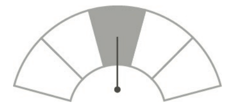
WELLS FARGO
Investment Institute

Investment Strategy

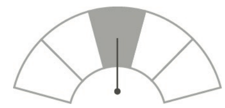
Weekly guidance from our Investment Strategy Committee **June 21, 2022**

Real Assets spotlight

John LaForge
Head of Real Asset Strategy



Neutral
Commodities



Neutral
Private Real Estate

"Pandemics can set off a vicious cycle of economic despair, inequality, and social unrest." — International Monetary Fund (IMF) (December 11, 2020)

Food crisis may be looming

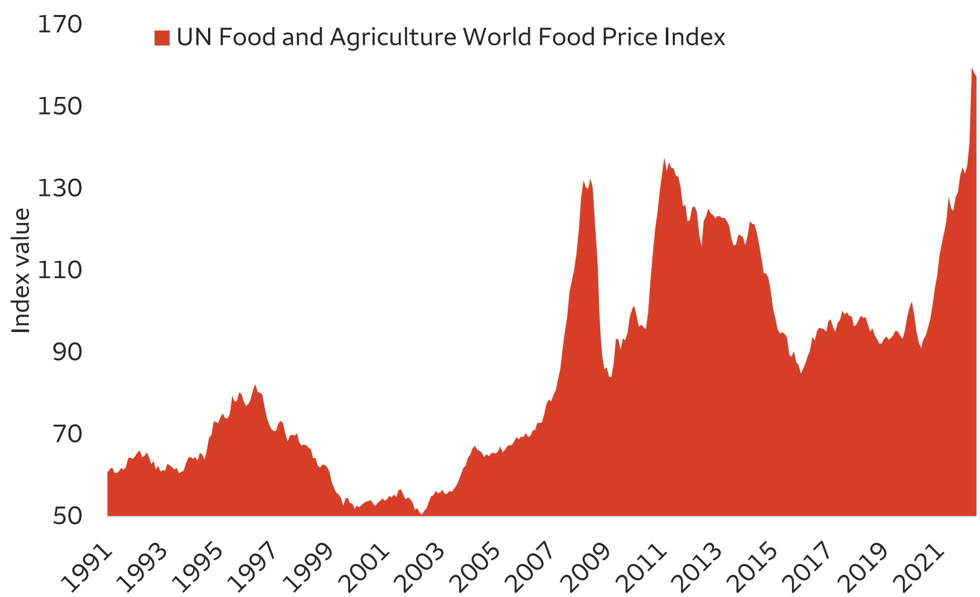
When thinking of this year's high commodity prices, energy most often comes to mind. And this makes sense, as energy commodity prices have handily outperformed the other three main commodity groups year-to-date: industrial metals, food, and precious metals. In the U.S., as an example, average gasoline prices hit an all-time high of $4.95 per gallon last week.

As painful as the extra energy costs have been, higher global food prices may be the more troublesome trend. So far in 2022, corn, soybean, and wheat prices are higher by 31%, 28%, and 36%, respectively. These gains are unfortunately on top of similar price spikes in 2021. The chart below highlights the United Nations Food and Agriculture World Food Price Index is up 60% since the start of 2021. And regrettably, this is as good as the food news gets. A confluence of factors in play could make it hard for food prices to drop in 2022 and 2023. We think odds are increasing that some of the world's poorest countries could soon face a food crisis.

The strong U.S. dollar: an often overlooked problem

One of the more important factors in play, although often overlooked, is the strong U.S. dollar. It sits near 15-year highs, and according to Ned Davis Research, it has been so strong that it is now overvalued versus 27 of the world's top 30 currencies. This matters because global commodities are often priced, and bought, in U.S. dollars. As the U.S. dollar rises, it takes more of a weaker currency to buy the same amount of a good or commodity. The poorest countries are often hit the hardest by this effect.

World food prices



Sources: Bloomberg, Food and Agriculture Organization of the United Nations, and Wells Fargo Investment Institute. Monthly data: January 31, 1991 – May 31, 2022.

In Egypt, for example, 70% of the population depends on food subsidy programs. The Russia-Ukraine war has created a web of economic problems for Egypt, and it has been compounded by the fact that the U.S. dollar is not its main currency. Egypt is one of the largest global importers of wheat — which is consumed with most meals — from Russia and Ukraine, and it is known to subsidize a significant portion of food costs to its citizens. Jittery investors, fearing higher food import bills, began pulling funds from Egypt's treasury markets. To stem the outflows, the Egyptian government devalued the Egyptian pound 14% versus the U.S. dollar, and the overnight deposit rate was hiked 2%, as of May 19, 2022. So far, so good, as fund outflows have slowed, but jittery investors are arguably not the largest concern.

