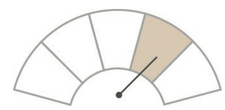
WELLS FARGO
Investment Institute

Investment Strategy

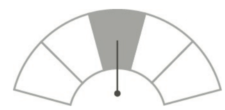
Weekly guidance from our Investment Strategy Committee **November 23, 2021**

Real Assets spotlight

Austin Pickle, CFA
Investment Strategy Analyst



Favorable
Commodities



Neutral
Private Real Estate

'Real' inflation hedges

"It is health that is real wealth and not pieces of gold and silver." — Mahatma Gandhi

Inflation has become a hot topic and major investor concern of late. We have written a number of detailed pieces as a result, and encourage readers to take the time to review them to understand our take on the most pressing questions. Today we drill down into real assets and how they have performed during past rising inflationary environments.

Real assets are those that derive their value from assets that you can see, touch, and taste — with the two major components being commodities and real estate. Oftentimes, real asset price increases are what fuels inflation in the first place, so we believe investing in these assets can work as a natural hedge against rising costs in our everyday lives. But is this assertion borne out in the data and how do real assets compare with traditional stocks and bonds?

To answer these questions, we measured returns during past rising inflationary environments. Table 1 includes return data for commodities and Table 2 does the same for REITs (real estate investment trusts). We include stock and bond returns in each table for comparison.

Table 1. Commodity performance in rising inflationary environments

Dates (CPI trough to peak)	Gold	Oil	Agriculture	Energy	Industrial Metals	Precious Metals	Commodities	Stocks	Bonds
1972-1974 (2.7-12.3)	196.1	N/A	441.5	N/A	N/A	N/A	326.4	-29.9	N/A
1976-1980 (4.9-14.8)	267.7	N/A	40.1	N/A	N/A	310.3	130.7	12.5	-2.8
1986-1990 (1.1-6.3)	-2.4	96.4	35.3	280.0	N/A	-11.7	99.6	43.1	33.3
1998-2000 (1.4-3.8)	-7.3	72.3	-29.9	30.9	9.9	-9.3	2.0	39.7	8.5
2002-2005 (1.1-4.7)	47.8	146.6	5.8	233.6	83.1	49.2	89.1	31.5	17.5
2006-2008 (1.3-5.6)	51.7	111.3	50.7	40.4	-4.4	46.6	31.2	-4.8	8.7
2009-2011 (-2.1-3.9)	70.2	14.0	30.3	-25.9	5.7	81.3	11.1	19.8	16.2
2015-2018 (-0.2-2.9)	3.8	15.3	-18.2	-29.9	0.3	-1.0	-15.7	44.5	3.9
2020-2021 (0.1-6.2)	3.1	135.5	69.6	94.6	70.2	4.6	62.8	54.5	0.3
Average return	**70.1**	**84.5**	**69.5**	**89.1**	**27.5**	**58.8**	**81.9**	**23.4**	**10.7**
% of time positive return	**78%**	**100%**	**78%**	**71%**	**83%**	**63%**	**89%**	**78%**	**88%**
% of time outperform bonds	**67%**	**86%**	**67%**	**71%**	**50%**	**63%**	**67%**	**78%**	**n/a**
% of time outperform stocks	**56%**	**71%**	**56%**	**57%**	**50%**	**50%**	**67%**	**n/a**	**25%**

Sources: Bloomberg, Wells Fargo Investment Institute, October 31, 2021. Percent of time positive is the number of positive returns divided by the total measured. Gold represented by the spot price. Oil represented by the front month futures price of West Texas Intermediate oil. Commodity sectors represented by the total return Bloomberg Commodity subindexes for Agriculture, Energy, Industrial Metals and Precious Metals. Commodities represented by the total return Bloomberg Commodity Index. Stocks represented by the total return S&P 500 Index. Bonds represented by the total return Bloomberg U.S. Aggregate Bond Index. An index is not managed and not available for direct investment. This information is for illustrative purposes only. Results may not represent the experience of individual investors or any actual investment. **Past performance is no guarantee of future results.**

