WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee | May 9, 2022

Global Macro spotlight

Mary Rumsey
Investment Strategy
Analyst

Central bank policies around the world

Worldwide inflation has increased significantly since March 2020 and the onset of COVID-19. Around the world, central banks have taken various approaches to tame inflation while trying to prevent the onset of a recession.

Federal Reserve

In November 2021, the United States' Federal Reserve (Fed) began tapering bond purchases, a process which ended in March. The Fed then increased its federal funds rate to 0.25% – 0.50% after slashing it at the onset of the COVID-19 pandemic. It raised the rate another 0.50% on Wednesday, May 4. We expect the central bank to keep raising rates, lifting the federal funds rate to 2.50% – 2.75% by the end of this year and 3.25% – 3.50% by the end of 2023. This week, the Fed also outlined its plan to passively shrink the Fed's balance sheet beginning in June.

Bank of England

At its May meeting, the Bank of England (BOE) raised its main bank rate for the fourth time in as many meetings, to 1.00%. This is also the level at which the bank said it would begin considering actively selling off assets on its balance sheet — a hawkish step from its previous policy of letting assets simply roll off, as it has been doing since March. At the bank's meeting this week, the BOE launched an internal study into the possibility of active sales.

European Central Bank

The European Central Bank (ECB) has not raised any interest rates since before the pandemic began. But, the ECB's emergency pandemic purchases ended at the end of March 2022. Since then, the bank has stated it plans to reduce its ongoing bond buys until purchases end in the third quarter. Then, expectations are that the ECB will consider beginning a cycle of rate hikes.[1]

Bank of Japan

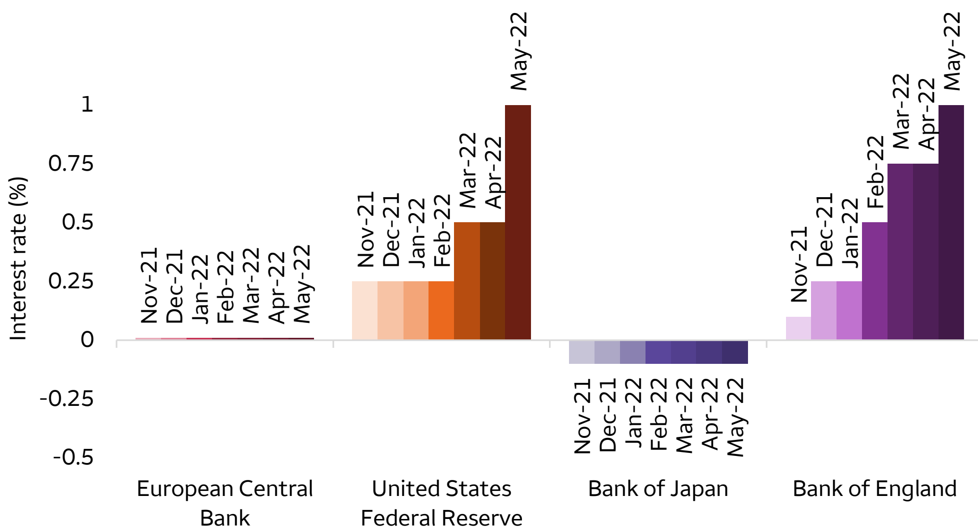
One of the most dovish central banks is the Bank of Japan, which has not raised any rates or reduced its asset purchases. Yet Japan has not experienced anywhere near the same level of inflation as other countries — in fact, as of March 2022, headline inflation was only at 1.2% year on year, well below both the bank's target rate of 2.0% and the 8.5% inflation in the U.S. Consumer and producer sentiment in Japan is also markedly different from that in the U.S. While in the U.S., consumers have bid up prices by increasing demand, price increases in Japan are mostly due to companies trying to pass on increased input costs.