Potential social unrest

While appeasing investors is important to keep trade flowing, the Egyptian government is most concerned about the consumer. As food prices continue to climb higher, more citizens need assistance, and the potential for social unrest rises. Egypt understands the fear of social unrest better than most. Increased food prices led to "bread riots" in 1977, 2011, and 2017. Many reading this may remember the slogan that toppled the Egyptian government in 2011 during the Arab Spring: "bread, freedom, and social justice."[1]

Learning from these past events, the Egyptian government has already implemented a series of reforms to subsidize and cap food prices early, and as best they can. They are also a bit more fortunate than the poorest food-importing countries, as they typically hold four to five months of wheat demand in storage. Many of the poorest food-importing countries are doing what they can for their citizens too, but time may be running thin. High food prices do not typically have an easy or quick fix, and we are seeing a growing number of countries with excess foodstuffs hesitant to export them. India is the latest to do so, banning wheat exports on May 13, 2022.[2]

1. Sinico, Sean (March 26, 2022). "Egypt: Soaring wheat prices turn food security into a priority." DW.com.
2. USDA, Foreign Agricultural Service (May 19, 2022). "India: India bans wheat exports due to domestic supply concerns".

Equities

Chao Ma, PhD, CFA, FRM
Global Portfolio and Investment Strategist

Sam Lombardo
Investment Strategy Analyst

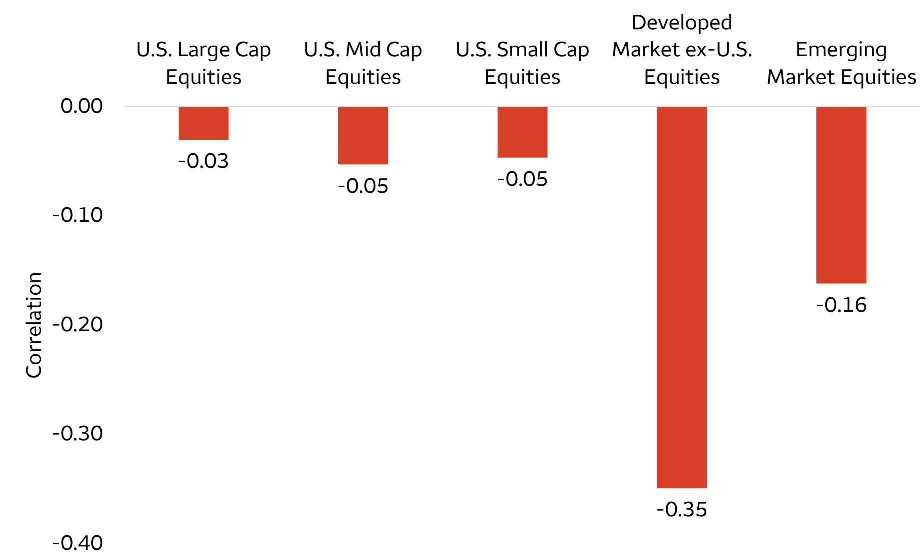
What does a strong dollar mean for equities?

The U.S. dollar exchange rate, represented by the DXY Index,[3] has appreciated by 10% in 2022, driven by elevated market volatilities in light of high inflation, tightening monetary policies, and a slowing economy.

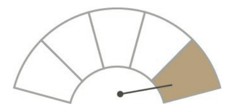
We believe U.S. dollar exchange rate impacts the value of equity investments in two ways. First, U.S.-dollar-denominated international equity assets are exposed to currency movements. To U.S. investors, the value of international assets decreases after accounting for exchange-rate impact of a strengthening dollar. This is also reflected in a negative correlation between international asset prices and the dollar (see chart below). Second, a firming dollar may be a headwind for the earnings of U.S. companies that generate a high percentage of revenues from international markets. When the dollar appreciates, overseas earnings have to be converted into increasingly expensive dollars in order to bring those earnings home. For example, over the past 10 years, S&P 500 Index sectors with higher than 50% sales from international countries experienced slower earnings growth and lagging market returns when the dollar appreciated.

We favor U.S. equities over international markets — a view well-supported by a firming U.S. dollar. We also maintain our neutral or favorable views in sectors that have a relatively low exposure to revenues from foreign countries, including Health Care, Industrials, and Utilities.

