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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **May 3, 2021**

Global Macro spotlight

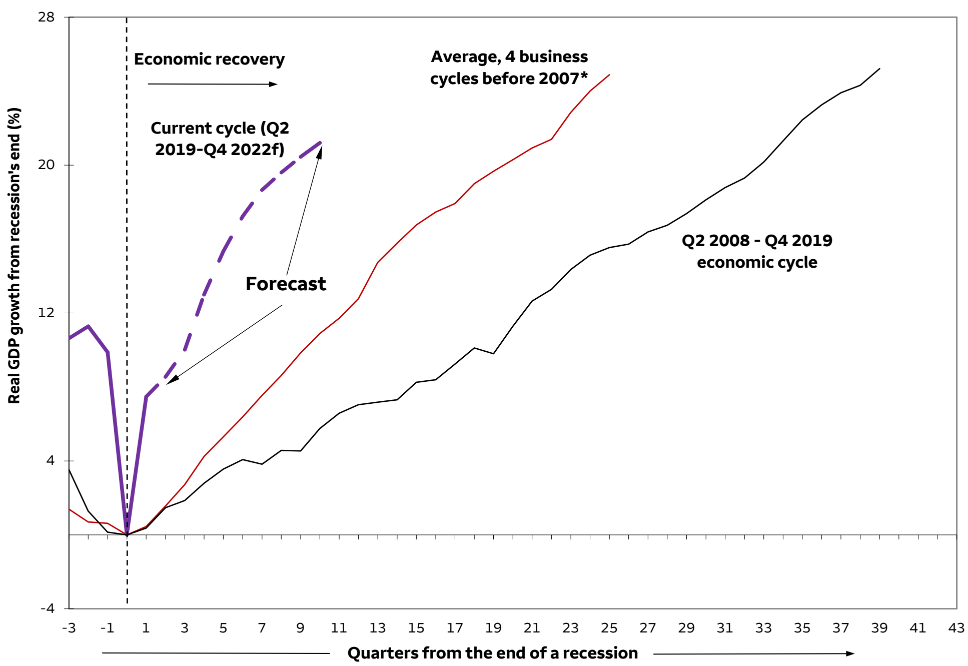
Gary Schlossberg
Global strategist

Investors peek beyond the boom

A second wind. The economy has entered stage two of a V-shaped recovery that began with its freefall a year ago and is now moving beyond a make-do rebound propelled by spending on merchandise and services keyed to stay-at-home activity. We believe that the economy now is set to piggyback on mass vaccinations, propelling travel and other close-contact services to the leading edge of their strongest growth in over 35 years. Support from the economy's reopening is being reinforced by aggressive fiscal and monetary stimulus, the release of pent-up demand, and the drawdown of sizable household savings.

What comes after that will likely provide important insights to asset market performance and portfolio strategy. This hasn't been a typical, deep economic cycle like those in 1981-1982 and 2008-2009. The pandemic's unexpected shock produced a slump more like the economy's short but deep recession tied to credit controls in early 1980. Then, like now, the economy expanded rapidly from a deep recession as the disruption subsided. The strong recovery back then contributed to its own early end by adding to the pressure on inflation and higher interest rates, ultimately touching off a long, deep recession in 1981-1982.

Is powerful economic growth set to lose steam in 2022?



Sources: U.S. Commerce Department, Wells Fargo Investment Institute (WFII), April 27, 2021. *Cycles based on recessions ending in Q4 1960, Q4 1970, Q1 1975, Q3 1982, Q1 1991, Q3 2001. GDP = Gross Domestic Product. f = WFII forecast.

Neither boom nor bust. Another flare-up of the pandemic is the most visible threat to growth this year and next. Enduring wage-price pressure ranks second, threatening to send interest rates higher and to squeeze the economy in much the same way it did in 1981. Now, unlike then, accelerating wage and price increases will likely have more to do with temporary dislocations and bottlenecks from a wrenching, V-shaped recovery than with fundamental changes perpetuating increases in both. Structural restraints, including globalization and a weak labor movement, still are potent enough to prevent a sustained rise of wages and inflation as temporary bottlenecks ease. Subdued inflation expectations add to inertia against rising price pressures, too.

We view more likely is a shift from rapid to more sustainable economic growth over the course of 2022. First, we believe steadying inflation will allow the Federal Reserve (Fed) to maintain easy credit conditions, even as it slowly retreats from ultra-accommodation. The mismatch between historically low interest rates and a strengthening economy is large enough to allow a prolonged shift to less stringent monetary policy before Fed-engineered rate increases threaten economic growth.

