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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee — November 16, 2020

Global economy spotlight

Gary Schlossberg
Global Strategist

Toward a kinder, gentler foreign economic policy?

The stars appear to be aligned for re-engagement by the U.S. with the rest of the global economy. First, foreign policy provides the best opportunity for presidential action in a likely split government, choking off most tax, spending, and regulatory initiatives requiring legislative action. Anything short of a formal treaty requiring congressional approval is fair game for the president. That includes tariff decisions, international sanctions, and membership in international organizations.

Second, President-elect Biden's stints as chairman of the Senate Foreign Relations Committee give him an appreciation of an active foreign policy's economic and political benefits. Third, world trade's diminished role as a global growth engine leaves it ripe for revitalization at a time when the U.S. and global economies can ill-afford its loss. To that end, the incoming administration seemingly recognizes the support to trade and to overall economic growth from regionalism, multilateralism, and yes, globalization.

Changes to the global economy make it difficult to re-globalize in a way that was done in its heyday of recent decades. In fact, the president-elect's attitude parallels that of President Trump through proposals to re-shore U.S. multinationals' overseas operations where feasible, bringing high-paying, blue-collar jobs with them. Wariness toward complex, just-in-time supply chains was laid bare by the pandemic. Trade tensions with China are not expected to ease materially, underscored by China's recent effort to formalize decoupling with a more inward-looking development strategy in its most recent Five-Year Plan.

However, we believe a return to some form of globalization seems worth the effort, even recognizing today's realities. Re-engaging with U.S. allies provides greater leverage in resolving common grievances with China over intellectual property theft, subsidies, and cyber-security. Even tensions with China could be eased and trade relations improved by coordinating efforts on issues of common interest, like climate change.

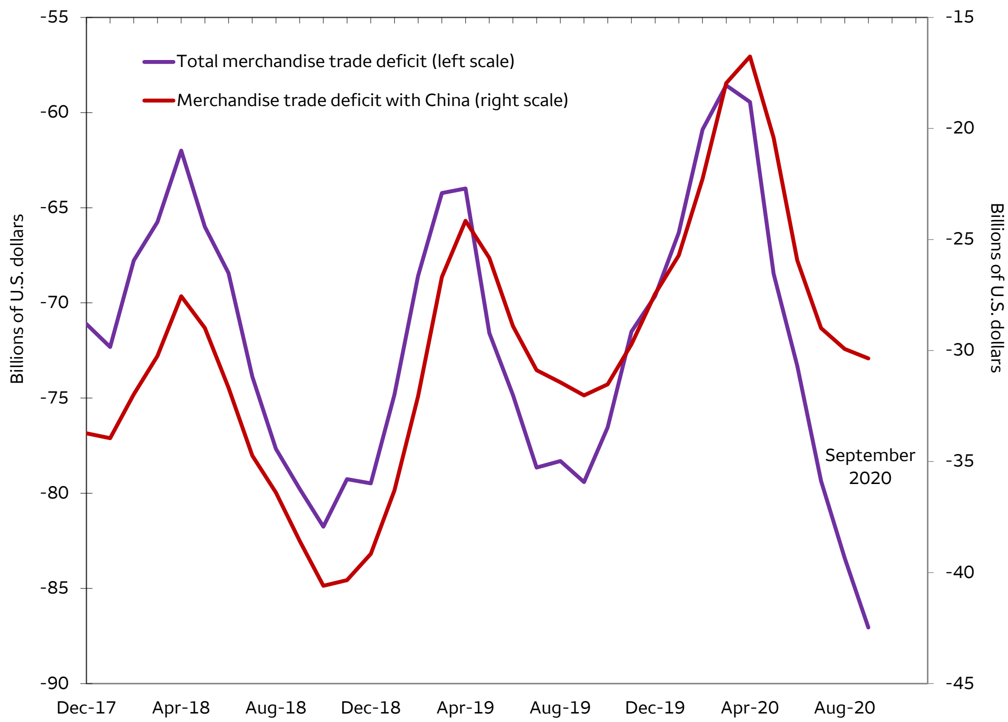
Investment implications of a new globalism

There may be no going back to globalization as rigorous as it was in the past few decades. However, relaxing some of the restraints of the past several years still would have advantages for businesses and investors. At its core, globalization is a key ingredient of decades-long disinflation restraining interest rates and supporting financial asset prices. There's also the efficiency and cost control that comes from relying on low-cost producers abroad for imports of intermediate and finished goods not produced economically in the U.S. More open trade allows U.S. multinationals to take full advantage of their global competitiveness. And any move from confrontation to cooperation — or at least coexistence — provides a more stable, investment-friendly operating environment both for multinationals and domestic-oriented firms.

