Investment Strategy

Weekly guidance from our Investment Strategy Committee **October 11, 2021**

Equities spotlight: Review of stock market corrections and rebounds......2

- Stock market volatility has re-emerged and we expect this trend to continue.
- Absent a recession or excessive valuation, history suggests that equity-market downturns rebound relatively quickly, providing investors with an opportunity to rebalance portfolios.

Equities: China has issues but all emerging markets are not the same.......4

- Strong commodity prices and attractive valuations provide tailwinds for some commodity-producing emerging markets.
- Headlines out of China have overshadowed bright spots in emerging markets. We remain neutral, but investors should be selective within emerging markets.

Fixed Income: Global interest rates – past the trough 5

- Norway became the first developed market to raise interest rates post-COVID-19 on September 23. It is fair to say we are likely past the trough in developed market policy rates.
- Emerging markets passed this point more than a year ago, and the weighted-average EM policy rate is now clearly rising, with central banks in Latin America, Europe, and Asia raising rates.

Real Assets: OPEC+: Another meeting, another 400k.....................................6

- OPEC+ agreed to a 400 thousand barrels per day (Mbdp) oil production increase last week.
- Barring meaningful price or political pressure, expect OPEC+ to stick to its plan to increase production 400 Mbpd each month. The next meeting is November 4.

Alternatives: Moderating return expectations for Equity Hedge 7

- The Equity Hedge strategy has delivered strong returns over the past two- and three-year periods, exemplifying the broader improvement in security selection that we have highlighted previously.
- Even though fundamental drives of security selection remain in place, we anticipate modestly lower returns for Equity Hedge in 2022, especially if the backdrop for equity beta deteriorates.

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Equities spotlight

Review of stock market corrections and rebounds

Doug Beath
Global Investment Strategist

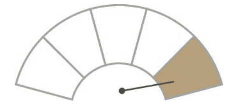
Volatility returned to equity markets during September, with the benchmark S&P 500 Index registering the worst month since March 2020. While the problems surrounding China's largest real estate company were probably a catalyst, equity investors have also been concerned about future Federal Reserve (Fed) policy and decelerating economic data due to the highly contagious Delta variant and supply-chain bottlenecks worldwide.

To some extent, a pullback was inevitable given the unusual tranquility of markets; the S&P 500 Index had not experienced a decline of 5% in nearly a year, and major U.S. stock indices were producing record highs on a regular basis. In addition, the CBOE Volatility Index (VIX) has been hovering at very low levels of around 15 to 25. Nevertheless, the recent stock market drop coupled with the likelihood of additional volatility heading into 2022 provides a good opportunity to review the history of stock market plunges, rebounds, and how they relate to corrections, bear markets, and the economy.

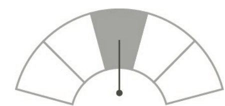
Correction versus Bear Market

To be sure, the 5% drop that occurred last month does not qualify as an official stock market correction at this point (decline of 10-20% from peak to trough), but it's never too early to mentally prepare for additional volatility. Historical data of market corrections since 1979 indicate that there were 11 corrections. What's significant to investors is how quickly stocks rebounded after the market bottomed. On average, the S&P 500 recaptured all of the lost ground in approximately 10 months. In this scenario, we believe "buying on the dips" can be rewarding to investors during equity market corrections.

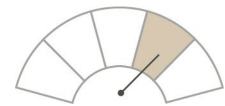
In terms of bear markets, defined as equity declines of 20% or more, there have been 5 such episodes since 1980 prior to the market collapse associated with the COVID pandemic.[1] As expected, the duration of the bear-market period and the rebound phase are significantly longer than market corrections. On average, the S&P 500 took approximately 3.4 years (pre-COVID) to recapture lost ground, with the previous two bear markets prior to the pandemic requiring 7.2 and 5.5 years respectfully to rebound. Under these circumstances, a strategy of reducing risk assets early in the turbulent period would be more effective than aggressive rebalancing.



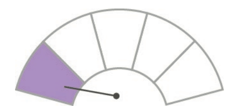
Most favorable
U.S. Large Cap Equities



Neutral
U.S. Mid Cap Equities



Favorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities

Neutral
Emerging Market Equities

[1] Due to the extraordinary circumstances of the COVID-19-related bear market and recession – including a two-month recession (-31.4% GDP plunge from February 2020 to April 2020), and a one-month bear market (S&P 500 Index -33.9% from February 19, 2020 to March 23, 2020), our focus is on the bear market periods prior to the pandemic.

