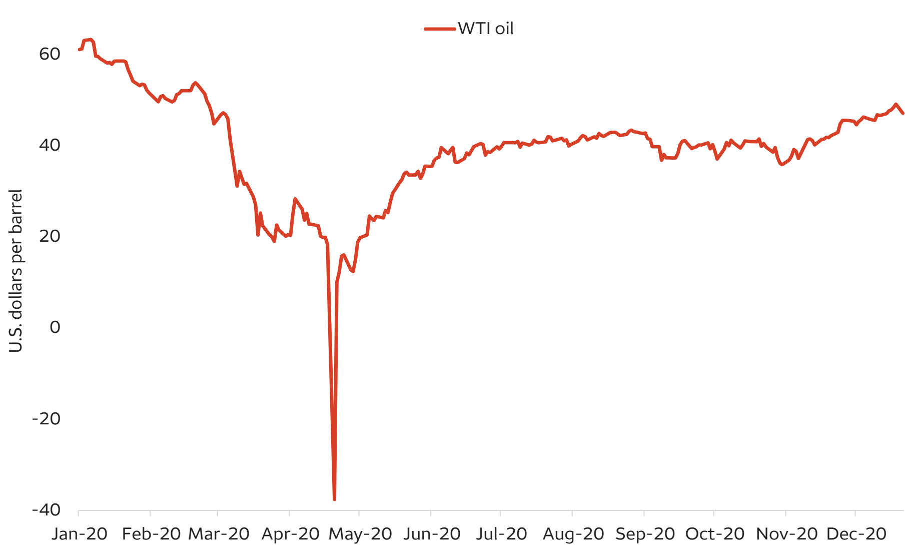


Favorable
Commodities



Unfavorable
Private Real Estate

West Texas Intermediate (WTI) oil price



Sources: Bloomberg, Wells Fargo Investment Institute. Daily data: January 1, 2020 - December 21, 2020. **Past performance is no guarantee of future results.**

Alternatives

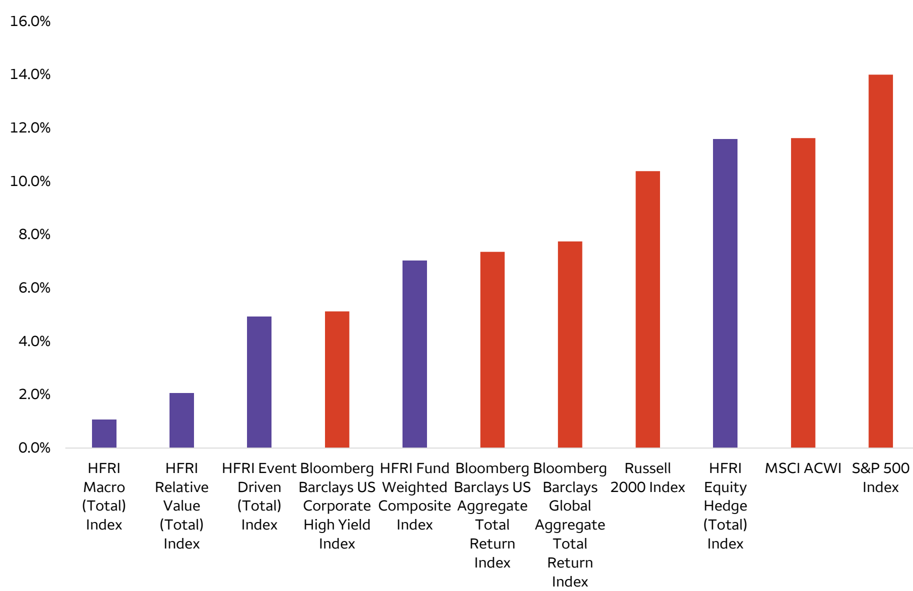
Strong year for Equity Hedge while other strategies lagged

With a month to go before a tumultuous 2020 comes to an end, the average hedge fund (as measured by the HFRI Fund Weighted Composite Index) was up over 7%, capturing nearly all of the year-to-date global fixed-income returns and approximately 60% of the global equity returns.[5] While 2020 industry returns will likely lag 2019's 10.5% return, they are nearly double the 3-, 5-, and even 10-year annualized returns, which are 4.4%, 5.0%, and 4.0%, respectively.[6]

We are particularly pleased with the 11.6% return for Equity Hedge this year, which through November has captured nearly all of the global equity returns. While return dispersion was significant among managers this year, we find that most did very well with their long positions, rotated capital successfully following the March lows, and generally managed factor exposure well.