An added advantage of a more open economy would be to slow or reverse momentum away from the U.S. dollar as the international currency in world trade and finance brought on by the use of U.S. trade and financial sanctions in recent years. The dollar's still-dominant role draws foreign investors toward financing outsized U.S. trade and budget deficits. It also reduces currency risk on U.S. international (often dollar-denominated) transactions while preventing the drift toward a less efficient multi-currency system of trade and finance.

And then there are the results of trade protectionism and, more broadly, policies to bring manufacturing back to the U.S. Tariffs have done little to improve the U.S. trade deficit overall, even as it remains below its peak 2018 reading. That's an indication of imports originally sourced from China now coming from other low-cost areas. Reshoring overseas operations has its limits, too, confined to those higher-margin operations that can accommodate elevated wage costs in the U.S. or where businesses are willing to substitute lower-cost capital for labor. Policies like these also run the risk of disrupting investment by foreign multinationals in the U.S., responsible for an increase of more than 2.3 million mostly higher-paying jobs in the U.S. between the end of the last recession in 2009 and 2017 alone.[1]

Tariffs fail to prevent a worsening U.S. trade deficit



Sources: U.S. Commerce Department, Wells Fargo Investment Institute, November 11, 2020.

[1] Survey of Current Business, Department of Commerce, December 2019.

Equities

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

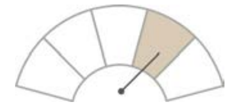
Implications of COVID-19 vaccine on the equity market

This week, news that one of the experimental COVID-19 vaccines in development prevented more than 90% of infections in a study of tens of thousands of subjects lifted markets that had been grappling with a recent wave of infections.

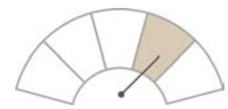
Although early-stage in nature, we do believe news like this points to the light at the end of the tunnel — an eventual global containment of the COVID-19 virus. The containment is potentially a catalyst for a more balanced economic recovery, where companies most impacted by the pandemic and the economic recession could finally see a path toward improved business and upticks in earnings. Not surprisingly, the stock price of these businesses that have been struggling in the past months enjoyed a big positive reversal in the hours after the vaccine news, as shown in the chart.

Looking through these shorter-term dynamics, however, we believe that some of the trends that the pandemic accelerated might continue. These could include the virtual-experience economy, investments in technology, innovation, health care, and supply chain reshoring. Companies that have succeeded relatively more than others during the pandemic may have the potential to retain their leadership over the long run.

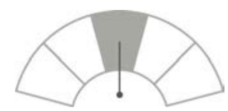
We prefer a diversified approach to equity investing, and we favor U.S. equities, as well as the Information Technology, Consumer Discretionary, Communications Services, and Health Care sectors. We believe these sectors can benefit from a number of market drivers and trends.