Table 2. REIT performance in rising inflationary environments

Dates (CPI trough to peak)	Health Care REITs	Industrial REITs	Lodging REITs	Office REITs	Residential REITs	Retail REITs	Self Storage REITs	REITs	Stocks	Bonds
1998-2000 (1.4-3.8)	-41.5	-6.1	-56.4	-6.6	2.0	-18.1	-16.4	-19.1	39.7	8.5
2002-2005 (1.1-4.7)	76.4	87.1	44.7	62.5	61.9	127.5	100.7	82.0	31.5	17.5
2006-2008 (1.3-5.6)	21.8	-18.4	-41.8	-12.1	-16.2	-18.4	-10.0	-13.4	-4.8	8.7
2009-2011 (-2.1-3.9)	42.0	32.6	30.4	46.8	112.3	74.4	67.8	58.6	19.8	16.2
2015-2018 (-0.2-2.9)	5.5	80.6	19.6	17.6	29.0	2.5	38.0	25.1	44.5	3.9
2020-2021 (0.1-6.2)	41.0	58.3	63.1	32.2	60.0	91.2	90.4	45.8	54.5	0.3
Average return	**24.2**	**39.0**	**9.9**	**23.4**	**41.5**	**43.2**	**45.1**	**29.9**	**30.9**	**9.2**
% of time positive return	**83%**	**67%**	**67%**	**67%**	**83%**	**67%**	**67%**	**67%**	**83%**	**100%**
% of time outperform bonds	**83%**	**67%**	**67%**	**67%**	**67%**	**50%**	**67%**	**67%**	**83%**	**n/a**
% of time outperform stocks	**50%**	**67%**	**50%**	**33%**	**50%**	**50%**	**50%**	**33%**	**n/a**	**17%**

Sources: Bloomberg, Wells Fargo Investment Institute, October 31, 2021. Percent of time positive is the number of positive returns divided by the total measured. REIT subsectors represented by the respective total return FTSE NAREIT REIT subsector indexes. REITs represented by the total return FTSE NAREIT All Equity REITs Index. Stocks represented by the total return S&P 500 Index. Bonds represented by the total return Bloomberg U.S. Aggregate Bond Index. An index is not managed and not available for direct investment. This information is for illustrative purposes only. Results may not represent the experience of individual investors or any actual investment. **Past performance is no guarantee of future results.**

Table 1 confirms that the commodity complex has overwhelmingly performed well during these historical periods. The benchmark commodity basket had positive returns nearly 90% of the time, and even outdid both stocks and bonds two-thirds of the time (purple outline in Table 1). Interestingly, the commodity that most everyone associates with an inflation hedge, gold, was not the standout performer. That designation goes to oil. Yet, each commodity sector performed admirably and outpaced stocks and bonds at least half of the time.

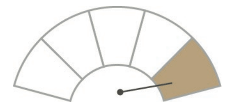
The average REIT (purple outline in Table 2) generally posted positive returns during these periods as well, and, more often than not, outperformed bonds but underperformed stocks two-thirds of the time. Magnitude and consistency of returns varied across property types, but generally those REIT sectors with shorter leases (for example, self-storage and residential), and those more closely tied to an accelerating economy (industrial and retail) outperformed.

This study makes clear that real assets have lived up to their billing and historically have performed well as an inflation hedge. Of course, past performance is not a guarantee of future results. Keep in mind though, that even assets that have generally outpaced inflation in the past, have also experienced sharp underperformance at times, and vice versa. In fact, commodities, REITs, and stocks all have experienced one or more double-digit drawdowns during past inflation spikes. This should highlight that building a diversified portfolio can be a prudent means to financial success rather than relying too heavily on a few assets. We want to be able to see the financial forest and the trees.