Second, proposed increases in government spending aren't likely to be as front-loaded as they were in March from the $1.9 trillion stimulus bill, easing bottlenecks that would otherwise risk higher inflation. We believe added fiscal headwinds will come from proposed corporate and individual tax increases. Lastly, we expect one-time support to be winding down by mid-2022 from the economy's reopening, the release of pent-up demand, and from the drawdown in savings supporting it.

Growth has typically slowed to a more sustainable rate late in the second year of a growth cycle without ongoing support from fiscal policy. Export-led strength can do only so much for an economy like the U.S. that is driven by domestic spending. And any ripple effect from this year's increased spending and hiring on added job growth and investment likely will be countered by the loss of one-time support from fiscal stimulus, pent-up demand, and excess savings.

What it means for investors. Fundamental changes in portfolio strategy could follow any shift to more moderate economic growth during the latter part of 2022. Broadly, slowing economic growth risks undercutting the reflation trade that has been in place since late last year. More moderate, sustainable economic growth and the steadier inflation we expect to accompany it also should limit the rise in bond yields and the gap between them and short-term interest rates more tightly controlled by the Fed.

For stocks, we believe the tilt from reflation as economic growth slows will encourage a move from economically sensitive sectors of the stock market toward higher-quality segments, including large-cap technology and more defensive stocks. Investment by U.S. residents in other developed-country markets will likely benefit from stronger economic growth abroad later this year and from a weaker dollar's support to currency-related gains on overseas investments.

Bond strategy could tilt from yield-enhanced sectors of the market back to a duration strategy in Treasury securities as increases in longer-term interest rates moderate. We expect the municipal (or muni) bond market to be an exception to the rule. Muni demand should be boosted by a likely increase in the top personal tax rate, increasing the value of a tax exemption. We also believe that added support could come from the proposed increase in the top capital gains tax rate large enough to dampen demand for stocks. By contrast, we view proposed corporate and personal tax increases as unfavorable for the bond market's taxable sector. Demand in this part of the market could suffer from reduced after-tax returns associated with the higher top rate on personal taxes. Moreover, the effect of higher capital gains taxes on the cost of equity financing and greater interest-related write-offs from the higher corporate tax rate could boost debt supply by encouraging a shift from equity to debt financing.

Equities

Krishna Gandikota
Investment Strategy Analyst

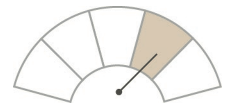
Reiterating our favorable guidance on small caps

We are reiterating our favorable guidance on U.S. Small Caps and view the recent pullback as a buying opportunity relative to the broader equity markets. Revisiting our initial upgrade back in January (please see the *Institute Alert* titled "Revising guidance, targets for stronger 2021 growth", January 19, 2021), we upgraded the asset class in an effort to take advantage of the Russell 2000 Index's greater exposure to cyclical sectors as they have tended to be closely tied to economic recoveries.

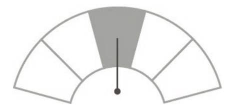
U.S. Small Caps (as measured by the Russell 2000 Index) are the best-performing asset class year-to-date with a 16.7% return compared to the S&P 500 Index's 11.4%.[1] Cheap borrowing costs, record amounts of fiscal stimulus, and a declining percentage of non-earning firms within the Russell 2000 Index keep us bullish for the equity class. In addition, small caps have tended to outperform their large-cap counterparts over a three-year period following a recession as investors allocate to riskier assets.

From a price-to-earnings valuation perspective, the Russell 2000 Index remains elevated relative to historical valuations, but is more attractive relative to the S&P 500 Index. The Russell 2000 Index continues to witness improving next 12 months earnings-per-share estimates, which shows a recovery to pre-pandemic levels.

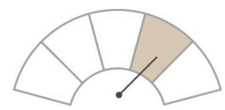
Historically, U.S. Small Caps have tended to have a positive correlation with U.S. GDP growth. We anticipate that a robust recovery in services and consumer spending will propel economic growth to the mid- to upper-single digits in the second half of 2021. With the reflation trade likely still in the early innings, we believe U.S. Small Caps have more room to run, and we remain favorable.



