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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **March 1, 2021**

[1] OPEC+ = The Organization of the Petroleum Exporting Countries and others such as Russia.

Global macro spotlight

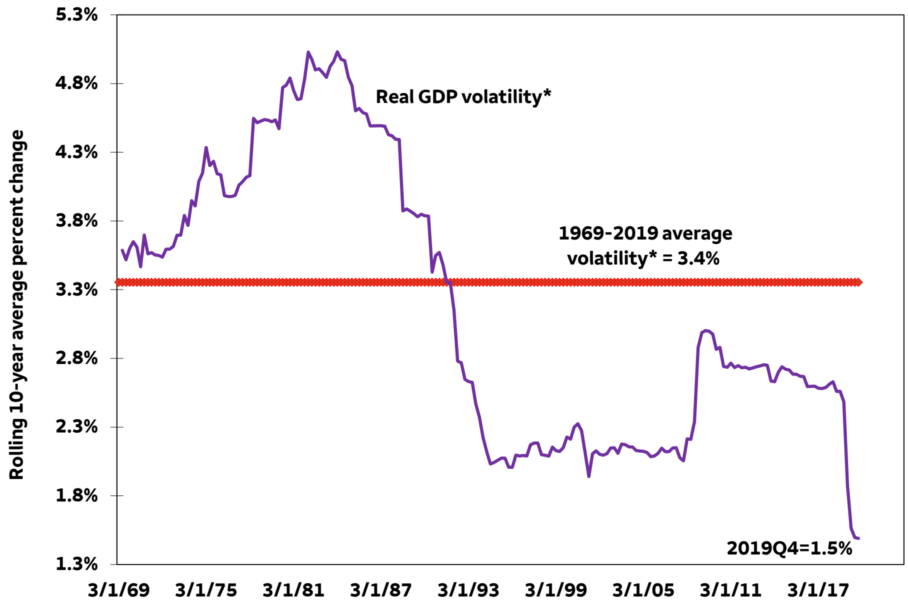
Gary Schlossberg
Global Strategist

Is the business cycle dead?

Is the business cycle dead? An odd question during the economy's recovery from the worst recession since the 1930s depression. Still, policymakers' success in heading off a credit crunch and preventing an even deeper economic slump has revived an ongoing debate over their ability to control future economic cycles.

Eliminating economic booms and busts has been the Holy Grail for economists since at least the 1960s, when hope first emerged for corralling the economic cycle. Inflation's more recent wind down was instrumental to the "Great Moderation" of economic stability that took hold in the 1990s and largely prevailed until the pandemic triggered major swings in economic activity after 2019 (see chart below).

From steadier growth to the economic cycle's demise?



Sources: U.S. Commerce Department, Wells Fargo Investment Institute, February 24, 2021. As measured by the standard deviation of quarter-to-quarter returns in real GDP over a rolling 10-year period.

The stakes for investors

We believe that ending the business cycle would be as important for portfolio strategy as it would be for the economy. Just how important was apparent from declining S&P 500 Index volatility during the economy's Great Moderation period, particularly in the decade before the onset of the 2020 pandemic. Steadier economic-growth and stock-market volatility ultimately was led by economically sensitive industrial, materials and consumer discretionary stocks, ultimately pulling the volatility of those sectors from 2010 to 2020 below that of traditionally more stable defensive sectors.

Our view is that taming the economic cycle might blur distinctions between the stock market's defensive and cyclically sensitive sectors — reducing the importance of macroeconomic factors driving performance. Active investing could get a lift as the focus would shift from a rising macroeconomic tide lifting all ships to a renewed focus on standout companies supported by financial and management quality. We believe that changes could carry over to the bond market, where lower inflation and reduced interest-rate volatility could make the current focus on more yield-oriented sector strategies more enduring.

Reports of its death…

Like Mark Twain, however, we believe that reports of the business cycle's death are premature. We see three reasons why efforts to fine-tune policy aren't likely to eliminate the swings in activity that make the business cycle.