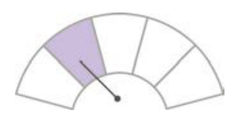
Favorable
U.S. Large Cap Equities



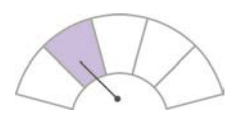
Favorable
U.S. Mid Cap Equities



Neutral
U.S. Small Cap Equities

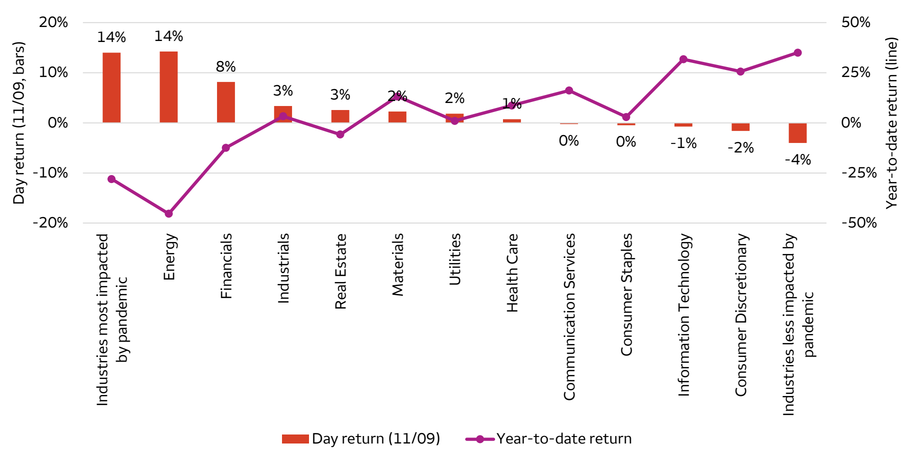


Unfavorable
Developed Market Ex-U.S. Equities



Unfavorable
Emerging Market Equities

Returns of industries and sectors on the November 9 announcement of a potential COVID-19 vaccine



Sources: Wells Fargo Investment Institute, © 2020 - Morningstar. All Rights Reserved[1]. As of November 9, 2020. S&P 500 Sectors and Industries are shown in the chart. We have reflected our view that industries less impacted by pandemic include internet retail, air freight and logistics, application software, homebuilding, and home improvement retail. We have also reflected our view that industries most impacted by the pandemic include airlines, hotels, resorts, cruise, casinos and gaming, apparel accessory and luxury goods.

Fixed Income

Brian Rehling, CFA
Head of Global Fixed Income Strategy

Reiterating high yield

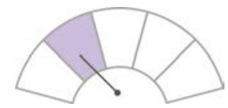
As we began 2020, the economy was growing, COVID-19 was not a global concern, and high-yield spreads were low. On January 13, 2020 the option adjusted spread (OAS) of the Bloomberg Barclays U.S. Corporate High Yield Index hit 315 basis points (100 basis points equal 1 percent), just slightly above the five-year low of 303 basis points. We had an unfavorable recommendation of the high-yield asset class in place at the time, mainly due to what we viewed as an expensive valuation. By March, COVID-19 shutdowns were a reality and investors moved out of risk assets in mass. High-yield spreads hit a high of 1100 basis points on March 23. Since that time, we have upgraded the high-yield class twice and currently hold a favorable recommendation on the asset class.

We have been encouraging investors to move down the credit spectrum and into higher-yielding fixed-income investments. Our first upgrade of high yield to neutral was announced on April 9, 2020. Our second upgrade to favorable was announced on August 7, 2020.

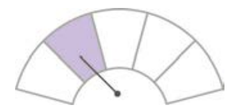
Spreads have come in, currently standing at 412 basis points, and our opinion is that they continue to offer investors value. Our expectation is that yields across the curve will remain at relatively low levels, likely for years. In our opinion, such an extended low-rate environment will continue to drive investors into more yield-oriented product. Moving down the credit spectrum is a viable strategy to increase yield, but it must be done with caution. We recommend investors use active management when purchasing lower-quality investments.

High yield spreads

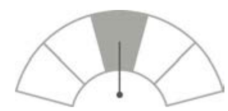
Sources: Bloomberg, Wells Fargo Investment Institute, November 11, 2020. Option-adjusted spread (OAS) is the spread relative to a risk-free interest rate.



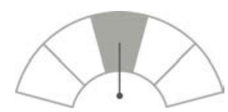
Unfavorable
U.S. Taxable Investment Grade Fixed Income



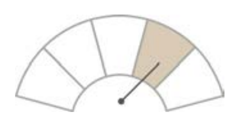
Unfavorable
U.S. Short Term Taxable Fixed Income



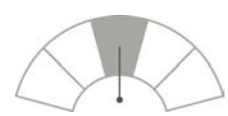
Neutral
U.S. Intermediate Term Taxable Fixed Income



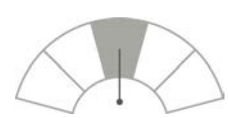
Neutral
U.S. Long Term Taxable Fixed Income



Favorable
High Yield Taxable Fixed Income



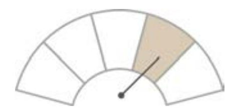
Neutral
Developed Market Ex.-U.S. Fixed Income