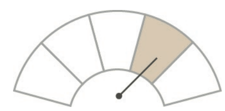
Correlation between U.S. dollar exchange rate and equity asset classes



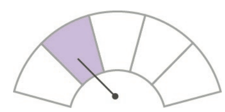
Sources: Wells Fargo Investment Institute and Bloomberg. Data as of June 14, 2022. Correlation was calculated based on the returns between September 1, 1992 and June 14, 2022. **U.S. Large Cap Equities** represented by S&P 500 Index. **U.S. Mid Cap Equities** represented by Russell Midcap Index. **U.S. Small Cap Equities** represented by Russell 2000 Index. **Developed Market ex-U.S. Equities** represented by MSCI EAFE Index. **Emerging Market Equities** represented by MSCI Emerging Markets Index. **Dollar exchange rate** represented by the U.S. Dollar Index (DXY). See end of report for index definitions.



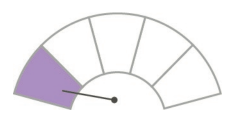
Most favorable
U.S. Large Cap Equities



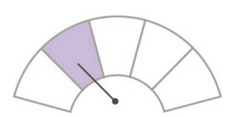
Favorable
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities



Unfavorable
Emerging Market Equities

3. Based on the dollar's trade-weighted exchange rate against a group of six major currencies: the euro, Swiss franc, Japanese yen, Canadian dollar, British pound, and Swedish krona.

Fixed Income

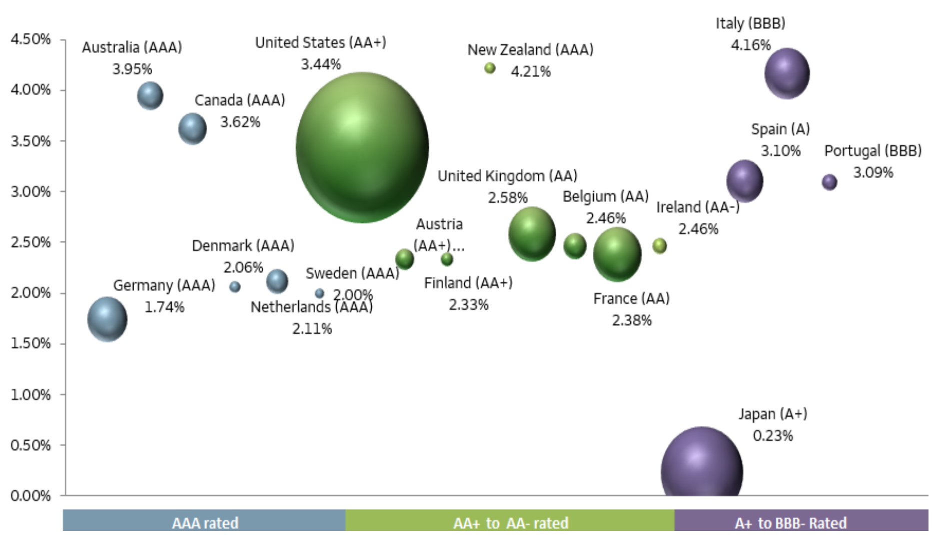
Major adjustments in developed market yields

The chart below illustrates the current situation (as of close June 14) of the developed market (DM) government bond universe across three key metrics: the 10-year maturity yield, on the vertical axis; credit quality, on the horizontal axis; and market size (as a proxy for liquidity), represented by the diameter of each bubble. A number of messages are immediately apparent.

First, it appears we are no longer in an "ultra-low" interest rate world. Yields may be still low by long-run historical standards, but they are certainly no longer extreme in the context of the past decade. Secondly, the biggest adjustment has come in eurozone yield levels. As recently as the start of this year, the 10-year German bund yield was still in negative territory. Then, most of the Standard & Poor's AAA-rated eurozone sovereign debt traded at yield levels at or below that of the Japanese Government Bond market, now the clear outlier. Above 1.5%, German bund yields are now back to levels last seen in 2014, before the European Central Bank (ECB) cut rates below zero.

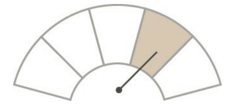
Thirdly, the U.S. Treasury market continues to dominate the DM universe in liquidity and yield. For this reason, we currently have no strategic allocation to DM bonds (ex-U.S.) and recently downgraded this asset class to unfavorable. We see little likelihood of currency gains rescuing DM bond (ex-U.S.) returns in the near future. The yen's weakness is driven by the rate gap apparent on the chart. Even as the ECB raises rates, it is hard to see the euro recovering strongly against the dollar, now that the central bank has ended bond purchases and the Italian and Spanish spreads over German bunds are once more volatile and widening.

The end of negative yields in the eurozone — Japan now the outlier

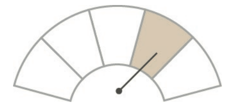


Sources: Bloomberg, JP Morgan, S&P, and Wells Fargo Investment Institute. Standard & Poor's ratings. Latest data as of June 14, 2022. Bubble size reflects the relative weight of the market within the bond index (JP Morgan GBI Broad). **Past performance is no guarantee of future results.** See disclosures for index definitions.