1. European Central Bank. April 14, 2022.

Impact

The differing policies of the major central banks is causing disruption in other markets — most notably the foreign exchange. As the most aggressive central bank, the Fed is moving real rates to positive ground. The widening interest rate differential between the United States and other countries is causing flight to, and subsequent strengthening of, the U.S. dollar. A strong U.S. dollar results in currency losses on the overseas income of U.S. firms, hitting hardest at large U.S. multinationals. Those same currency losses can apply to international investments by U.S. residents, if they are unhedged for exchange-rate changes. A strong U.S. dollar also tends to negatively affect emerging markets, as investment money shifts to the United States and as U.S.-dollar-denominated debt becomes more difficult to repay. These consequences of a stronger U.S. dollar are some of the reasons we maintain our preference for United States financial assets over international assets.

Key central-bank interest rates



Sources: Bloomberg/Wells Fargo Investment Institute. Data as of May 5, 2022.

Equities

Austin Pickle, CFA
Investment Strategy Analyst

"Chance is the first step you take, luck is what comes afterward." — Amy Tan

Highlighting recent guidance and target changes

April 28 saw us make a number of equity guidance and target changes. We highlight those changes below.

Higher interest rates, and inflation that slows more gradually than the economy, should combine to pressure price-to-earnings (P/E) multiples lower. Consequently, we lowered our 2022 S&P 500 Index target range to 4500 – 4700. We expect some recovery in P/E ratios by the end of 2023, because we believe that investors will be looking toward a stronger 2024 economy. These somewhat higher valuations should support higher prices by year-end, particularly in the U.S. Our 2023 S&P 500 Index target range is 4800 – 5000.

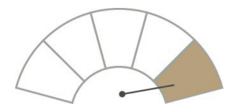
We upgraded the Consumer Staples sector to neutral from most unfavorable and the Energy sector to favorable from neutral. Consumer Staples' defensive characteristics make this sector potentially attractive during market volatility and as the economy slows. Higher interest rates, rising input prices, and weakening consumer spending are headwinds. Weighing these factors, we see a balance of positives and negatives that supports a neutral rating.

The oil and natural gas price spike has helped the Energy sector significantly outperform the S&P 500 Index year to date, as earnings growth estimates for 2022 continue to rise with the price of oil. Valuations, operational changes, our economic and commodity price outlook, as well as shifting market narratives should provide a solid foundation for continued — albeit likely less stunning — Energy sector outperformance over a tactical horizon through 2023.

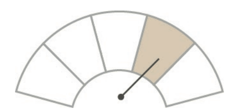
Revised equity sector guidance ranges

Sector	S&P 500 weight	WFII guidance ranges	Guidance
Communications Services	9.6%	-2% to +2%	Neutral
Consumer Discretionary	12.1%	-2% to +2%	Neutral
Consumer Staples	**6.1%**	**-2% to +2%**	**Neutral**
Energy	**3.8%**	**+2% to +4%**	**Favorable**
Financials	10.9%	-2% to +2%	Neutral
Healthcare	13.5%	+2% to +4%	Favorable
Industrials	7.7%	-2% to +2%	Neutral
Information Technology	28.2%	+2% to +4%	Favorable
Materials	2.6%	-2% to +2%	Neutral
Real Estate	2.8%	-2% to -3%	Unfavorable
Utilities	2.7%	-2% to -3%	Most unfavorable

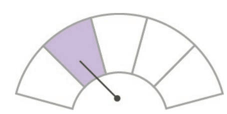
Sources: Bloomberg and Wells Fargo Investment Institute. Data as of April 19, 2022. Notes 1. Entries in bold indicate changes as of April 28. 2. Our guidance ranges can be used to take sector allocations in the direction consistent with our guidance (favorable, unfavorable, neutral, and so on). Guidance is based on certain assumptions and views of the market and are subject to change.



