Spotlight: Five “Es” driving the markets ................................................................. 2
  • We believe that key financial-market drivers for the remainder of 2020 will include the economy, earnings, easy monetary policy, epidemics, and elections.
  • Maintaining a diversified portfolio in 2020 has allowed many investors to weather the downturn and participate in the recovery with less volatility than through an all-equity portfolio.

Equities: M&A activity may have bottomed......................................................... 4
  • Several months into the COVID-19 crisis, merger and acquisition (M&A) activity now shows signs of a recovery. This is faster than was seen during the global financial crisis and dot-com bubble.
  • We believe that the Health Care, Information Technology, and Consumer Discretionary sectors could see more M&A transaction activity going forward.

Fixed Income: Lingering risks in the municipal market...................................... 5
  • Municipals have rebounded well from their March lows, and technicals currently are positive. We expect strong demand, and large redemptions in the next month, to continue outpacing supply.
  • We remain favorable on investment-grade (IG) municipals and recently upgraded high-yield (HY) municipals. Yet, selectivity remains important, given pandemic and budget challenges.

Real Assets: Gas is back .......................................................................................... 6
  • U.S. gasoline demand is nearly back to pre-pandemic levels.
  • Our 2020 year-end target midpoint for West Texas Intermediate (WTI) oil remains at $40 per barrel.

Alternatives: SPACs—A new force in corporate acquisitions......................... 7
  • SPACs (Special Purpose Acquisition Companies) have become increasingly important in the private equity and public market ecosystems, and their fundraising has been accelerating.
  • SPACs use their initial public offering (IPO) proceeds to seek to buy established private firms along specified parameters (generally within 24 months of IPO); they may acquire portfolio companies of private equity funds.
Spotlight

Five “Es” driving the markets

Maintaining a diversified portfolio through the COVID-19 crisis has allowed many investors to weather the downturn and participate in the recovery with less volatility than through an all-equity portfolio. What has driven market performance year to date is likely to remain “front and center” for the remainder of this year. Below, we discuss five key financial-market drivers that begin with the letter “E”: economy, earnings, easy monetary policy, epidemics, and elections.

Year-to-date asset class performance

Sources: Wells Fargo Investment Institute, Bloomberg, and FactSet. Data as of August 12, 2020. Please see disclosures for the composition of the Moderate Growth and Income, three asset group (Mod Growth & Inc. 3AG) portfolio, along with the indices used for asset class returns and their definitions. An index is not managed and not available for direct investment. Past performance is not a guarantee of future results.

Economy

The U.S. economy experienced one of its worst quarterly declines (-32.9%) in history during the second quarter. Although a sharp drop was expected, it was a bit surreal to see the official number released. We believe that the worst likely is behind us, and the economy appears to be recovering some of what it lost earlier this year. Our expectation is for a strong third-quarter rebound, followed by more modest growth through 2021. Investors will be watching closely for signs of additional green shoots (or moderating momentum) and assessing whether the economy can withstand further shutdowns should the virus metrics reaccelerate in the fall and winter.

Earnings

Earnings are the stock market’s lifeblood, and they serve as the basis for how most investors value companies. U.S. corporate profits took a significant second-quarter hit, and we expect S&P 500 Index earnings per share (EPS) to decline by more than 20% in 2020. With many companies pulling 2020 guidance, investors have focused on an expected 2021 rebound. Our forecast is for S&P 500 Index EPS to rise from $125 in 2020 to $145 in 2021—which remains below the 2019 peak of $163. Valuation multiples are pricing in a strong earnings recovery, so any profitability setback likely will put downward pressure on equity prices.
Easy monetary policies

Since the latest recession began, global central bankers have had the “pedal to the metal” when it comes to monetary policy. The Federal Reserve (Fed) has taken short-term rates to the zero “lower bound” (0.00%-0.25%), and the Fed has stated that it will maintain highly accommodative policies for some time. Policymakers also have provided credit-market support and offered additional funding to small- and medium-sized businesses. Internationally, both developed and emerging market policymakers have taken aggressive steps to limit the downturn’s damage. When many countries’ efforts to boost fiscal spending are added, these combined measures should continue to support financial markets.

Epidemics (and pandemics)

Technically, COVID-19 has been classified as a global pandemic. A pandemic is essentially an epidemic with greater range and coverage. Despite a July uptick, the growth in COVID-19 case counts, hospitalizations, and deaths appears to be leveling off. Even so, cases may rise again in coming weeks when more schools reopen and millions of U.S. students return to classrooms. Meanwhile, a second wave is still a possibility later this year. This could put pressure on hospitals during the normal influenza season. We expect that progress on treatments and vaccines likely will improve the survival rates in coming months and years. Financial markets have responded positively to encouraging virus news, and they should continue to do so as countries, corporations, and consumers become more confident in the health system’s ability to fight this disease.