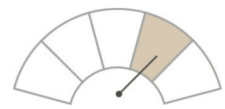
Peter Wilson
Global Fixed Income Strategist



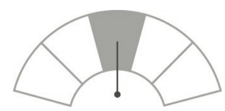
Favorable
U.S. Taxable Investment Grade Fixed Income



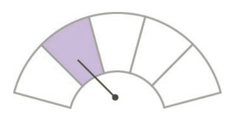
Favorable
U.S. Short Term Taxable Fixed Income



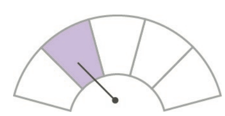
Favorable
U.S. Intermediate Term Taxable Fixed Income



Neutral
U.S. Long Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



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

Neutral
Emerging Market Fixed Income

Alternatives

M&A spreads point to attractive return potential ahead

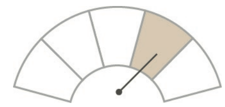
Justin Lenarcic
Senior Wealth Investment Solutions Analyst

Merger arbitrage involves investing in the equity of companies that are involved in mergers and acquisitions (M&A). Upon the announcement of a deal, the arbitrageur analyzes the deal, collects information, and tries to quantify the likelihood that the deal will be completed. As a general rule of thumb, because deals are complex and often include regulatory scrutiny and uncertainty, the stock of the company being acquired trades at a discount to the per share offer from the acquiring company. This "spread" between the acquisition price of the company being purchased and the price of the stock at the time of investment reflects the return potential for the arbitrageur. The higher the spread, the higher the return potential.

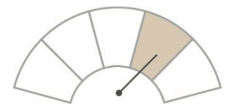
Within the broader Event Driven strategy, two of the three sub-strategies inherently assume a significant level of market risk. In other words, they have high beta. Merger Arbitrage, on the other hand, derives its return from specific deals and does not rely on the overall direction of the market. Of course there are macro variables that affect deal volume, but even there we have seen surprising resiliency in global M&A volume this year. In fact, although global deal volume is down year over year, it has averaged approximately $390 million per month, offering a relatively broad opportunity set.[4] Given growing concerns around inflation and economic growth, we may see a decline in volume, although merger spreads should remain at elevated levels. We believe it is a good time to be a merger arbitrageur.

Merger arbitrage spreads point to attractive return potential

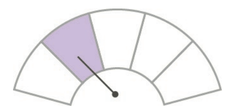
Sources: Citigroup Global Markets, Inc. Data reflects the average historical gross arbitrage spreads weighted by deal size. Data as of June 1, 2022. **Past performance is no guarantee of future results.**



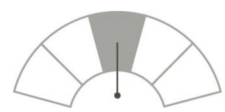
Favorable
Hedge Funds – Relative Value



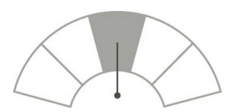
Favorable
Hedge Funds – Macro



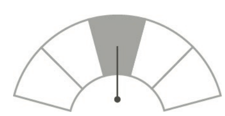
Unfavorable
Hedge Funds – Event Driven



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.

4. Citi Banking, Capital Markets & Advisory, "North America Executive M&A Summary," May 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. **Sovereign debt** is generally a riskier investment when it comes from a developing country and tends to be a less risky investment when it comes from a developed country. The stability of the issuing government is an important factor to consider, when assessing the risk of investing in sovereign debt, and sovereign credit ratings help investors weigh this 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.

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. Some of the risks associated with investment in the **Health Care** sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio's performance. **Utilities** are sensitive to changes in interest rates, and the securities within the sector can be volatile and may underperform in a slow economy.

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.

Merger arbitrage involves investing in event driven situations such as reorganizations, spin-offs, mergers, and bankruptcies, and involves the risks that the proposed opportunities in which the fund may invest may not materialized as planned or may be renegotiated or terminated which can result in losses to the fund.

Definitions

An index is unmanaged and not available for direct investment.

JP Morgan GBI Broad Total Return Index, measures the developed market government bond market.

MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of 21 developed markets, excluding the U.S. and Canada.

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

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

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. The 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 US stock market.

U.S. Dollar Index (DXY) measures the value of the U.S. dollar relative to majority of its most significant trading partners. This index is similar to other trade-weighted indexes, which also use the exchange rates from the same major currencies.

World Food Price Index (The FAO Food Price Index (FFPI)) is a measure of the monthly change in international prices of a basket of food commodities. It consists of the average of five commodity group price indices weighted by the average export shares of each of the groups over 2014-2016.

Standard & Poor's uses upper-case letters to identify a bond's credit quality rating. 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ('BB', 'B', 'CCC', etc.) are considered low credit quality, and are commonly referred to as "junk bonds". Ratings may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

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