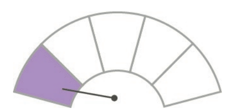
Favorable
U.S. Large Cap Equities



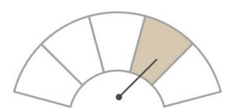
Neutral
U.S. Mid Cap Equities



Favorable
U.S. Small Cap Equities

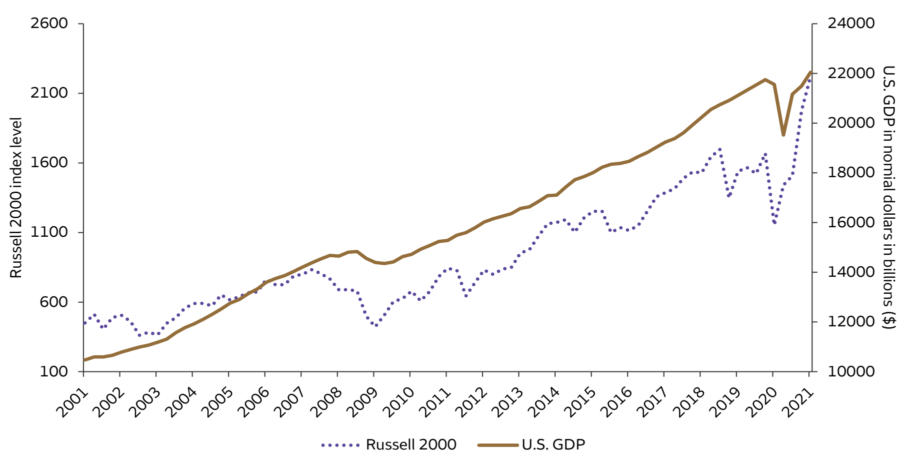


Most unfavorable
Developed Market
Ex-U.S. Equities



Favorable
Emerging Market Equities

U.S. GDP growth versus Russell 2000 return



Sources: Wells Fargo Investment Institute and Bloomberg. Data as of April 28, 2021. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

[1] Data as of April 27, 2021.

Fixed Income

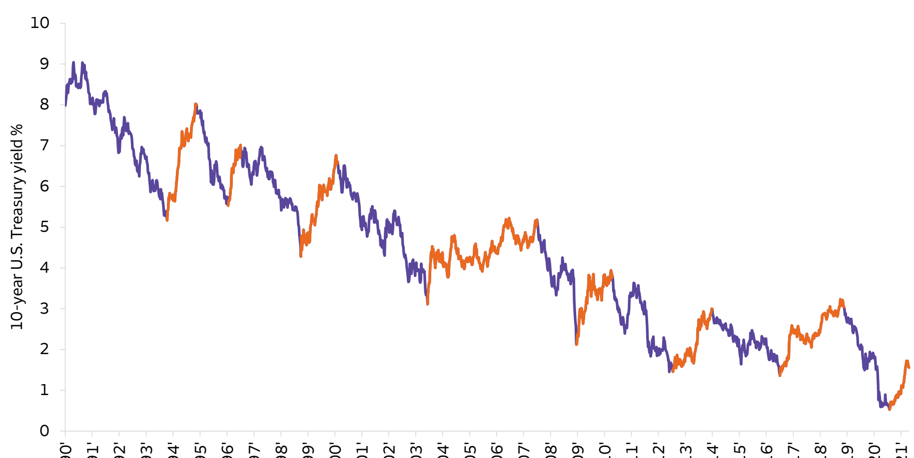
Rising U.S. Treasury yields likely to resume

Most major fixed-income classes managed to recover and display positive performance in April as U.S. Treasury yields declined slightly from the strong yield hike experienced in the first quarter. It is important to highlight that in the first quarter, U.S. Treasury yields climbed at the fastest pace over the past 60 years. Looking back at history, we can observe that there has been some consolidation in yield levels after strong spikes have occurred, and it seems like this period has not been the exception.

However, our belief is that U.S. Treasury yields will continue to climb higher throughout the rest of the year, supported by stronger economic growth and higher inflation expectations. Our year-end 10-year Treasury yield range currently stands between 1.75% and 2.25%. We are not expecting the yield hike to be a straight line because there will most likely be periods of consolidation and even pullbacks influenced by macroeconomic conditions or by technical adjustments, which we believe is the case on this occasion.

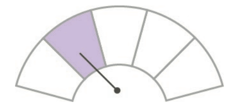
With so many positive U.S. economic figures being reported, investors may ask why the yield rise has not resumed yet. We have observed that technical consolidation between supply and demand has been driving the recent decline in yields along with hedging from institutional investors and some short covering from speculators. Referring to the 10-year Treasury yield specifically, our momentum-driven model is signaling that yields currently remain near fair value. However, we think the stage is set for a pickup in inflation in the near term which should help push intermediate-term real yields higher.