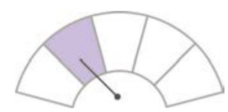
Neutral
Emerging Market Fixed Income

Real Assets

Austin Pickle, CFA
Investment Strategy Analyst



Favorable
Commodities



Unfavorable
Private Real Estate

"The two most powerful warriors are patience and time." — Leo Tolstoy

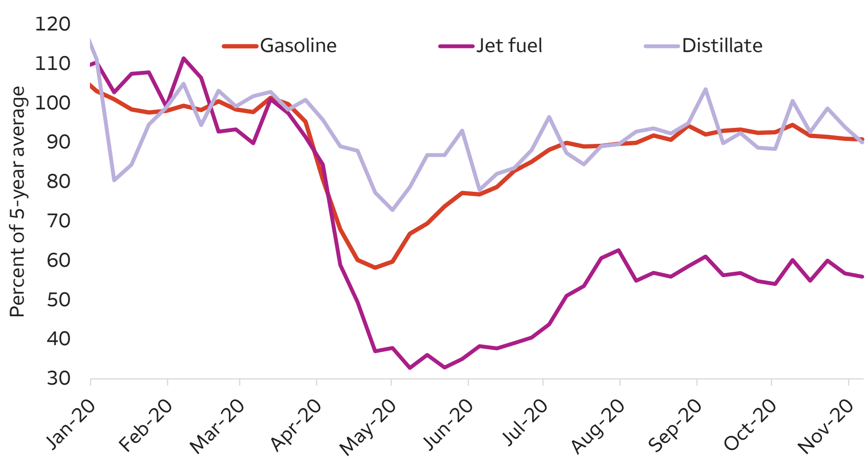
Oil — vaccine relief rally

Better-than-expected results of an experimental COVID-19 vaccine prompted a relief rally across markets last Monday. The relief was perhaps most palpable in the oil markets where the pandemic has decimated demand. Oil prices were up over 10% in just 2 days after the announcement. Since then we have been asked, "Does the vaccine news change our oil forecast?" We answer, "No."

While the promising vaccine announcement provided much-welcomed hope that there is light at the end of the pandemic tunnel, we suspect that patience is in order — patience for a vaccine to be approved, distributed in masse, and for life in general and oil demand to return to normal. We feel there are a number of headwinds that oil markets need to wade through in the meantime: elevated inventory levels, depressed demand (gasoline and diesel demand have plateaued at levels below normal, and jet fuel demand remains severely impaired — see chart), and substantial spare capacity to name a few. These issues will not be resolved overnight, even if an effective vaccine were to be approved today.

Our forecast is — and has been — that prices will be range-bound in the near term as these pandemic-induced issues hold sway before rebounding in the back half of the year as demand, inventories, and spare capacity return to more "normal" levels. This forecast was predicated on the availability of effective COVID-19 therapeutics and/or vaccines. Rather than alter our oil view, the recent vaccine announcement has increased our confidence in it.

U.S. gasoline, jet fuel, and distillate demand in 2020 versus the norm



Sources: Department of Energy, Bloomberg, Wells Fargo Investment Institute. Weekly data: January 3, 2020 – November 6, 2020. Demand data shown is a rolling 4-week average which is then compared to the normal 5-year average.

Alternatives

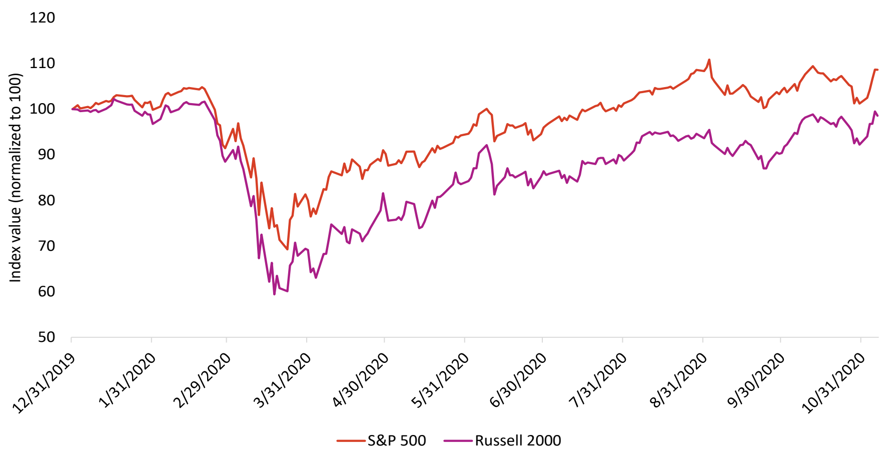
Private equity implications of a bifurcated recovery

The economic recovery underway in the United States has been characterized many ways — with different letters of the alphabet being utilized to characterize its shape. One hypothesis is that the recovery has been "K-shaped," meaning that some parts of the economy have recovered at a rapid rate, while others continue to be negatively affected. For instance, industries such as software and e-commerce have been beneficiaries of the current "stay-at-home" environment, while businesses levered to travel and hospitality have experienced significant headwinds. Different-sized companies have experienced a similarly uneven recovery. The chart below shows that the S&P 500 Index has outperformed the Russell 2000 Index by over 10% year to date.