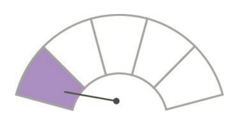
Most favorable
U.S. Large Cap Equities



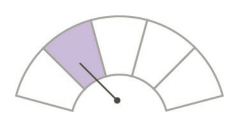
Favorable
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities



Unfavorable
Emerging Market Equities

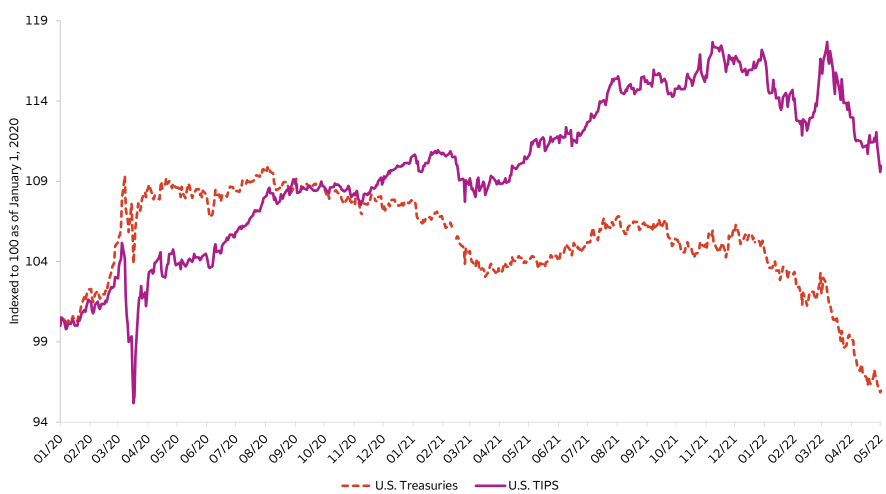
Fixed Income

TIPS — Caution warranted as inflation expectations peak

Although the debate regarding the long-term level of inflation in the U.S. has not been settled, we believe that realized, or actual, inflation will remain elevated and well above the Fed's average 2% target through the rest of the year and into 2023. For more than a year, inflation expectations and nominal U.S. Treasury yields have increased. This has allowed Treasury Inflation-Protected Securities (TIPS) to outperform nominal U.S. Treasury securities over this time frame. However, moving forward, we believe it will be more difficult for TIPS to continue to display better performance versus nominal Treasuries as inflation expectations top out and begin to decline. We currently have a neutral guidance recommendation on TIPS, but caution is warranted, especially as the Fed continues with its tightening cycle to tame inflation.

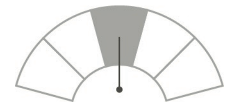
The supply and demand dynamic for TIPS is also likely to be less supportive moving forward relative to what it has been over the past year. In the most recent quarterly refunding statement from the Treasury department, it was announced that TIPS issuance would increase by $1 billion on each of the upcoming TIPS auctions (except the auction on May 10). The Treasury department expects demand for TIPS to remain robust, as it continues to stabilize the share of TIPS as a percentage of total marketable debt outstanding[2]. Investors should keep in mind that the Fed has been a large purchaser of TIPS, with a current share of above 20% of total market outstanding. Hence, the balance sheet runoff could begin to be a potential headwind for TIPS.

TIPS have outperformed Treasury securities as inflation expectations climbed

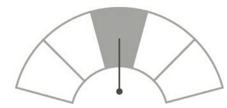


Sources: Bloomberg and Wells Fargo Investment Institute, May 4, 2022. Daily data from January 1, 2020 to May 3, 2022. TIPS = Treasury Inflation-Protected Securities. **Past performance is no guarantee of future results.** This is a relative performance comparison of the Bloomberg U.S. Treasury Index and the Bloomberg U.S. TIPS Index, both indexed to 100 as of Jan 1, 2020.

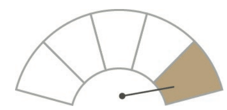
Luis Alvarado
Investment Strategy Analyst



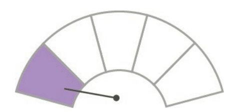
Neutral
U.S. Taxable Investment Grade Fixed Income



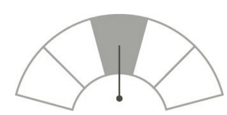
Neutral
U.S. Short Term Taxable Fixed Income



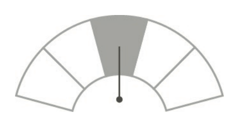
Most favorable
U.S. Intermediate Term Taxable Fixed Income



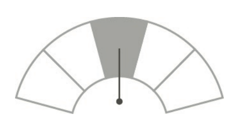
Most unfavorable
U.S. Long Term Taxable Fixed Income



Neutral
High Yield Taxable Fixed Income



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

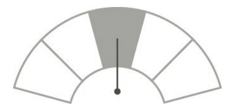


Neutral
Emerging Market Fixed Income

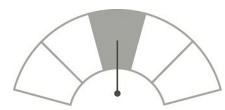
2. U.S. Department of Treasury, Quarterly Refunding , Financing Estimates 2nd Quarter, May 2 , 2022.

