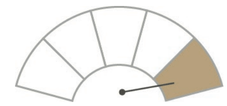
WELLS FARGO
Investment Institute

Investment Strategy

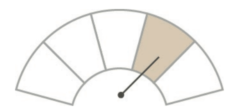
Weekly guidance from our Investment Strategy Committee **January 10, 2022**

Global Equities spotlight

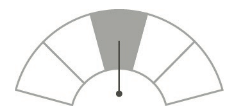
Chris Haverland, CFA
Global Equity Strategist



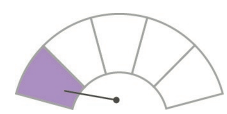
Most favorable
U.S. Large Cap Equities



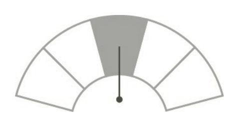
Favorable
U.S. Mid Cap Equities



Neutral
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities



Neutral
Emerging Market Equities

Potential equity market drivers in 2022

2021 was an exceptional year for equity market returns. The S&P 500 Index led the way, driven by strong economic and earnings growth, encouraging news on the pandemic, and extremely accommodative monetary and fiscal policies. While the pandemic likely will remain a key risk in 2022, we believe equity markets may be influenced by slowing but growing earnings, transitioning Federal Reserve (Fed) policy, and uncertainty around the U.S. mid-term elections. In this environment, we continue to favor equities over bonds, U.S. over international equities, and high-quality U.S. Large and Mid Cap Equities.

Slowing but growing earnings

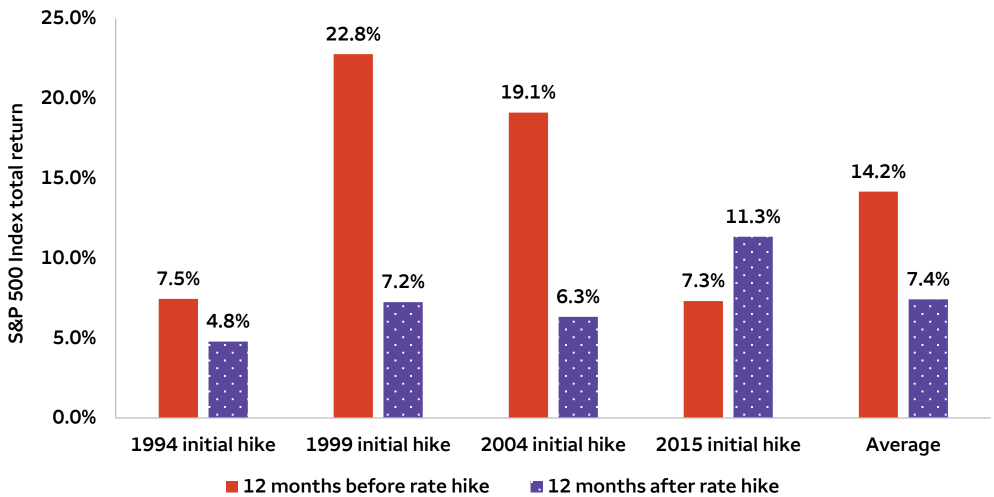
Corporate earnings surged in 2021 as the economy reopened and business revenue and margins moved higher. After rising an estimated 50% in 2021, we expect S&P 500 Index profits to grow by approximately 12% in 2022 — as the cycle ages, it is normal to see earnings growth slow. We see sales rising at an above-average pace, margins stabilizing as supply-chain issues ease, and stock buybacks reaching record levels. Once again, we believe earnings will be most pronounced in cyclical sectors such as Industrials, Energy, and Consumer Discretionary, with Information Technology also expected to post strong results for the year. 2021 equity market returns were driven by robust earnings growth with the forward price-to-earnings (P/E) multiple actually contracting from 23x to 20x by year-end. While the current multiple is above the 10-year average multiple of 18x, it is in line with the five-year average. In 2022, we expect earnings growth to be the key driver of returns with P/E multiples remaining range bound.

Transitioning Federal Reserve policy

Policymakers around the world took aggressive actions in 2020 to combat the pandemic-induced recession. These monetary policies were largely maintained in 2021, supporting equity market gains. Last month the Fed announced plans to taper its bond purchase program at an accelerated pace, likely ending in the first quarter. Policymakers also discussed the possibility of shrinking the Fed balance sheet and hiking rates later this year. Unwinding the stimulus program will come at a time when the economy is growing, the employment situation is improving, and inflation is above Fed targets. The financial markets digested the last Fed tapering in 2014 well, with the S&P 500 Index rising 12% (including a drawdown of more than 7%). Higher quality U.S. equity classes and sectors outperformed during this period.