Elections

The 2020 U.S. presidential election is less than three months away. At the moment, our base case is that former Vice President Joe Biden will win. We also see a higher probability of a blue wave, meaning that the Senate would switch to a Democratic majority. If this is the outcome, we expect corporate tax reform to be high on the priority list (unless the economic recovery falters). Biden’s plan calls for the statutory corporate-tax rate to increase from 21% to 28%. Our work suggests that this could translate into a modest 5-6% decline in 2021 S&P 500 company profits. Having said that, there are other proposed policies that could stimulate growth and possibly offset a higher tax burden. The stock market has been a reliable predictor of the presidency in the past (an 87% success rate since 1928). When the S&P 500 Index has risen in the 90 days prior to the election, the incumbent party historically has won. When the market has declined during that period, the incumbent party historically has lost.
Equities

M&A activity may have bottomed

Global stimulus efforts have provided ample liquidity to firms as they navigate the pandemic’s unknowns. According to S&P Global Market Intelligence, U.S. public companies reported cash of more than $2.5 trillion during the second quarter, up from $2.0 trillion at year-end 2019. Despite the substantial corporate-cash positions, North American M&A activity took a nosedive in 2020’s first quarter, with the U.S. suffering some of the steepest declines—as ambiguity around earnings kept firms focused on conserving cash.¹ We are beginning to see signs of a gradual M&A recovery. Yet, activity is still well below pre-pandemic levels, and average transaction values have been relatively small (at less than $1 billion).²

We expect corporations and other investors to remain selective toward M&A transactions in the near term. To date this year, the largest U.S. deals have been in the Energy, Information Technology (IT), and Industrial sectors.³ We expect automation and data analytics to continue driving deals across sectors, particularly for those companies with premier balance sheets in IT and Health Care. The hard-hit brick and mortar retail—and travel and leisure—industries also could present attractive M&A opportunities as they carve out and sell businesses in an effort to repair balance sheets and improve liquidity. We believe that the Health Care, IT, and Consumer Discretionary sectors could see more M&A transaction activity going forward. Our guidance remains most favorable on the IT sector and favorable on Health Care and Consumer Discretionary.

North American M&A activity plunged in the first quarter of 2020


¹ Source: Dealogic, July 31, 2020.
² Ibid.
³ Ibid.

© 2020 Wells Fargo Investment Institute. All rights reserved.
Fixed Income

Lingering risks in the municipal market

Investor enthusiasm continues to fuel the municipal-bond market. Prices have rebounded sharply since March 23 as investors continue to direct flows to municipals. As of August 11, the Bloomberg Barclays Municipal Bond Index had returned 12.9% from the March 23 lows, while yields continued to decline. We are currently experiencing a positive technical period for municipals. We expect large redemptions over the next month—coupled with strong demand—to continue outpacing supply.

Market functioning has improved since the Fed added liquidity to the municipal-bond market, following the worst of the pandemic’s impact this spring. The focus now has turned toward credit and political risk. Credit fundamentals have been deteriorating among weaker issuers, due to COVID-19 repercussions. In addition, although congressional aid for states and municipalities may eventually appear, its timing and size are still unclear, reflecting political risk.

Nevertheless, over the past 10 years, most states have focused on strengthening their reserves for the next economic downturn. While the budget pressure facing state and municipal governments is significant, many states are holding substantial rainy day fund balances. We expect this to help cushion any blows and lessen the risk of credit-rating downgrades. Still, in a challenging credit environment, investors should be selective when purchasing municipal credits, particularly those with lower credit ratings.

We remain favorable on IG municipals, and we recently upgraded HY municipals to neutral as valuations remain attractive and spreads are wide. We expect positive single-digit returns for both IG and HY municipals for the remainder of 2020.

States’ rainy day funds have grown

Sources: Wells Fargo Investment Institute, Bloomberg, National Association of State Budget Officers, August 11, 2020. Chart shows yearly data, 2000–2021 from The Fiscal Survey of States, spring 2020. Figures for 2020 are estimated; figures for fiscal 2021 are projected based on governors’ recommended budgets. Forecasts and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.
Real Assets

“No disguise can long conceal love where it is, nor feign it where it is not.” — Francois VI, Duc de La Rochefoucauld

Gas is back

When the U.S. shut down in March and April, and Americans were directed to “stay at home,” one of the first economic victims was gasoline demand. With most cars parked, gasoline demand cratered like we’ve never seen before. The green line in the chart highlights that gasoline demand in April fell by more than 40% year-over-year.

Of course, oil and gasoline prices cratered too. Oil, especially, had a hard time. At one point, it closed below zero, at -$37 per barrel. Some oil strategists thought this could be the new norm, and they lowered their oil targets to $20 and below. We did not feel that a new norm was evolving, and we left our year-end $40 WTI oil midpoint target alone.

We’re always a bit cautious when we hear, “it is different this time.” We saw the short-term oil and gas demand destruction too—but our take was that the demand downshift would be short-lived—and that demand would rebound more quickly than most thought. Our view is that Americans, and much of the world, remain addicted to progress (higher living standards), which is another way of saying that they are addicted to oil. Oil is what “makes the world go round.” There remains a direct link between global oil demand and global economic growth. Yes, renewables are the future. But, until that future matures (likely decades), we fully expect hydrocarbons, like oil and gasoline, to be in high demand. Notice, below, that U.S. gasoline demand is, impressively, almost back to pre-“stay at home” levels.

