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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **October 12, 2020**

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- An elections' impact on the market has been short term historically, with the markets broadly trending higher during the terms of presidents from both political parties.
- We believe it is important to focus on long-term goals and not to try to time market movements around elections.

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- The lack of swift fiscal stimulus suggests that monetary policies will remain easy for the foreseeable future.
- In an environment in which monetary stimulus is likely to remain extremely accommodative, we recommend considering credit-sensitive fixed-income securities.

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- The vast majority of today's hydrogen is "gray" (produced by fossil fuels) and not "green" (produced by clean energy).
- Costs will need to come down substantially for green hydrogen to compete economically with gray hydrogen.

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- Even with strong support from the Federal Reserve (Fed), credit selection remains important and the environment for active management remains favorable.
- Long/short credit strategies should do well over the near-term, as third quarter earnings season coupled with generally higher volatility heading into the election can lead to price dislocations and attractive entry points.

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Equities spotlight

Chao Ma, Ph.D., CFA, FRM
Global Portfolio and Investment Strategist

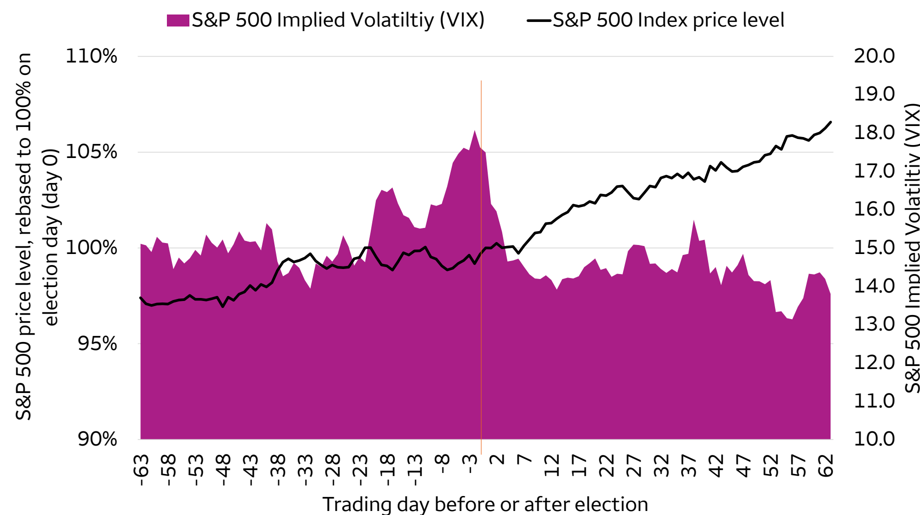
Navigating the final stretch of the election cycle

Investing during the election cycle can be challenging on the nerves, and 2020 promises to be no different. As we enter the final month before Election Day, news headlines on topics such as the presidential debates, campaign rallies, and a candidate's COVID-19 test can draw strong emotions among investors and potentially move markets. Here we want to share our analysis that may help investors navigating the final stretch of the election cycle.

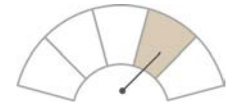
Elections' impact on the market has been short term in nature

Historically, elections have impacted the market when they were imminent, especially in the final two to four weeks. As shown in Chart 1, equity market volatility, represented by the VIX Index, has been slightly elevated in the month before an election on average and has been as much as 20% higher than the long-term average during the final two weeks prior to Election Day. During this time, we note that the S&P 500 was likely influenced by uncertainties around the election outcome. However, outside this one-month period, the S&P 500 tended to discount the influence of election news.

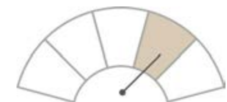
Chart 1. Equity volatility and price during the election cycle



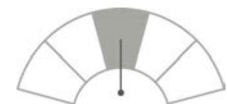
Sources: Bloomberg, Wells Fargo Investment Institute. Average of past presidential election years since 1988, except when recession overlaps with election (i.e. 2008). S&P 500 price is rebased to 100% on the Election Day. Date axis shows the days before and after Election Day. The VIX index is a real-time market index that represents the market's expectation of 30-day forward-looking volatility. Derived from the price inputs of the S&P 500 Index options, it provides a measure of market risk and investors' sentiments. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.**



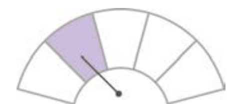
Favorable
U.S. Large Cap Equities



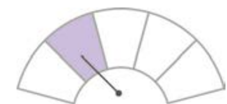
Favorable
U.S. Mid Cap Equities



Neutral
U.S. Small Cap Equities



Unfavorable
Developed Market Ex-U.S. Equities



Unfavorable
Emerging Market Equities

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Timing the market based on an election may miss opportunities