The Fed is also poised to raise the federal funds rate in 2022. While a handful of rate hikes over the next year or two would be a shift in Fed policy, we would not consider it restrictive. In addition, Fed action typically has a lagged effect on the economy. Therefore, the initial rate increase in 2022 is unlikely to derail the economic recovery or lead to a recession in the near term. It could, however, add volatility to the equity markets as investors adjust to a less accommodative Fed. Fed tapering and early rate hikes do not indicate the end of a business cycle. However, they could signal a move from early cycle dynamics to mid-cycle drivers — when investors should consider moving up in quality and have greater balance in value and growth sectors. Historically, the S&P 500 Index has risen in the 12 months prior to and the 12 months after the first rate hike, with lower average returns after the initial move (see chart below).

S&P 500 Index performance before and after first Fed rate hike



Sources: Wells Fargo Investment Institute and Bloomberg, January 3, 2022. Rate hike dates: 2/4/1994, 6/30/1999, 6/30/2004, 12/16/2015. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future resul**ts.

Mid-term election volatility

Mid-term election years have often brought about political uncertainty, leading to increased market volatility. In fact, of the four presidential cycle years, the year of mid-term elections historically has been the most volatile. On average, these years have been choppy for equity markets leading up to the election. As the political environment becomes more clear (just prior to and after the election), equity markets have tended to move higher. Since 1990, the average drawdown for the S&P 500 Index in mid-term election years has been 17%. While it is impossible to accurately forecast a correction of this magnitude, we do know that the index has gone more than a year without falling at least 10%. If the equity markets experience a pullback as the fiscal and monetary landscape shifts, it could represent a buying opportunity. After the election, investors often anticipate stimulative policies as politicians begin to pivot to the presidential election. On average, the S&P 500 Index has gained 27% in the 12 months following mid-term election year corrections.

Fixed Income

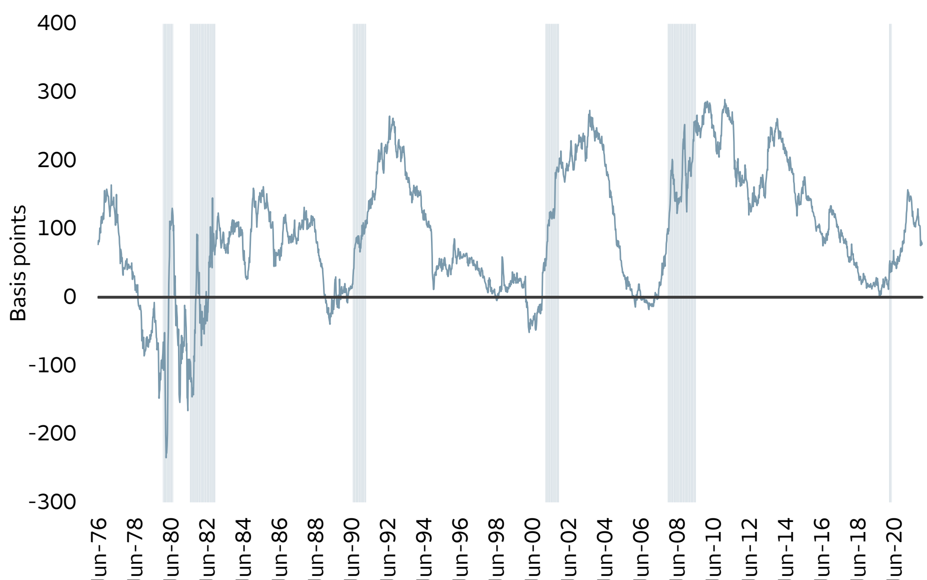
Brian Rehling, CFA
Head of Global Fixed Income Strategy

Yield curve trends

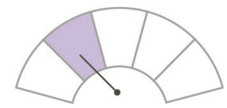
The yield curve has historically followed fairly predictable long-term trends, typically steepening early in an economic recovery before flattening and finally inverting into an eventual economic downturn. This pattern has been repeated consistently over the past 30 years. Predictably every cycle, theories abound to explain why this time is different. Also quite predictably, the yield curve continues to send signals as to the future state of the economy.

It appears that the yield curve already hit its maximum steepness for the current cycle in April 2021. Maximum curve steepness typically occurs within 24 months of the end of the recession. The yield curve is acting like it has in previous cycles. We are now in a period where we expect the steepness of the yield curve to remain near current levels or slowly flatten for an extended period. This phase can last a number of years and generally correlates to a risk-on period in capital markets. With expected Federal Reserve rate hikes this year, we should continue to see longer-term rates move modestly higher to maintain a positive curve slope. With the potential for modestly higher longer-term rates, a stable to flatter yield curve, and a continued economic recovery, we continue to favor both intermediate maturities and higher-yielding segments of the bond market such as high-yield and preferred securities.