Problem one, for us, is overestimating policymakers' effectiveness to avoid the same human errors and data misinterpretation that have dogged all forecasters.

Second, the same cushioning effect of low inflation and subdued interest rates creates its own stresses and strains in the financial market and, ultimately, the economy. Successfully subduing both inflation and interest rates encourages the kind of borrowing and rising asset prices that left markets vulnerable to financial and economic disruptions over a decade ago. In this way, we believe, efforts to stabilize the economy and the financial market have left both sensitive to interest-rate changes when inevitable disturbances do occur.

Risks from ultra-low inflation and interest rates have been aggravated in the past year by the Fed's massive injection of money into the financial markets, partly to purchase Treasury securities to fund the government's rapidly expanding debt. Financial distortions created by aggressive government intervention also have undercut the role of interest rates in allocating capital and of asset prices in accurately measuring securities' quality and risk. There is also the incentive for excessive risk taking if businesses and investors come to expect government support to bail them out of difficult economic circumstances.

Third, we view policy fine-tuning to steady the economic cycle as largely irrelevant when the economy is confronted by a massive "unknown unknown" — like the pandemic or the big increases in oil prices during the 1970s. Policy also has had a mixed record in countering more slowly developing, identifiable problems due to any combination of political pressure, unexpected changes abroad, weather events, and other economic shocks. Economic reforms aimed at providing flexibility to absorb outside shocks often have been a double-edged sword, generating unintended market volatility, as we learned in the years following the shift from fixed to floating exchange rates in the early and mid-1970s.

Staying the course

For investors, we believe that an economic cycle alive and well means favoring markets and sectors that tend to outperform at the beginning of a business cycle. That strategy is influenced, at the moment, by an unusual economic cycle providing potential post-pandemic opportunities for technology and social media platforms nearly as great as those investors saw in 2020.

Likewise, our view is that the economically sensitive Industrials, Materials, and Consumer Discretionary sectors are likely to be propelled by what we believe could be the strongest economic growth in over 35 years. We also expect a moderate rise in interest rates to favor several yield-enhanced sectors of the bond market, including high-quality corporate, preferred and municipal securities over Treasury debt, which tend to be more susceptible to price declines if interest rates move higher as we expect.

Equities

Chris Haverland, CFA
Global Asset Allocation Strategist

Interest rates and equity valuations

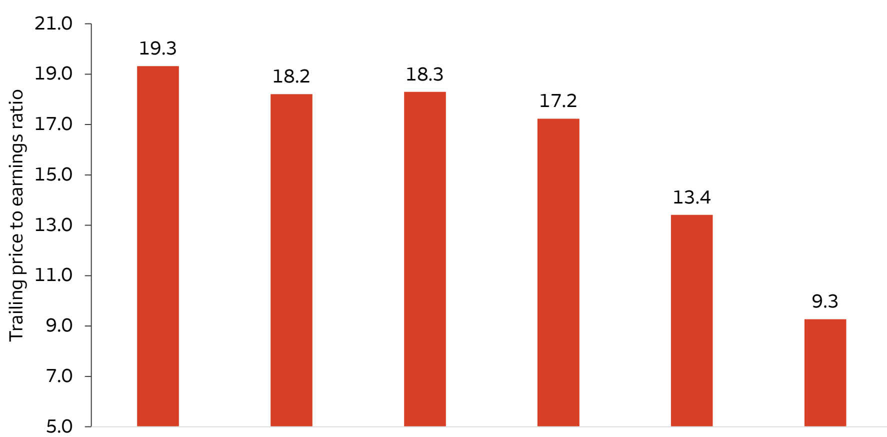
With longer-dated interest rates rising, some investors are questioning equity market valuations. Since the beginning of the year, the U.S. 10-year Treasury yield has climbed approximately 50 basis points to 1.4% (100 basis points equals 1%). While this is a sizable move on a percentage basis, the absolute level remains low, relative to history. Prior to COVID-19, the 10-year yield was near 2.0%, and the average in the decade leading up to the pandemic was 2.4%.