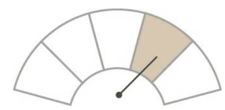
We remain favorable on commodities and neutral on REITs.

Equities

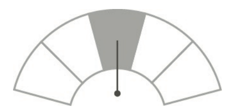
Chris Haverland, CFA
Global Equity Strategist



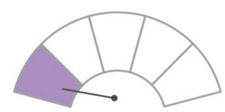
Most favorable
U.S. Large Cap Equities



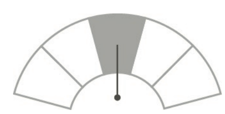
Favorable
U.S. Mid Cap Equities



Neutral
U.S. Small Cap Equities



Most unfavorable
Developed Market
Ex-U.S. Equities



Neutral
Emerging Market Equities

Creating balance between cyclical and growth sectors

While our forecast is for above-average economic and earnings growth through 2022, we expect the pace of growth to slow. This environment has the potential to benefit both cyclical and growth-oriented sectors, suggesting a more balanced approach to our sector guidance. Therefore, we recently upgraded the Information Technology sector from neutral to favorable and downgraded the Energy sector from favorable to neutral.

If the cycle matures and economic growth begins to normalize as we expect, secular growth sectors, such as Information Technology, typically take a leadership role. Quality is a key component of our upgrade, with Information Technology leading all sectors in quality metrics such as return on equity and (low) leverage. While valuations are above historic averages, we believe investors likely will continue to pay a premium for consistently growing, high-quality companies insulated from cyclical slowdowns.

The Energy sector likely will be supported by higher oil prices in 2022. However, after a strong run in 2021, we believe it is prudent to take some profits while maintaining a full sector weighting. Fundamentals remain supportive with elevated earnings growth prospects, improving earnings revisions, and still reasonable valuations. These positive attributes are balanced with potential regulatory risk, sensitivity to slowing global growth, headwinds from green energy initiatives, a strengthening U.S. dollar, and relatively high leverage.

We now have favorable ratings on two growth sectors (Communication Services and Information Technology) and two cyclical sectors (Financials and Industrials). Even though the cycle is maturing, we believe it is too early to get defensive in sector positioning, and maintain our most unfavorable guidance for Consumer Staples and Utilities.

Wells Fargo Investment Institute sector guidance

Sector	S&P 500 weight (%)	WFII Guidance Ranges	Guidance
Communications Services	10.7%	+2% to +4%	Favorable
Consumer Discretionary	13.2%	-2% to +2%	Neutral
Consumer Staples	5.6%	-4% to -6%	Most unfavorable
Energy	2.8%	-2% to +2%	Neutral
Financials	11.1%	+2% to +4%	Favorable
Health Care	12.8%	-2% to +2%	Neutral
Industrials	8.0%	+2% to +4%	Favorable
Information Technology	28.3%	+2% to +4%	Favorable
Materials	2.5%	-2% to +2%	Neutral
Real Estate	2.6%	-2% to +2%	Neutral
Utilities	2.4%	-2% to -3%	Most unfavorable

Sources: Wells Fargo Investment Institute, Bloomberg, 11/15/2021.

Fixed Income

The Fed transition

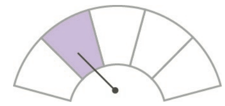
The Federal Reserve (Fed) is entering a transition period of both monetary policy and membership. We are anticipating an announcement from the White House at any time on the choice for Fed Chair. At the same time, the Fed has begun reducing asset purchases with a goal of ending balance sheet expansion by midsummer 2022. We believe this period of Fed transition has been well-digested by fixed-income markets but it does increase the uncertainty going forward.

If the White House transitions away from Jerome Powell as Fed Chair, we expect that the pick would lean more dovish but remain within the mainstream of current Fed thinking. The initial reaction from fixed-income markets to such a nomination would likely be to steepen the curve, pushing long-term rates a bit higher in the near-term. Regardless of the selection, we think that inflation data will dictate Fed monetary policy in 2022.