Consolidation has occurred during rising 10-year yield periods

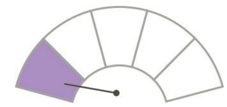


Sources: Wells Fargo Investment Institute and Bloomberg, April 30, 2021. Weekly data from January 2, 1990 to April 30, 2021. Rising yield periods highlighted in orange color. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. **Past performance is no guarantee of future results.**

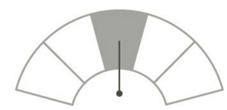
Luis Alvarado
Investment Strategy Analyst



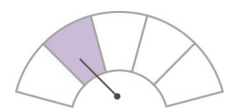
Unfavorable
U.S. Taxable Investment Grade Fixed Income



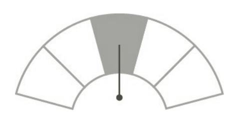
Most unfavorable
U.S. Short Term Taxable Fixed Income



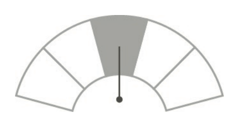
Neutral
U.S. Intermediate Term Taxable Fixed Income



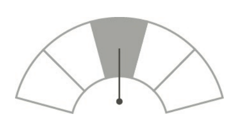
Unfavorable
U.S. Long Term Taxable Fixed Income



Neutral
High Yield Taxable Fixed Income



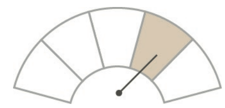
Neutral
Developed Market Ex.-U.S. Fixed Income



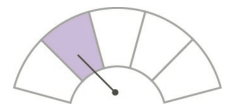
Neutral
Emerging Market Fixed Income

Real Assets

John LaForge
Head of Global Real Asset Strategy



Favorable
Commodities



Unfavorable
Private Real Estate

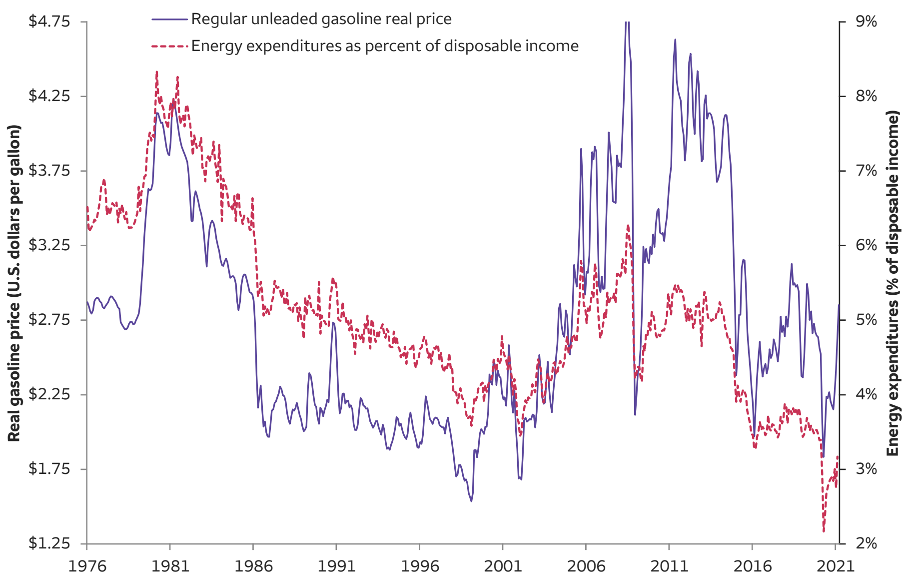
"The dearer a thing is, the cheaper as a general rule we sell it." — Samuel Butler

Gas prices on the move

During 2020, we were rarely asked about gasoline prices. And rightfully so, as talk of travel took a back seat to health and safety. The gas questions are making a comeback in 2021, however. Thanks to $60 per barrel (West Texas Intermediate) oil prices and key refinery outages in Texas, gasoline prices have risen 25% in 2021. After seeing gas prices slip below $2 in 2020, drivers are now faced with a $2.87 average price.[2] And it may not stop there. Summer driving is nearly here, the economy is getting lively again, and gasoline inventories sit near five-year lows. Our advice is to go fill up under $3, while you still can.

Rising gasoline prices typically hit lower-income households harder than higher-income households. For those making $33,000 a year or less, gasoline accounts for roughly 8% of yearly spending. For those making more than $200,000 a year, spending on gasoline is closer to 1%.[3] If there is a silver lining, it is that energy spending does not hit most pocketbooks like it once did. The red dashed line in the chart below highlights that energy consumption, as a percentage of the average American's disposable income, has slipped from a high of 8% in 1980 to about 3% today.