Within private equity, it appears that sponsors have honed in on small- and middle-market targets in 2020, with median deal value declining 19% compared to 2019.[2] As evidenced by the performance of the public indexes, small and middle market companies have been disproportionately impacted by COVID-19, potentially leading to more attractive valuations and a better opportunity set "down market" for private equity sponsors. Activity appears to be thawing as well, with deal count increasing 48% quarter-over-quarter in Q3 2020 (although still below prior year levels).[3]

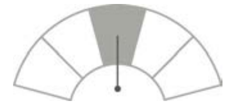
We generally remain neutral on private equity, but favor strategies focused on the middle market with flexible mandates that can take advantage of both sides of the bifurcated recovery — up and down the capital structure. Regardless of the future shape of the recovery, these strategies should be well-positioned to deploy capital and achieve attractive risk-adjusted returns.

The recovery for small-capitalization companies has lagged its larger peers

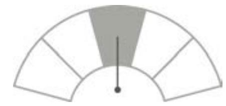


Sources: Bloomberg, November 2020. Returns are year to date through November 6, 2020. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

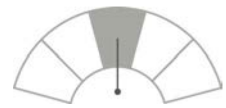
Nick Sprague, CFA
Global Alternative Investment Strategist



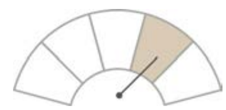
Neutral
Private Equity



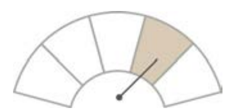
Neutral
Hedge Funds – Macro



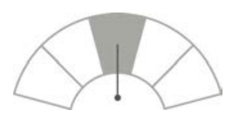
Neutral
Hedge Funds – Event Driven



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 suitable for all investors and are only open to "accredited" or "qualified" investors within the meaning of U.S. securities laws.

[2] Pitchbook Q3 2020 North American M&A Report.
[3] Pitchbook Q3 2020 US PE Breakdown.

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.

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. **Communication** services companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. 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. **Consumer Staples** industries can be significantly affected by competitive pricing particularly with respect to the growth of low-cost emerging market production, government regulation, the performance of the overall economy, interest rates, and consumer confidence. 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. Investing in the **Financial** services companies will subject a investment to adverse economic or regulatory occurrences affecting the sector. 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. **Materials** industries can be significantly affected by the volatility of commodity prices, the exchange rate between foreign currency and the dollar, export/import concerns, worldwide competition, procurement and manufacturing and cost containment issues. **Real estate** investments have special risks, including possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions. 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. **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 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.

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

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.

S&P 500 Communication Services Index comprises those companies included in the S&P 500 that are classified as members of the GICS® communication services sector.

S&P 500 Consumer Staples Index comprises those companies included in the S&P 500 that are classified as members of the GICS® consumer staples sector.

S&P 500 Consumer Discretionary Index comprises those companies included in the S&P 500 that are classified as members of the GICS® consumer discretionary sector.

S&P 500 Energy Index comprises those companies included in the S&P 500 that are classified as members of the GICS® energy sector.

S&P 500 Financials Index comprises those companies included in the S&P 500 that are classified as members of the GICS® financials sector.

S&P 500 Health Care Index comprises those companies included in the S&P 500 that are classified as members of the GICS® health care sector.

S&P 500 Industrials Index comprises those companies included in the S&P 500 that are classified as members of the GICS® industrials sector.

S&P 500 Information Technology Index comprises those companies included in the S&P 500 that are classified as members of the GICS® information technology sector.

S&P 500 Materials Index comprises those companies included in the S&P 500 that are classified as members of the GICS® materials sector.

S&P 500 Real Estate Index comprises those companies included in the index that are classified as members of the GICS® real estate sector.

S&P 500 Utilities Index comprises those companies included in the S&P 500 that are classified as members of the GICS utilities sector.

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