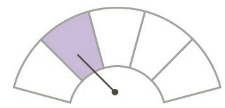
We recently increased our year-end 2022 interest rate targets. Our expectation is that we will see a single rate increase in 2022 as the Fed reacts to the competing forces of growth and inflation. Our 2022 year-end federal funds rate target is 0.25%-0.50%. In addition, we increased both our year-end 2022 10-year and 30-year rate targets by 0.25%. The 10-year Treasury yield target range for year-end 2022 is 2.00%-2.50% and the 30-year Treasury yield target range is 2.50%-3.00%.

In the context of a continuing economic recovery and still historically low yields, we continue to favor equities over fixed income. Given our expectation for modestly higher rates in 2022 and the potential for a period of increased Fed uncertainty, we reiterate our guidance to position fixed-income portfolios defensively.

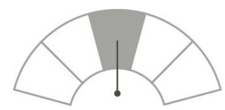
Brian Rehling, CFA
Head of Global Fixed Income Strategy



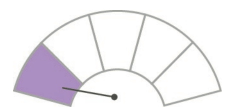
Unfavorable
U.S. Taxable Investment Grade Fixed Income



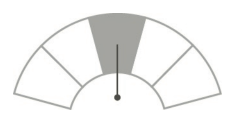
Unfavorable
U.S. Short Term Taxable Fixed Income



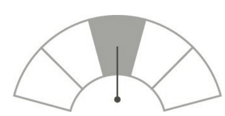
Neutral
U.S. Intermediate Term Taxable Fixed Income



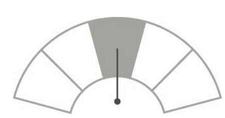
Most unfavorable
U.S. Long Term Taxable Fixed Income



Neutral
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

Alternatives

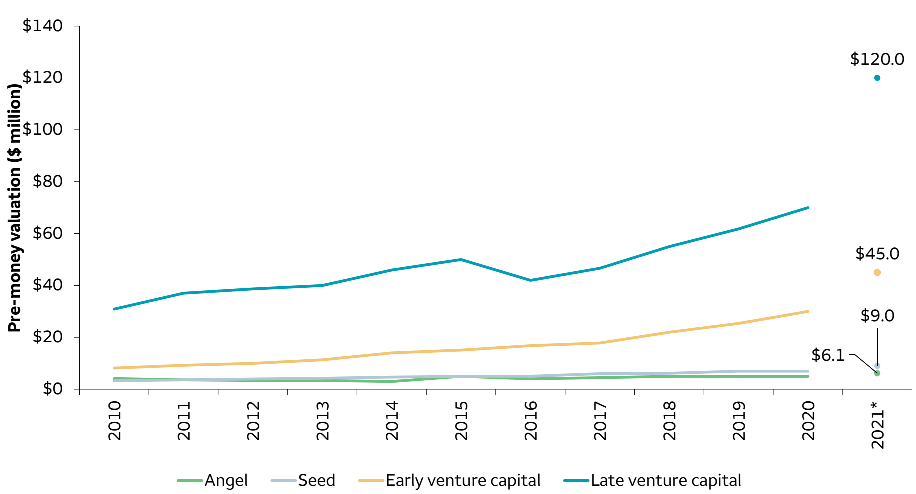
Are venture capital valuations a concern?

Despite the eye-popping increase in pre-money valuations seen below, we still like the idea of investing in ideas (venture capital) over mature companies (large cap buyout) heading into 2022. As seen below, venture capital investing is generally divided into four stages: (1) angel, (2) seed, (3) early venture capital, and (4) late venture capital. Pre-money valuations for both angel and seed stages are consistent over the last decade, and this year is no exception. However, we can see a notable increase in both early- and late-stage valuations, especially in 2021, where late-stage venture capital valuations are up over 70% this year. This raises two key questions: what is driving this surge in pre-money valuations, and are they simply too high?