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Further examination of bear market periods demonstrates that 4 of 5 aforementioned episodes were associated with a recession in the U.S. There was only one exception: October 19th, 1987, which was an issue of valuation, as the equity risk premium[2] turned negative with the spike in long-term Treasury yields rising from 7% to 10%.

Next, we examine today's situation to assess the probability of whether the recent turbulence or potential volatility in the future could morph into something more serious. Consider the following:

1. In our view, the U.S. is unlikely to enter a recession in the near future. The deceleration of COVID-19 cases, improving foot traffic in sectors most affected by the pandemic, along with narrow corporate bond spreads and solid purchasing managers' surveys point to accelerating growth in the current quarter.
2. While the Fed is expected to begin raising short-term interest rates in 2023 or earlier, market-implied indicators suggest that interest rate normalization will be very gradual and take years to complete.
3. Valuations measured on both trailing and forward earnings (20.7x and 18.9x, respectively) are now above their historical averages, but do not appear expensive relative to fixed income. The equity-risk premium is currently around 350 basis points (100 basis points equal 1 percent), above previous norms.

In our view, the current environment, including market-based indicators and surveys, do not portend a recession or bear market at this moment. Consistent with historical data regarding equity-market corrections and rebounds, we favor investors taking advantage of any significant market pullback to rebalance portfolios and invest in equities at more attractive prices.

[2] The equity risk premium (ERP) is the excess return that investing in the stock market provides over a risk-free rate, usually the return from Treasury bonds. A standard definition for the ERP is the earnings yield of the S&P 500 (inverse of the PE ratio based on forward-looking earnings) relative to the yield on long-term Treasuries. Based on this measure, the ERP is over 300 basis points today, which is above the long-term average of approximately 200 basis points (Source: Wells Fargo Investment Institute).

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Equities

Ken Johnson, CFA
Investment Strategy Analyst

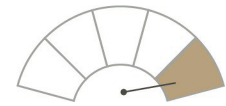
China has issues but all emerging markets are not the same

True to history, emerging market (EM) equities exploded at the start of the recovery. Performance later waned as the reflation trade paused and China racked up negative headlines reflecting regulatory challenges and slower growth. In consideration of these tumultuous events and China's weighting within the MSCI EM Index (currently 33.7%), we lowered our MSCI EM target range for year end 2021 to 1200-1400. Subsequently, the index rallied to our new target midpoint, prompting us to lower our tactical guidance to neutral.

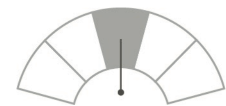
The events in China represent only part of the EM equities story. Commodity prices have been on a tear with oil and natural gas prices reaching levels not seen in years. We believe these prices are likely to remain elevated throughout the winter months, which supports energy-producing emerging regions and firms. Iron ore took a nose dive as steel producers cut production, but the pain may be starting to subside. This provides a boost for producers in South American countries such as Brazil.

Valuations for emerging markets are mixed. MSCI EM Asia represents countries with some of the richest valuations. The region currently trades at a 7.1% premium to its 10-year average. Alternatively, MSCI EM ex-Asia currently trades at a 25.9% discount to its history. When you exclude China and other EM Asia countries, the EM story switches from one of weakness to one of resilience and opportunity (see chart below).

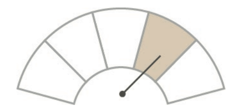
The bottom line is that the structure of the MSCI EM Index shrouds bright spots for investors. We remain neutral, but we believe investors should be selective within emerging markets.