Equity investors shouldn't fear rising interest rates as long as the move is supported by an improving economic backdrop. In 2021, we expect one of the best years for economic growth in decades. We anticipate this to likely lead to modestly higher inflation and longer-term interest rates. While this could cause short-term disruptions in the stock market, we look for accommodative monetary policies and well-behaved credit markets should dampen the impact.

Upward movements in rates can impact equity valuations. However, historically, price/earnings (P/E) multiples have not declined meaningfully until rates reach significantly higher levels. The chart below shows only modest deterioration in trailing P/E multiples as rates rise above 2.0%. Our forecast is for the 10-year yield to increase but stay below 2.0% this year.

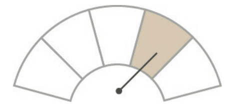
In most rising-rate environments, both yields and equities have moved higher. A good example is in 2013, when the 10-year yield rose from 1.77% to 3.04% while the S&P 500 Index surged 30% (January 1, 2013 – December 31, 2013). Our favored sectors have historically performed well when rates rise in Information Technology, Consumer Discretionary, Materials, Industrials, and Financials.

S&P 500 Index median P/E multiples during different interest-rate regimes

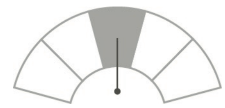


Nominal 10-year interest rate	Less than 2.0	2.0 to 4.0	4.0 to 6.0	6.0 to 8.0	8.0 to 10.00	Greater than 10.0
Average inflation	1.6	1.8	2.5	4.6	6.1	7.2

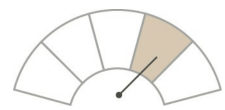
Sources: Bloomberg, Wells Fargo Investment Institute, February 26, 2021. Data range: 1/1/1962-1/31/2021.



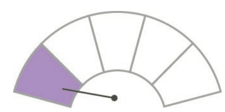
Favorable
U.S. Large Cap Equities



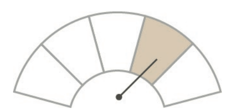
Neutral
U.S. Mid Cap Equities



Favorable
U.S. Small Cap Equities



Most unfavorable
Developed Market
Ex-U.S. Equities



Favorable
Emerging Market Equities

Fixed Income

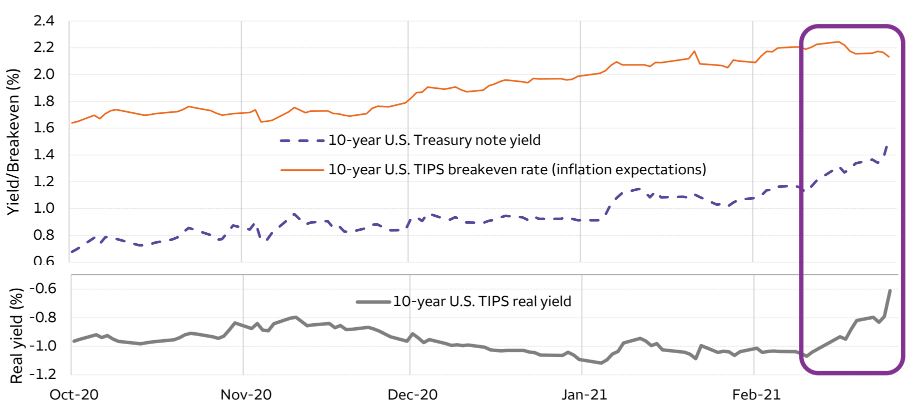
Peter Wilson
Global Fixed Income Strategist

How worrisome is the latest surge in U.S. (real) yields?