Gasoline prices versus energy expenditures as a % of disposable income



Sources: Bloomberg, Bureau of Economic Analysis, U.S. Department of Energy (DOE), Wells Fargo Investment Institute. Monthly data: January 31, 1976 – March 31, 2021. Real gasoline price is adjusted for inflation by Consumer Price Index (CPI). Energy expenditures as a percent of disposable income takes U.S. personal consumption expenditures on energy goods and services divided by U.S. disposable personal income both as reported by the Bureau of Economic Analysis.

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2 According to the DOE, as of April 28, 2021.
3 Based on an average annual gasoline expenditure of $2,727 as reported by the Bureau of Labor Statistics for December 31, 2019.

Alternatives

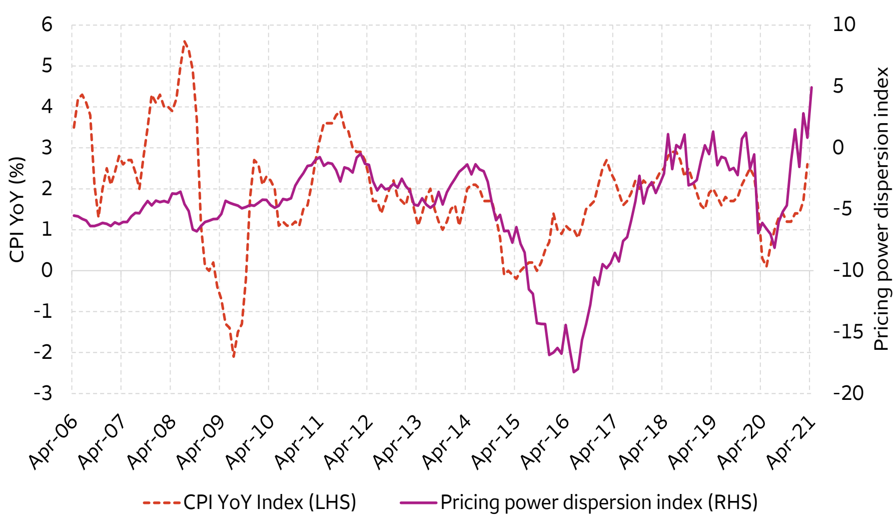
Re-opening trade shifting to pricing power trade

Justin Lenarcic
Senior Global Alternative Investment Strategist

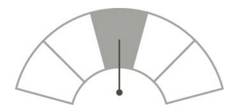
Over the last year, hedge fund positioning has been linked to several broad and well-known themes. Beginning with the recovery and re-opening theme, managers have tried to capture the twin tailwinds of monetary and fiscal stimulus with vaccine development and deployment. Fortunately, many hedge fund managers have benefited from these themes, and we have seen strong resulting performance. But now, some managers are questioning how much runway is left on the re-opening trade and have shifted into the next iteration of the post-pandemic era, focusing on a pricing power trade.

We are particularly interested in how this theme plays out for equity hedge managers. Though returns have been quite strong for this favorable strategy over the past 12 months, they have struggled so far this year, and we would like to see a return of short alpha (excess return), which may come via dispersion in pricing power. The chart below shows the relationship between inflation and a custom index (Pricing Power Dispersion Index) comparing companies with strong pricing power to those that lack pricing power.[4] That differentiation has increased significantly alongside the year-over-year increase in inflation, which is providing a catalyst for sector and stock selection.

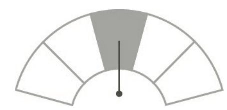
Inflation could be the next driver for active equity selection



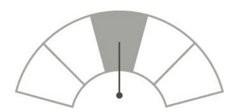
Sources: Bloomberg, Goldman Sachs, Wells Fargo Investment Institute. Data as of April 27, 2021. YoY = year-over-year. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**



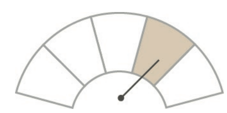
Neutral
Private Equity



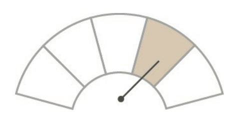
Neutral
Hedge Funds – Macro



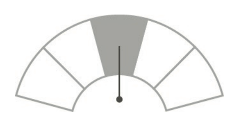
Neutral
Hedge Funds – Event Driven



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

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[4] Custom index created in Bloomberg using the difference between the Goldman Sachs Inflation Outperform equity basket and the Goldman Sachs Inflation Underperform equity basket. Each basket consists of S&P 500 equities that have demonstrated low/high earnings & sales correlation to CPI, low/high price correlation to 10 year breakevens, and have seen gross margins increase/decrease over the most recent inflation up cycle.

Risk Considerations

Forecasts and targets are 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. **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. 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.

Definitions

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

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 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market.

An index is unmanaged and not available for direct investment.

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