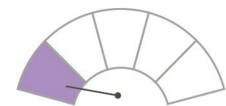
Most favorable
U.S. Large Cap Equities



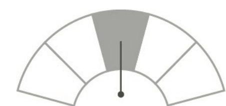
Neutral
U.S. Mid Cap Equities



Favorable
U.S. Small Cap Equities

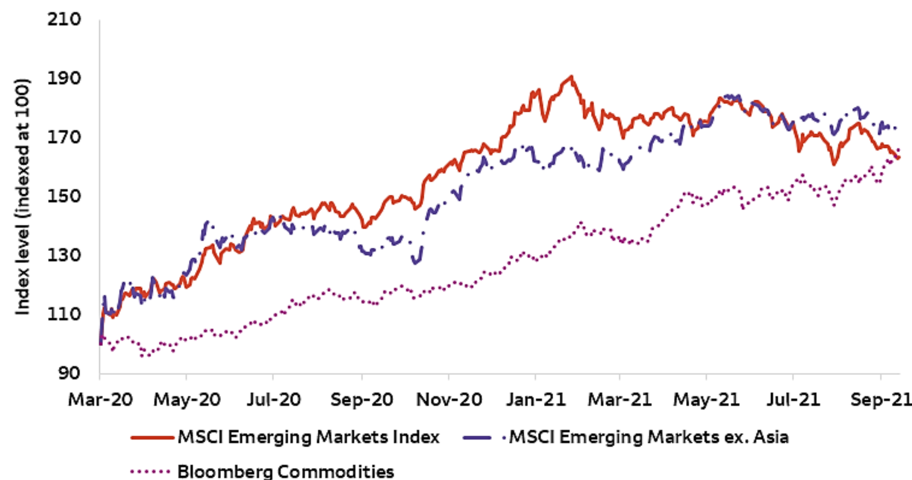


Most unfavorable
Developed Market Ex-U.S. Equities



Neutral
Emerging Market Equities

MSCI Emerging Markets ex-Asia outperforming broader MSCI EM index



Sources: Wells Fargo Investment Institute, Bloomberg, 10/6/2021. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** Please see the end of the report for index definitions.

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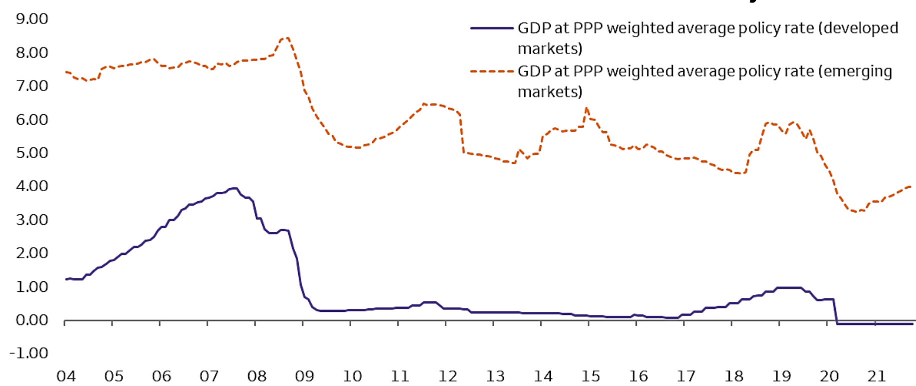
Fixed Income

Global interest rates – past the trough

Unless the economic outlook worsens dramatically, the U.S. Federal Reserve (Fed) looks set to begin reducing its quantitative easing bond purchases by the end of the year. The European Central Bank (ECB) has already slowed the pace of purchases, and will soon discuss whether to end its Pandemic Emergency Purchase Program (PEPP). On September 23, the Bank of Norway became the first developed market (DM) central bank to raise rates since the onset of the COVID-19 pandemic (from 0.00% to 0.25%), and the Reserve Bank of New Zealand quickly followed suit (hiking from 0.25% to 0.50%). After the September monetary policy meeting of the Bank of England, the market now sees three rate increases in the U.K. by the end of 2022.

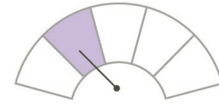
In this context it is fair to say that we have likely passed the peak of bond purchases and the trough of interest rates for this cycle (although with a Gross Domestic Product, or GDP, weighting of just over 1%, compared to an almost 84% combined weight for the U.S., the eurozone, and Japan, Norway's and New Zealand's rate hikes are not yet visible on the chart). The chart does clearly show that the trough in emerging market (EM) policy rates was more than a year ago, in the third quarter of 2020. So far in 2021, at least 10 EM central banks, as diverse as Brazil, Russia, and South Korea, have raised interest rates. We will delve deeper into the implications of this next stage in the monetary policy cycle in future reports.

Global central bank rates have bottomed out: EM lead the way

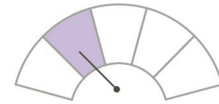


Sources: International Monetary Fund (IMF), Bank for International Settlements, national central banks, Bloomberg, Wells Fargo Investment Institute. Latest data as of October 6, 2021. The DM series is a weighted average of 11 DM central bank policy rates, using gross domestic product (GDP) at purchasing power parity (PPP) as weights. The EM series is a weighted average of 26 EM central bank policy rates, using GDP at PPP as weights. Purchasing Power Parity is the measurement of prices in different countries that uses the prices of specific goods to compare the absolute purchasing power of the countries' currencies. The IMF produces data on PPP that is commonly used to compare the size of economies across countries.