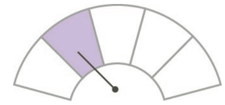
The rise in U.S. Treasury securities yields was initially driven by a rise in inflation expectations, but this has changed — with 10-year real yields moving higher faster than nominal yields and surging to seven-month highs last week. In the short term, there are reasons to be cautious. For the first time, the market is seriously challenging the Fed commitment to keeping rates low, with market indicators now suggesting the first rate hike as soon as late 2022 — compared to the Fed's December "dot plot" median expectation of rates on hold at least until 2024. Also, there are signs of supply concerns – the spike in yields was caused by a very poor 7-year auction – and of other market dislocations.

However, we remain relatively sanguine about the impact of the move on risk assets and the broader economy. Inflation expectations and real yields are two sides of the positive reflation narrative — the former rising in anticipation of demand-driven price rises, the latter reflecting a brighter outlook for real economic growth. Secondly, it is the speed of the move, rather than the level of yields, that is disturbing the equity markets. While we do expect yields to continue to rise and the curve to steepen in 2021, we do not expect rates — nominal or inflation-adjusted — to rise to levels that would damage government financing or derail the recovery. Finally, if short-term rates markets continue to bring forward their expectations of the first rate rise, we would anticipate more aggressive pushback from the Fed to counter this view.

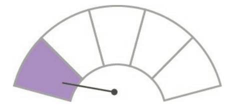
Driver of bond sell-off shifts from inflation expectations to real yields



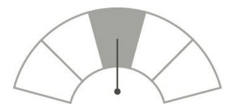
Sources: Bloomberg, Wells Fargo Investment Institute, latest data as of February 25, 2021. TIPS are Treasury Inflation-Protected Securities. The breakeven inflation rate is the difference between the yield on the nominal (regular) U.S. Treasury and the inflation-adjusted security of the same maturity, and is one measure of the market's expectations for annual inflation over the period. Current performance may be higher or lower than the performance quoted above. Yields and returns will fluctuate as market conditions change. **Past performance is not a guarantee of future results.**



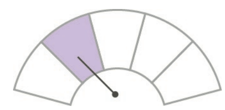
Unfavorable
U.S. Taxable Investment Grade Fixed Income



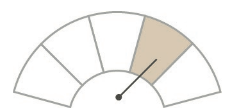
Most unfavorable
U.S. Short Term Taxable Fixed Income



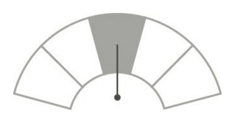
Neutral
U.S. Intermediate Term Taxable Fixed Income



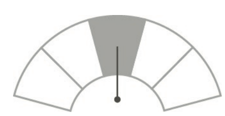
Unfavorable
U.S. Long Term Taxable Fixed Income



Favorable
High Yield Taxable Fixed Income



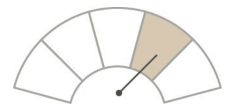
Neutral
Developed Market Ex.-U.S. Fixed Income