Real Assets

John LaForge
Head of Real Asset Strategy



Neutral
Commodities



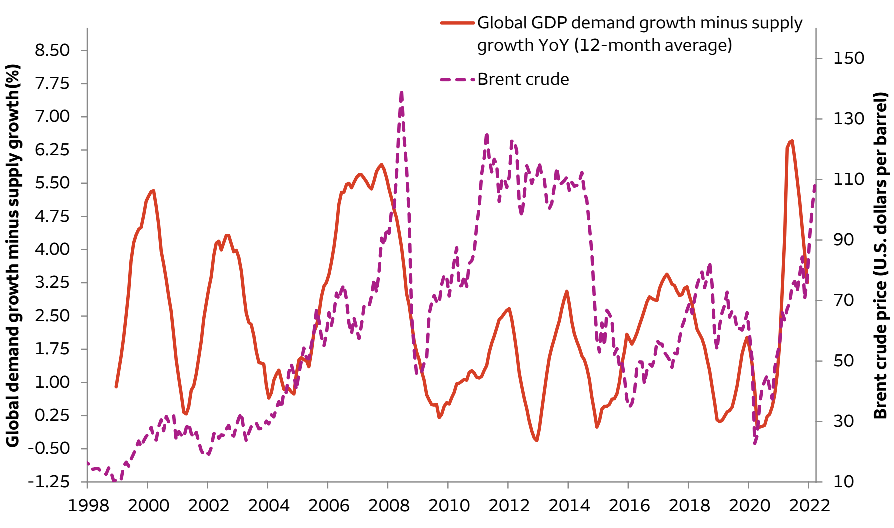
Neutral
Private Real Estate

Oil on global demand watch

Oil prices have been rising for the better part of two years. It all began when oil's fundamentals looked their darkest — in the summer of 2020. Demand was still falling, but at a slower pace. That was followed by record global stimulus and the election of an anti-fossil-fuel U.S. administration. This was key because U.S. oil production remained tame in 2021, even as oil prices surged. By the end of 2021, oil prices had doubled their pre-COVID-19 levels, while U.S. oil production dropped 13%. Oil's last price push was sparked by the world's third-largest oil producer, Russia, invading Ukraine and beginning the Russia-Ukraine war.

Today, Brent crude oil, a global benchmark, sits near $108 per barrel. This is 39% higher than the start of the year, but off its March 7 $135-per-barrel high. Reclaiming the $135-per-barrel level may hinge on the same factor that started this story — global demand growth — which has started to slow some, alongside global gross domestic product (GDP) growth. The falling solid red line in the chart represents global demand growth losing ground to global supply growth. A falling red line does not necessarily spell doom for oil prices, but if it continues, it suggests the oil price rally may slow too.

Brent oil price versus global oil demand and supply balance



Sources: U.S. Energy Information Administration, Bloomberg, and Wells Fargo Investment Institute. Monthly data: January 31, 1997 – March 31, 2022. Global demand growth is the year-over-year real oil consumption weighted GDP growth data from the U.S. Energy Information Administration. Global supply growth is the year over year World crude and liquid consumption data from the U.S. Energy Information Administration. YoY = year over year.