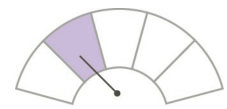
10-Year Treasury Yield – 2-Year Treasury Yield



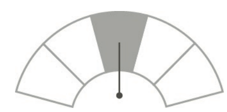
Sources: Bloomberg, Wells Fargo Investment Institute, January 6, 2022. 100 basis points equal one percent. **Past performance is no guarantee of future results. Current performance may be higher or lower than the performance quoted above. Yields and returns will fluctuate as market conditions change.**



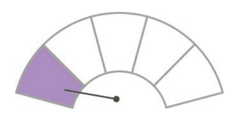
Unfavorable
U.S. Taxable Investment Grade Fixed Income



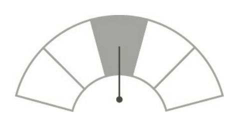
Unfavorable
U.S. Short Term Taxable Fixed Income



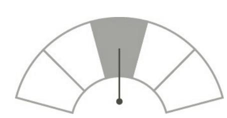
Neutral
U.S. Intermediate Term Taxable Fixed Income



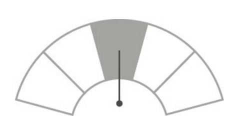
Most unfavorable
U.S. Long Term Taxable Fixed Income



Neutral
High Yield Taxable Fixed Income



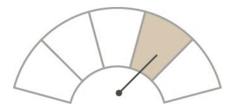
Neutral
Developed Market Ex.-U.S. Fixed Income



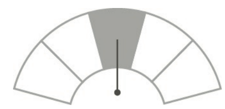
Neutral
Emerging Market Fixed Income

Real Assets

John LaForge
Head of Global Real Asset Strategy



Favorable
Commodities



Neutral
Private Real Estate

"Textile machines use more energy than needles. Cars use more energy than horses. Modern homes use more energy than tents … Human progress is the development of technology replacing fallible precious human labor with reliable energy." — Saifedean Ammous, author of The Fiat Standard

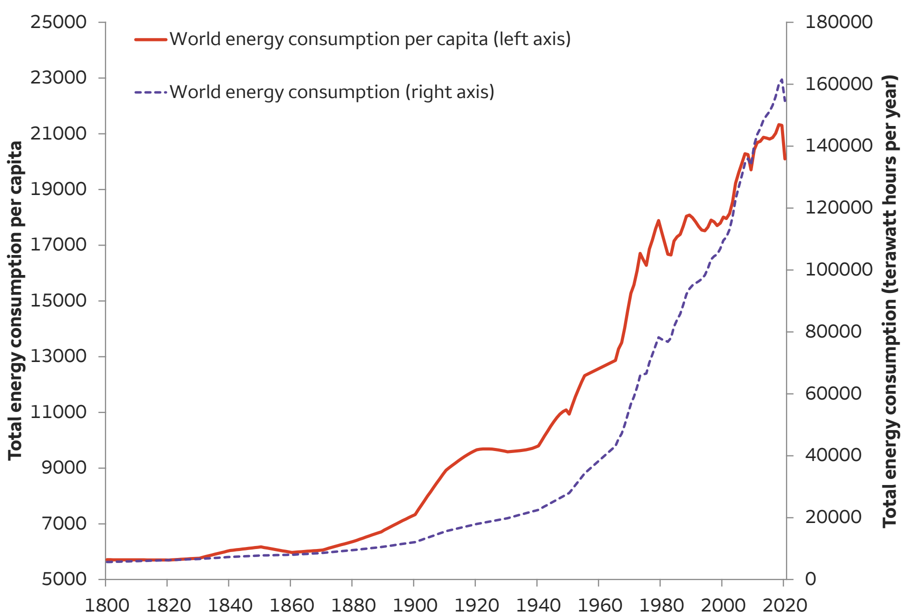
The green movement's uphill battle

As we roll into 2022, passage of the Build Back Better framework legislation, proposed by the Biden Administration, is top of mind. Inside the legislation are hundreds of billions of dollars earmarked for clean energy and climate investments. While not law yet, our view is that approval is a matter of when in 2022, not if.

We applaud additional measures to reduce greenhouse gas emissions, and see tangible progress being made in renewables use. When final official 2021 statistics are released, fossil fuels will likely represent 82%–83% of global energy use, down from 86% in 2018. A big part of this drop was due to dramatically lower oil demand, but there is no getting around the fact that total renewables use rose over the same time. The days of fossil fuels representing 85% or more of global energy use appear to finally be a thing of the past.