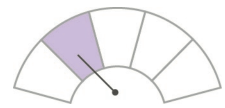
Neutral
Emerging Market Fixed Income

Real Assets

Austin Pickle, CFA
Investment Strategy Analyst



Favorable
Commodities



Unfavorable
Private Real Estate

"Never be limited by other people's limited imaginations." — Dr. Mae Jemison

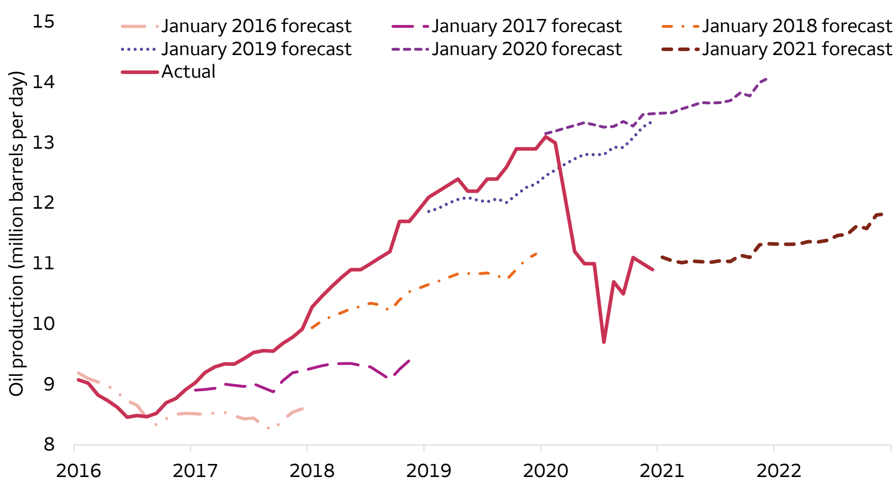
Oil supply strategy shift

Prior to 2020, the shale oil revolution had been characterized by impressive oil production gains that had consistently outpaced even the most optimistic forecasts (see chart). There had been a "maximize production" mindset across U.S. oil-producer C-suites[2]. But that may be changing. Investors have called for a shift in strategy to focus more on capital discipline and less on production. Are the oil-producer C-suites listening?

C-suites seem to be. "Capital discipline," "deleveraging," "boosting cash flow," and "supporting dividends and buybacks" have been repeated ad nauseam on recent earnings calls. Evidence does support that the group is following through on this talk. U.S. oil production has flat-lined around 11 million barrels per day since May — despite the fact that West Texas Intermediate (WTI) oil prices have increased 80% since then. In fact, the current WTI price is over $60, which is significantly higher than the average shale oil well breakeven cost of around $40. In the pre-pandemic "pump at will" regime, we would have expected producers to open the spigots in this environment. Yet, the oil supply flood has not come. It seems that oil producer C-suites — at least for now — are talking the "supply restraint" talk and walking the "supply restraint" walk.

This supply restraint shown by U.S. producers — as well as historic coordinated OPEC+ production cuts — have been integral in driving oil prices to pre-pandemic highs, even though demand has yet to fully recover.

U.S. oil production: Actual versus forecasts



Sources: Energy Information Administration (EIA), Bloomberg, Wells Fargo Investment Institute. Monthly data: January 31, 2016 - December 31, 2022. Forecasts taken from the EIA's monthly Short-Term Energy Outlook report. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

[2] C-suites refer to the executive level management in a company.

Alternatives

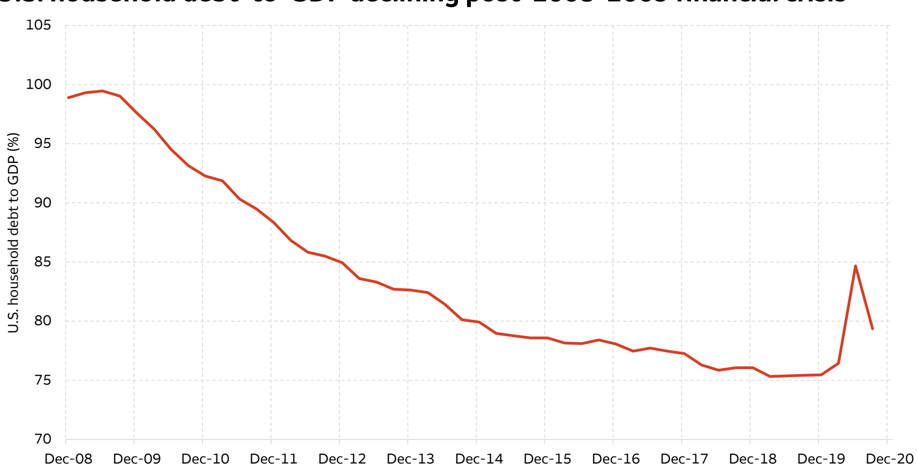
Structured credit — A source of alternative income

The COVID-19 crisis has compounded the challenge for investors seeking income. With interest rates likely to remain near historic lows for even longer than expected, investors will need to broaden their perspective to seek durable income without taking outsized risks. We believe the expanding global universe of credit will be critical to delivering income and helping investors meet their investment objectives. To address this theme, qualified investors should consider allocations to Relative Value hedge fund strategies with a focus on securitized credit. The Structured Credit strategy can combine trading expertise with credit analysis to take advantage of higher yields and market inefficiency while targeting a durable income yield of approximately 6%-8%.