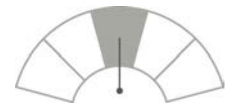
The Event Driven, Relative Value, and Macro Indexes performed more in line with their annualized returns, with Event Driven outperforming slightly thanks to a strong showing by Activist managers. Credit-sensitive strategies such as those focused on structured credit and distressed credit faced steep mark-to-market losses in March and April but have done well to regain the majority of those declines. While the near-term opportunity set for distressed is murky, we are optimistic that structured credit returns will re-price higher, assuming the economy continues its recovery.

The average equity hedge manager captured nearly 100% of the global equity market return year-to-date

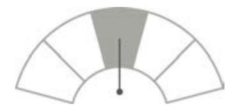


Sources: Bloomberg, Wells Fargo Investment Institute. Data as of November 30, 2020. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

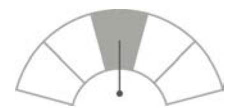
Justin Lenarcic
Senior Global Alternative Investment Strategist



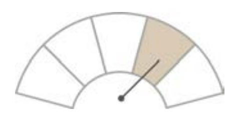
Neutral
Private Equity



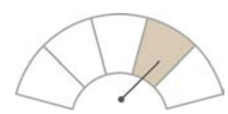
Neutral
Hedge Funds – Macro



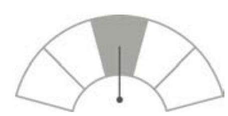
Neutral
Hedge Funds – Event Driven



Favorable
Private Debt



Favorable
Hedge Funds – Equity Hedge



Neutral
Hedge Funds – Relative Value

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

[5] Global fixed income is represented by the Bloomberg Barclays Global Aggregate Total Return Bond Index and Global Equities is represented by the MSCI All Country World Index.
[6] Hedge Fund Research, Inc.

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.

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.

Definitions

Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Bloomberg Barclays Global Aggregate Bond Index provides a broad-based measure of the global investment grade fixed-rate debt markets. It is comprised of the U.S. Aggregate, Pan-European Aggregate, and the Asian-Pacific Aggregate Indexes. It also includes a wide range of standard and customized subindices by liquidity constraint, sector, quality and maturity.

Bloomberg Barclays U.S. Treasury Index includes public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Bloomberg Barclays U.S. Corp Investment Grade Index includes publicly issued U.S. corporate and Yankee debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

Bloomberg Barclays U.S. Corporate High Yield Index covers the universe of fixed-rate, noninvestment-grade debt.

HFRI Equity Hedge (Total) Index maintains positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios.

HFRI Event-Driven (Total) Index consists of Investment Managers who maintain positions in securities of companies currently or prospectively involved in corporate transactions of a wide variety, including but not limited to: mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. ED exposure contains a combination of sensitivities to equity markets, credit markets and idiosyncratic, company specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2000 single-manager funds that report to HFR Database. Constituent funds report monthly net-of-all-fees performance in U.S. dollars and have a minimum of $50 Million under management or a 12-month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

HFRI Macro (Total) Index consists of investment managers who trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed-income, hard currency, and commodity markets.

HFRI Relative Value (Total) Index consists of Investment Managers who maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities Manager employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative or other security types. RVA position may be involved in corporate transactions also, but as opposed to ED exposures, the investment thesis is predicated on realization of a pricing discrepancy between related securities, as opposed to the outcome of the corporate transaction.

Note: HFRI Indices have limitations (some of which are typical of other widely used indices). These limitations include survivorship bias (the returns of the indices may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information self-reported by hedge fund managers that decide on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.

MSCI All Country World Index (MSCI ACWI) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of 23 developed and 26 emerging markets.

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.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 23 emerging markets.

Note: MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI.

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.

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

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.

An index is unmanaged and not available for direct investment.

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