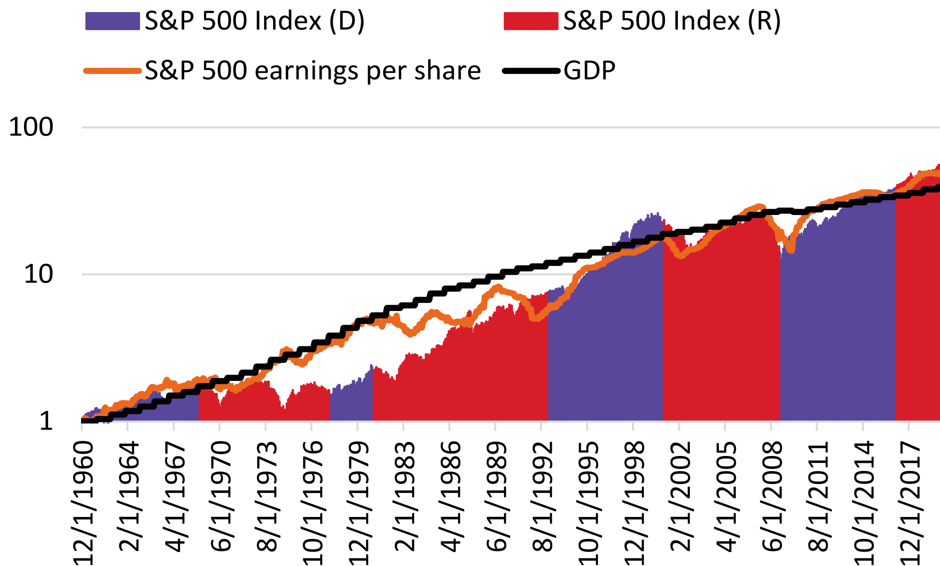
Broadly the market historically has tended to go up through the election cycle. Historically, S&P 500 companies have generated a 9% average return in the 12 months before an election and a 13% average return in the 12 months after —higher than the 8% long-term return average since the 1980s. In the final month before Election Day, the return of global equities and fixed-income markets has been positive.[1]

Politics can bring out strong emotions, but has not historically significantly changed the direction of market movements. This is why we prefer not to time market movements around elections.

The market went up during the terms of presidents from both political parties

Certainly, there are differences between candidates, but the history of the economy and the S&P 500 Index suggest that changes in presidential leadership have made little difference when it comes to long-term investment returns. Chart 2 below illustrates the S&P 500 trended higher historically regardless of which party was president. The long-term drivers of the S&P 500 were the economy and business earnings. We prefer not to allow election predictions and outcomes alone to drive investment decisions, and we favor staying invested for the long haul to meet long-term financial goals. As is often the case with investing, we believe it is important to put aside short-term noise and focus on long-term goals.

Chart 2. S&P 500 Index prices increased during both Republican and Democratic presidencies



Sources: Bloomberg, Wells Fargo Investment Institute, October 2020. Data indexed to 1 in December 1960. Data shown in log scale. S&P 500 Index (R) and S&P 500 Index (D) indicate the periods when Republican (R) and Democratic (D) presidents are in office. GDP: Gross Domestic Product. The chart shows the level of S&P 500 price, earnings, and GDP, as a multiple relative to their respective 1969 level. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.**

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[1] Equity returns measured by the S&P 500 Index, MSCI EAFE Index, and MSCI EM Index. Fixed income returns measured by the Bloomberg Barclays U.S. Aggregate Bond Index.

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Fixed Income

Brian Rehling, CFA
Head of Global Fixed Income Strategy

Fed asks for fiscal stimulus — Lawmakers delay

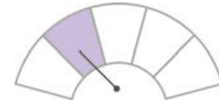
Last week, Fed Chair Powell delivered his latest economic views to a gathering of the National Association for Business Economics. In his words, the economy still has "a long way to go." Underscoring this assessment of the economy was a clear request for more fiscal stimulus. While many lawmakers agree that more stimulus is needed, they are unable to agree on the size and scope of the next stimulus package, and as a result President Trump instructed his team to halt all stimulus negotiations until after the election.

In our opinion, aggressive monetary policies should be coordinated with significant fiscal stimulus to be most effective. Undoubtedly, there will be a future price to pay for the rapid accumulation of government debt, but addressing the current situation must be the immediate focus.