So far in 2021, we have seen an increased appetite for exposure to residential and consumer credit. New issuance has been met with robust demand while secondary trading activity has remained strong. We continue to see an extension of two primary themes — relative value and ongoing embedded value. And increased likelihood of an additional, substantial stimulus package could further benefit residential and consumer debt products.

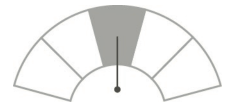
In addition to market dynamics, borrower profiles have also improved as U.S. consumers meaningfully reduced their leverage, U.S. household debt-to-GDP declined by more than 20% since 2008,[3] and debt-to-income ratios and consumer credit scores for residential mortgages improved. Despite these improved fundamentals, the COVID-19 crisis caused a dislocation. While prices have somewhat recovered, yields have not been distorted by central bank buying (not part of the Fed purchase program) and remain elevated compared to pre-pandemic levels, creating a potentially compelling opportunity.

U.S. household debt-to-GDP declining post-2008-2009 financial crisis

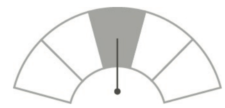


Sources: International Monetary Fund (IMF), Wells Fargo Investment Institute. Data through Third Quarter 2020.

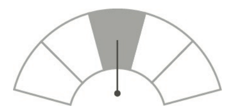
James Sweetman
Senior Global Alternative Investment Strategist



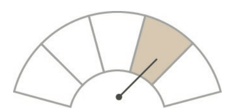
Neutral
Private Equity



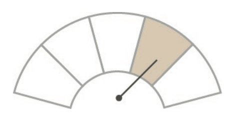
Neutral
Hedge Funds – Macro



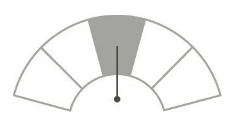
Neutral
Hedge Funds – Event Driven



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.

[3] IMF through Third Quarter 2020.

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. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate. **Treasury Inflation-Protected Securities (TIPS)** are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond to fluctuate more than other fixed income securities. TIPS have special tax consequences, generating phantom income on the "inflation compensation" component of the principal. A holder of TIPS may be required to report this income annually although no income related to "inflation compensation" is received until maturity. Income from **municipal securities** is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT). **Preferreds securities** have special risks associated with investing. Preferred securities are subject to interest rate and credit risks. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. 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.

The use of alternative investment strategies such as structured credit, involve significant risks. Structured credit strategies generally aim to generate return via positions in the credit sensitive area of the fixed income markets. The strategy generally involves the purchase of corporate bonds with hedging of the interest exposure. Managers can generally purchase any type of security in the capital structure, including companies suffering financial distress. These instruments can include corporate bonds, mortgages, suppliers' claims and bank loans. Credit and other derivatives are used to establish the portfolio and for hedging purposes. Such strategies involve taking advantage of mispriced credit exposure at certain points in the term structure of single name credits relative to other points in the same term structure. Positions may use, but are not limited to, traditional fixed income and credit securities, as well as other structured credit products and credit derivatives, such as credit default swaps. The use of alternative investment strategies may require a manager's skill in assessing corporate events, the anticipation of future movements in securities prices, interest rates, or other economic factors. No assurance can be given that a manager's view of the economy will be correct which may result in lower investment returns or higher return volatility.

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.

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. **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.

General Disclosures

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