U.S. gasoline demand by year

Alternatives

SPACs—A new force in corporate acquisitions

SPACs (Special Purpose Acquisition Companies) have become increasingly important in the private equity and public market ecosystems. SPACs are companies formed to raise capital via initial public offerings (IPOs) to make corporate acquisitions. Known as “blank check companies,” they do not have operations or specific acquisition targets upon IPO.

SPAC IPO activity has increased dramatically in recent years as private equity managers, hedge fund managers, and others have established SPACs. As shown in the chart, SPACs raised $1.8 billion from 12 IPOs in 2014—jumping to $25 billion via 64 IPOs so far in 2020.4 Year to date through August 7, the amount raised and total IPOs had already surpassed 2019’s totals.

SPACs use their IPO proceeds to attempt to acquire established private businesses along pre-specified industry parameters generally within 24 months of the IPO. SPACs may acquire portfolio companies of private equity venture capital, growth equity, and buyout funds seeking exits. Successful acquisitions result in publicly traded operating companies with new names and symbols. Of the 452 SPACs raised since 2003, almost half (224) have completed acquisitions, totaling $39.3 billion. An additional 33 SPACs have announced pending acquisitions totaling $8.4 billion.

The longer-term impact of SPACs on private equity may be mixed. SPACs provide an additional (and attractive) exit route for private equity funds, generally providing faster and more certain exits than generic IPOs do. However, SPACs may increasingly compete with traditional buyout investors for attractive mid-market and large corporate acquisitions, thereby diminishing expected returns.

SPAC fundraising accelerates

![Graph showing SPAC fundraising accelerates from 2014 to 2020]

Sources: SPAC Data, Wells Fargo Investment Institute, August 7, 2020.

4 All data from this article is provided by SPAC Data as of August 7, 2020.

© 2020 Wells Fargo Investment Institute. All rights reserved.
Risk Considerations

Forecasts are not guaranteed and 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. Income from **municipal securities** is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT). 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. **Risks associated with the Consumer Discretionary sector** include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players; reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. The **Energy sector** may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. 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 and government regulations, among other things, all of which can significantly affect a portfolio’s performance. Risks associated with the **Technology sector** include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market.

**Special Purpose Acquisition Company (SPAC)** is a company with no commercial operations that is formed strictly to raise capital through an initial public offering (IPO) for the purpose of acquiring an existing company. Also known as “blank check companies,”

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

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**

An index is unmanaged and not available for direct investment.

**Moderate Growth and Income 3AG Portfolio**: 3% Bloomberg Barclays U.S. Treasury Bills (1–3 Month) Index, 32% Bloomberg Barclays U.S. Aggregate Bond Index, 6% Bloomberg Barclays U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index, 21% S&P 500 Index, 12% Russell Mid Cap Index, 8% Russell 2000 Index, 6% MSCI EAFE Index, 7% MSCI Emerging Markets Index.

**Bloomberg Barclays Municipal Bond Index** is an unmanaged index composed of long-term tax-exempt bonds with a minimum credit rating of Baa.

**U.S. Treasury Fixed Income Bloomberg Barclays U.S. Treasury Index** is the U.S. Treasury component of the U.S. Government Index. The index consists of public obligations of the U.S. Treasury with a remaining maturity of one year or more.

U.S. Municipal Fixed Inc: Bloomberg Barclays U.S. Municipal Index represents municipal bonds with a minimum credit rating of at least Baa, an outstanding par value of at least $3 million and a remaining maturity of at least one year. The index excludes taxable municipal bonds, bonds with floating rates, derivatives and certificates of participation.

U.S. High Yield Fixed Inc: Bloomberg Barclays U.S. Corporate High Yield Index covers the universe of fixed rate, non-investment grade debt.

Developed ex-U.S. Fixed Inc: JPMorgan Global ex-U.S. Government Bond Index measures the performance of non-U.S. government bonds.

Emerging Market Fixed Income: JPMorgan Emerging Markets Bond Index (EMBI Global) currently covers 27 emerging market countries. Included in the EMBI Global are U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

U.S. Large Cap Equity: S&P 500 Index is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation and financial companies.

U.S. Mid Cap Equity: Russell Midcap® Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap Index is a subset of the Russell 1000® Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap Index represents approximately 27 percent of the total market capitalization of the Russell 1000 companies.

U.S. Small Cap Equity: Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately eight percent of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

Developed Market ex-U.S. Equity: MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada.

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

Frontier Market Equity: MSCI Frontier Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of frontier markets. The MSCI Frontier Markets Index consists of 24 frontier market country indexes.

Commodities: Bloomberg Commodity Index is comprised of 23 exchange-traded futures on physical commodities weighted to account for economic significance and market liquidity.

Public Real Estate: FTSE EPRA/NAREIT Developed Index is designed to track the performance of listed real-estate companies and REITs in developed countries worldwide.

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.

General Disclosures

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS’ opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

© 2020 Wells Fargo Investment Institute. All rights reserved.