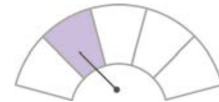
The lack of additional swift fiscal stimulus puts an even greater onus on monetary policies. We expect the Fed will keep rates at low levels for years to come. In such an environment, we favor:

- Corporate and high yield bonds - Moving down the credit spectrum is a viable strategy to increase yield but must be done with caution. We recommend investors use active management when purchasing lower-quality investments.

- Preferred Securities - Investors may also find somewhat higher yields, and longer duration in preferred securities. While higher-yield expectations in preferred securities may be desirable for many investors, this sector can exhibit unusually high volatility during times of stress. Investors should purchase income in preferred securities with a buy-and-hold mentality.



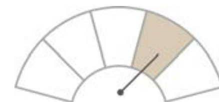
Unfavorable
U.S. Taxable Investment Grade Fixed Income



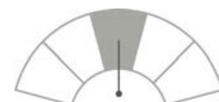
Unfavorable
U.S. Short Term Taxable Fixed Income

Neutral
U.S. Intermediate Term Taxable Fixed Income

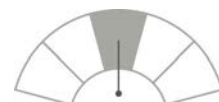
Neutral
U.S. Long Term Taxable Fixed Income



Favorable
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

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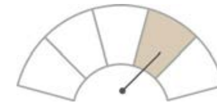
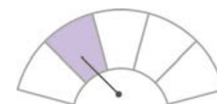
Real Assets

Austin Pickle, CFA
Investment Strategy Analyst

"Those who cannot change their minds cannot change anything." — George Bernard Shaw



Favorable
Commodities



Unfavorable
Private Real Estate

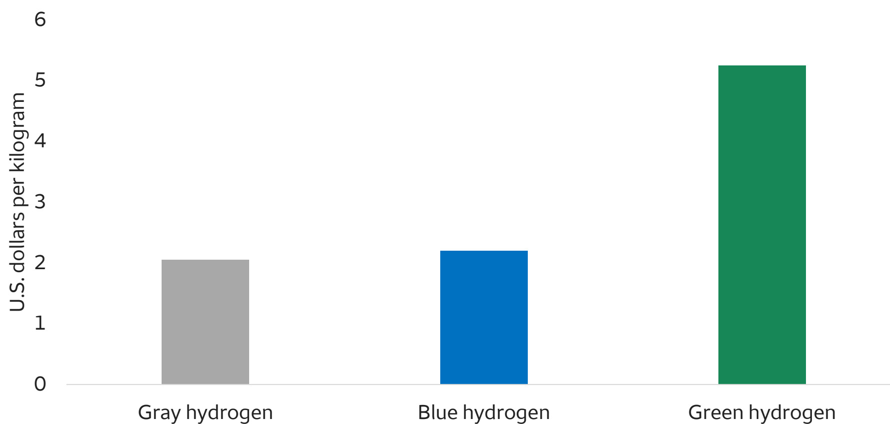
Hydrogen — An intro

In the quest for a cleaner future, solar, wind, and battery technologies have garnered the lion's share of attention, investment, and success over the past decade. The relative newcomer to the energy transition's public eye is hydrogen. This summer, the European Union (EU) announced a "Hydrogen Strategy," Saudi Arabia announced plans for the world's largest green hydrogen plant, and a major airplane manufacturer revealed plans for hydrogen-powered, zero-emission commercial aircrafts. Let's discuss this new kid on the clean energy block.

Hydrogen — the easiest element to remember in chemistry class — emits only water during combustion or when used in a fuel cell to generate electricity. It has the potential to decarbonize a variety of carbon-heavy sectors and could be a major component of the future clean energy landscape. Hydrogen is widely available and heavily used today. Why is it not considered part of the clean energy solution now? The reason is because the vast majority (96%) of today's hydrogen is "gray" (produced from fossil fuels which generates significant CO2 emissions).[2] Hydrogen's other code names include "blue" (where production emissions are captured) and "green" (hydrogen produced from clean energy sources). One of the key issues with transitioning from "gray" to "green" — like so many other things — is cost. The cost to produce "green" hydrogen is currently significantly higher than the cost to produce "gray" (see chart).

Proponents hope that the push to decarbonize our energy future will draw attention and investment to hydrogen's substantial clean energy potential and eventually allow green hydrogen to scale.

Hydrogen production costs



Sources: International Energy Agency (IEA), Wells Fargo Investment Institute, October 7, 2020. Gray hydrogen figure is the average of the min/max cost range of hydrogen produced with natural gas or coal. Blue hydrogen shows the average of the min/max cost range of hydrogen produced with natural gas with carbon capture. Green hydrogen is the average of the min/max cost range of hydrogen produced with renewables.