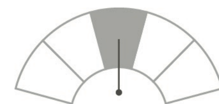
Peter Wilson
Global Fixed Income Strategist



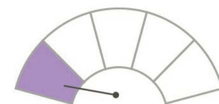
Unfavorable
U.S. Taxable Investment Grade Fixed Income



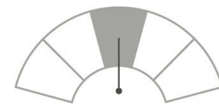
Unfavorable
U.S. Short Term Taxable Fixed Income



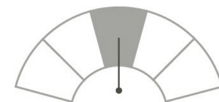
Neutral
U.S. Intermediate Term Taxable Fixed Income



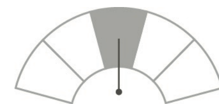
Most unfavorable
U.S. Long Term Taxable Fixed Income



Neutral
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

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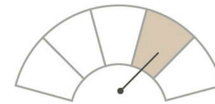
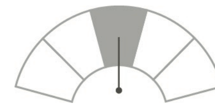
Real Assets

Austin Pickle, CFA
Investment Strategy Analyst

"If you want to lift yourself up, lift up someone else." — Booker T. Washington



Favorable
Commodities



Neutral
Private Real Estate

OPEC+[3]: Another meeting, another 400k

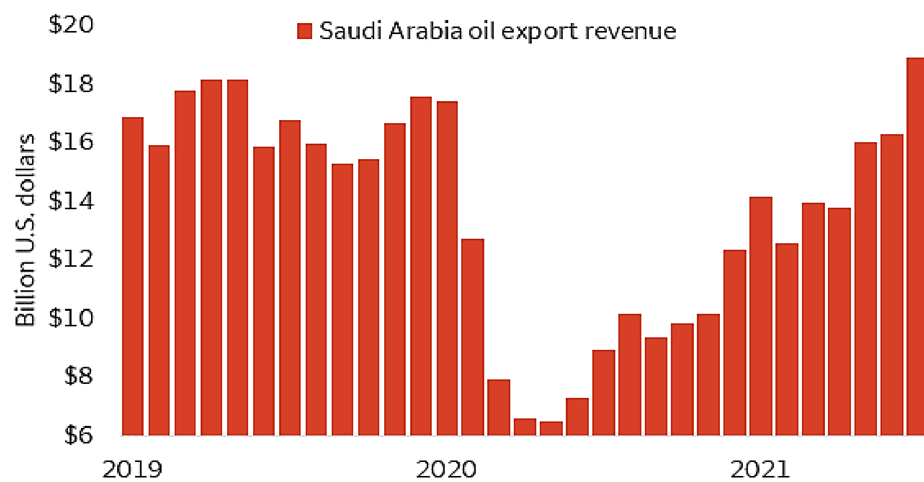
On October 4, OPEC+ agreed to stick with its predetermined plan to increase oil production by 400 thousand barrels per day (Mbpd). Oil prices surged on the news as some market participants anticipated that the group would announce a larger production increase. Why did OPEC+ not deviate from their plan? In short, we believe a lack of pressure.

Oil prices that are too low could crimp revenues for OPEC+ members and create pressures for the group to cut production to buoy prices. In our opinion, prices that are too high are problematic as well, as they could stunt growth and demand outlooks and prompt political pressures from major customers to boost production.

What price levels are "too low" and "too high" for OPEC+ members is open to speculation but we suspect that today's prices are currently near the group's sweet spot. Prices have rebounded and appear well-supported, oil revenues are at multiyear highs (see chart below), demand is robust and growing, and the economic recovery appears to be on solid footing. In other words, there is currently little to no pressure on OPEC+ to change course.

But that can change quickly. Any number of scenarios could increase the pressure on OPEC+ to deviate from their plan: another COVID-19 wave (knock on wood that we have seen the last of these), an intensifying European and Asian energy crunch, production interruptions, etc. If pressures materialize to the point of action, we should find out in short order as OPEC+ is scheduled to meet monthly, with the next being November 4.

Saudi Arabia oil export revenues at multiyear high



Sources: Bloomberg, General Authority for Statistics Kingdom of Saudi Arabia, Wells Fargo Investment Institute. Monthly data: January 31, 2019 – July 31, 2021.

[3] The Organization of the Petroleum Exporting Countries and others such as Russia.