Alternatives

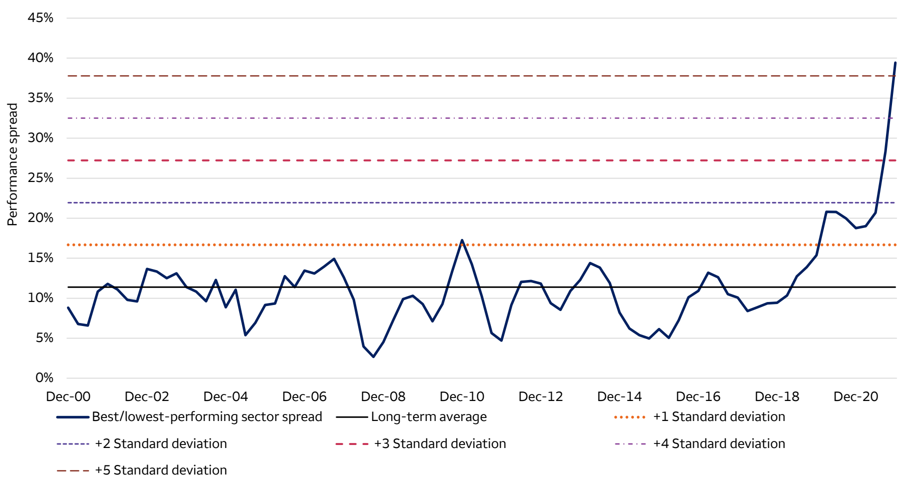
Justin Lenarcic
Senior Wealth Investment Solutions Analyst

Real estate dispersion breaching historical levels

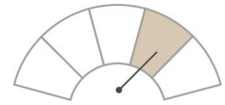
There may be a lot of reasons to invest in real estate these days. With inflation continuing to build, real assets such as property can offer investors purchasing power protection alongside much needed income. Net operating income has just about fully recovered from the COVID-19 slump, occupancy levels have — in most cases — shown stability, and a new supply of commercial real estate remains below historical averages. That said, perhaps more than ever, investors need to pay attention to the real estate sectors they have exposure to.

As seen below, for the past 20 years, the average spread between the rolling 1-year returns of the best and worst real estate sectors was around 11%. While not an insignificant spread, it does somewhat limit the need for an actively managed real estate portfolio. In other words, passive exposure to a broadly diversified collection of private commercial real estate has done just fine. But the spread has increased dramatically in the past two years, blowing through key historical averages, and even through five standard deviations above the long-term average. Said differently, the difference between the best and worst real estate sectors has never been wider, and actively managing real estate exposure is quite important. Industrial properties, for instance, have dramatically outperformed in recent years, while retail has declined and office has barely budged. Understanding the fundamental drivers of these properties, and — more importantly — gauging the longevity of these trends, is key for private real estate investors going forward.

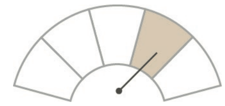
Five standard deviation spread in best versus worst real estate sectors



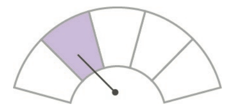
Sources: Investors Diversified Realty LLC, NFI-ODCE. Based on NFI-ODCE Index, also known as NCREIF Fund Index, showing best/lowest-performing sector spread based on 1-year trailing property type appreciation returns. Data as of the fourth quarter of 2021. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**



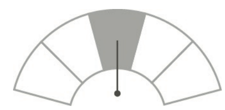
Favorable
Hedge Funds – Relative Value



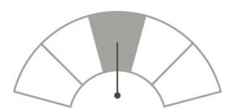
Favorable
Hedge Funds – Macro



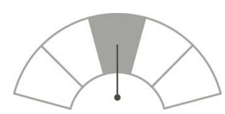
Unfavorable
Hedge Funds – Event Driven



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.

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. **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. 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.

Index definitions

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

Bloomberg U.S. TIPS Index represents Inflation-Protection securities issued by the U.S. Treasury.

NFI-ODCE Index, also known as the National Council of Real Estate Investment Fiduciaries (NCREIF) Fund Index, is an Open End Diversified Core Equity and is utilized as an institutional real estate performance benchmark. The NFI-ODCE Index is an index of investments returns (gross of fees) of the largest private real estate funds pursuing a core investment strategy which is typically characterized by low risk, low leverage (less than 40%), and stable properties diversified across the US.

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

An index is unmanaged and not available for direct investment.

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