[2] https://www.worldenergy.org/assets/downloads/WEInsights-Brief-New-Hydrogen-economy-Hype-or-Hope-ExecSum.pdf.

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Alternatives

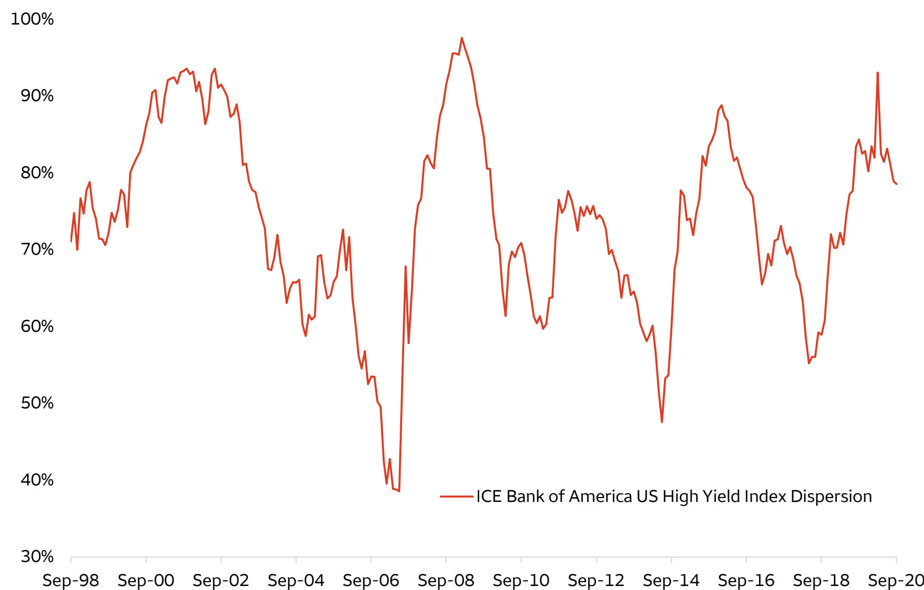
Justin Lenarcic
Senior Global Alternative Investment Strategist

Don't be fooled by the Fed — Credit selection still matters

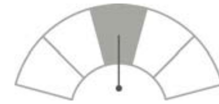
The emergency measures taken by the Fed in the throes of the coronavirus pandemic were enormously important in quelling the dislocation taking place in corporate credit markets. By establishing the Primary and Secondary Market Corporate Credit Facilities in late March, not only was the Fed able to restore capital market activity across a huge swath of corporate debt, but also indirectly helped propel a historic resurgence in debt issuance. Since these facilities were established on March 23, 2020, the Bloomberg Barclays U.S. Corporate High Yield Total Return Index is up over 26%, and there has been over $300 billion of new issuance, nearly equaling total high-yield issuance experienced in the entirety of 2019.[3]

Investors should recognize, however, that even though the headline index has performed strongly since the nadir of the correction, there is still a high degree of credit dispersion. One popular measure of dispersion is provided by Bank of America Merrill Lynch, which tracks the proportion of bonds by face value in the ICE Bank of America U.S. High Yield Index that are marked outside +/- 100 basis points of the overall index level.[4] Currently, nearly 80% of the bonds in the index are marked outside of those parameters, highlighting a very fertile environment for active management and long/short credit strategies.

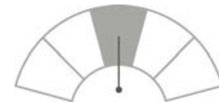
Despite tighter spreads, credit dispersion is still elevated



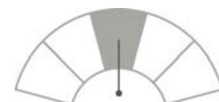
Sources: Bank of America Merrill Lynch. Data as of September 30, 2020. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.**



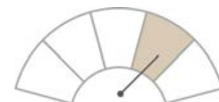
Neutral
Private Equity



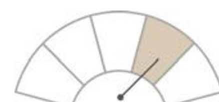
Neutral
Hedge Funds – Macro



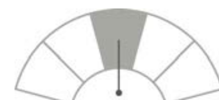
Neutral
Hedge Funds – Event Driven



Favorable
Private Debt



Favorable
Hedge Funds – Equity Hedge



Neutral
Hedge Funds – Relative Value

Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not suitable for all investors and are only open to "accredited" or "qualified" investors within the meaning of U.S. securities laws.

[3] Bloomberg, October 2020.
[4] 100 basis points equal one percent.

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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 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

Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Bloomberg Barclays U.S. Corporate High Yield Index covers the universe of fixed-rate, noninvestment-grade debt.

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

ICE BofA Merrill Lynch U.S. High Yield Index tracks the performance of U.S. dollar denominated, below investment-grade rated corporate debt publicly issued in the U.S. domestic market.

MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, 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 emerging markets.

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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