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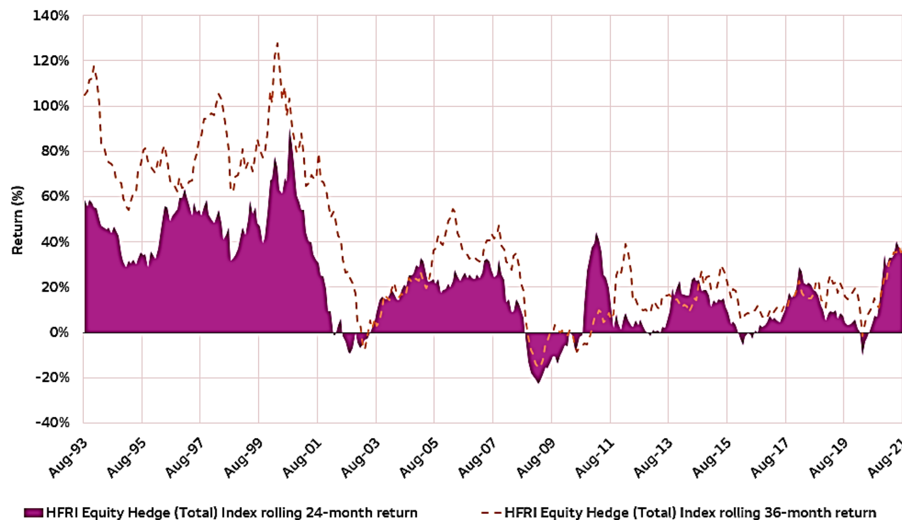
Alternatives

Moderating return expectations for Equity Hedge

One of our favorite strategies for most of the era after the Global Financial Crisis has been Equity Hedge. While performance for this popular strategy has ebbed and flowed, the rolling two- and three-year returns have – on average – exceeded our capital market assumptions.[4] As shown in the chart below, the current rolling two-year and three-year returns are nearly 40%, which not only surpasses recent peaks, but also highlights our view that a "new era" for hedge funds began back in the fourth quarter of 2018.[5] While we certainly did not anticipate the pandemic, nor the fiscal and monetary stimulus that would propel asset prices higher, we did envision a better environment for equity security selection and active management.

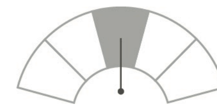
We find ourselves now at an interesting crossroads for Equity Hedge. On one hand, fundamental drivers of dispersion such as inflation, supply chain disruptions, potentially higher corporate taxes, and higher interest rates should continue to foster a supportive stock picking environment. But it is possible that we also see a further decline in upward earnings revisions from peak levels, which could put pressure on funds that have more beta, or market exposure. In other words, though the environment remains conducive to Equity Hedge, and we continue to anticipate cyclical returns that exceed our capital market assumptions, we doubt that returns will be as robust as they have been over the past few years. This also means that we may begin shifting our guidance away from higher-beta, more directional strategies and back into the lower-net, low beta defensive Equity Hedge strategies that we prefer in the middle to later stages of the cycle.

Equity Hedge Returns are hovering near the cycle peak

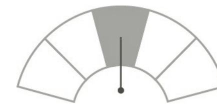


Sources: HFRI, Wells Fargo Investment Institute. Chart shows the rolling two-year and three-year return of the HFRI Equity Hedge (Total) Index. Data as of August 31, 2021. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

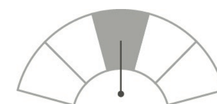
Justin Lenarcic, CAIA
Senior Global Alternative Investment Strategist



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] The average rolling two-year return from March 2009 through August 2021 is 9.8%, while the average three-year return for the same period is 13.4%. WFII CMAs for equity hedge have ranged from 5.5% to 8.7%.

[5] WFII, "*An Aging Cycle – But Early Innings for Alternatives,*" November 2018.

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Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

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

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

Definitions

An index is unmanaged and not available for direct investment.

Bloomberg Commodity Index is comprised of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity.

CBOE Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

HFRI Equity Hedge (Total) Index maintains positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios.

Note: HFRI Indices have limitations (some of which are typical of other widely used indices). These limitations include survivorship bias (the returns of the indices may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information self-reported by hedge fund managers that decide on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.

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

MSCI Emerging Markets *(*EM*)* Asia Index captures large and mid-cap representation across 9 *Emerging Markets* countries. With 1,117 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

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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.

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