We still caution patience on renewables dominating global energy use anytime soon, though. For renewables to gain market share, they must replace not only today's fossil fuel demand, but tomorrow's too. The chart shows us that as the world has grown, so has energy use. And not just total energy use (chart, dashed blue line), but per-person energy use too (chart, solid red line). Renewables are not only fighting an entrenched opponent in fossil fuels, but perversely, human progress too.

World energy consumption



Sources: Our World in Data, BP Statistical Review of World Energy, World Bank, and Wells Fargo Investment Institute. Yearly data: 1800-2020. Per capita energy consumption is measured by taking the world energy consumption divided by the world population.

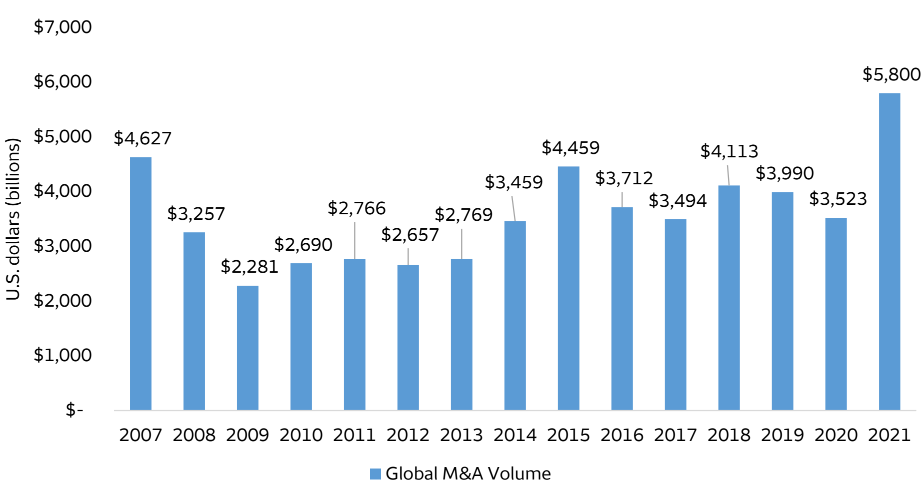
Alternatives

Opportunities in Merger Arbitrage strategy

Global merger and acquisition (M&A) activity set a record in 2021 with an estimated $5.8 trillion in global deal activity, surpassing $5.0 trillion for the first time in history.[1] This figure is close to 65% higher than the deal value for 2020 and surpasses the previous record set in 2007 by 25%. The U.S. has led the charge, representing nearly 60% of all global M&A deals. The Information Technology sector was the most active in 2021 with over $1.4 trillion in M&A volumes, up more than double year-over-year. Another record on track to be surpassed is the financial-sponsor-related M&A activity, which is approaching a $2 trillion year of merger activity, highlighting the expanding role Private Equity firms are playing in M&A markets.

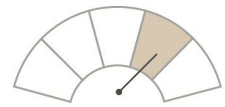
We believe this record volume of deal activity, combined with expectations of a more hostile regulatory environment, has created an attractive opportunity for the Merger Arbitrage strategy, which we upgraded to favorable entering 2022. Merger Arbitrage spreads have widened to near historical levels. At the beginning of 2022, the expected spread for the 20 largest all-cash mergers in the U.S. is exceeding 1060 basis points.[2] Moreover, Merger Arbitrage offers investors exposure to an investment strategy that typically offers low correlation to traditional asset classes and a hedge to rising interest rates. Merger Arbitrage provides a floating rate yield exposure and has historically delivered returns positively related to interest rates and changes to rates. We believe that the attractive spread, diversification benefits, and positive relationship to interest rates make Arbitrage a timely complement to equity and fixed-income portfolios in a potentially volatile rising rate market.

Global M&A has record year

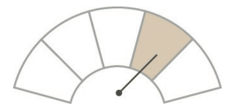


Sources: Dealogic, Wells Fargo Investment Institute, December 2021.

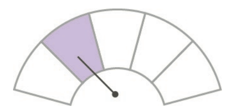
James Sweetman
Senior Global Alternative Investment Strategist



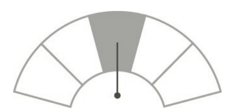
Favorable
Hedge Funds – Relative Value



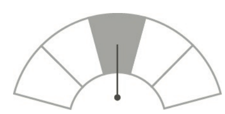
Favorable
Hedge Funds – Macro



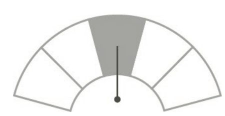
Unfavorable
Hedge Funds – Event Driven



Neutral
Hedge Funds – Equity Hedge



Neutral
Private Equity



Neutral
Private Debt

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

[1] Dealogic, January 2022.
[2] Merger Arbitrage Limited, January 2022.

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 appropriate only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

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