The environment we find ourselves in is dominated by technological innovation. Multiple industries including transportation, energy, financials, and health care are being rapidly disrupted. The digitalization of the global economy coupled with undercurrents of energy transition, genomics, and decentralized finance (DeFi) are producing seemingly endless possibilities. The implications of this new era in innovation are not only driving investor interest, but also valuations.

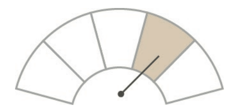
As to whether or not valuations reflect true potential or pie-in-the-sky assumptions, unfortunately our answer is, “it depends.” Venture capital investing is fraught with risk, and many investments fail to live up to expectations. But those that do can be tremendously impactful within a portfolio for qualified investors. Yes, valuations are high, but not high enough for us to be concerned.

Late stage venture capital valuations are up over 70% in 2021

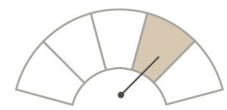


Sources: Pitchbook, Wells Fargo Investment Institute. Data as of September 30, 2021. See end of the report for methodology and definitions.

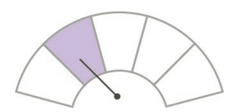
Justin Lenarcic, CAIA
Senior Global Alternative Investment Strategist



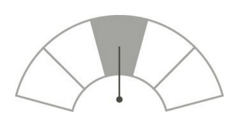
Favorable
Hedge Funds – Relative Value



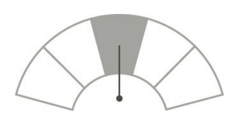
Favorable
Hedge Funds – Macro



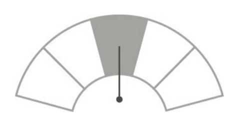
Unfavorable
Hedge Funds – Event Driven



Neutral
Hedge Funds – Equity Hedge



Neutral
Private Equity



Neutral
Private Debt

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

Risk Considerations

Forecasts, targets and estimates are based on certain assumptions and on our current 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. 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. Investing in physical commodities, such as **gold**, exposes a portfolio to other risk considerations such as potentially severe price fluctuations over short periods of time and storage costs that exceed the custodial and/or brokerage costs associated with the portfolio's other holdings. Products that concentrate their investments in the gold industry increase their vulnerability to international, economic, monetary and political developments affecting the industry. **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.

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.

Methodology and definitions for chart on page 6:

We include equity investments into startup companies from an outside source. Investment does not necessarily have to be taken from an institutional investor. This can include investment from individual angel investors, angel groups, seed funds, VC firms, corporate venture firms, corporate investors, and institutions, among others. Investments received as part of an accelerator program are not included; however, if the accelerator continues to invest in follow-on rounds, those further financings are included. All financings are of companies headquartered in the US, with any reference to "ecosystem" defined as the combined statistical area (CSA). We include deals that include partial debt and equity.

Angel investors provide financial backing for small startups or entrepreneurs, typically in exchange for ownership equity in the company. The funds that angel investors provide may be a one-time investment to help the business get off the ground or an ongoing injection to support and carry the company through its difficult early stages.

Seed capital is a form of securities offering in which an investor invests capital in a startup company in exchange for an equity stake or convertible note stake in the company.

Early Venture Capital is intended for companies in the development phase. This stage of financing is usually larger in sum than the seed stage because new businesses need more capital to start operations once they have a viable product or service.

Late Venture Capital is for more mature companies that may or may not be profitable yet, but have proven growth and are generating revenue.

Definitions

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

Bloomberg Commodity Index is comprised of 23 exchange-traded futures on physical commodities weighted to account for economic significance and market liquidity. No related group of commodities (e.g., energy, precious metals, livestock and grains) may constitute more than 33 percent of the index as of the annual reweighting of the components. No single commodity may constitute more than 15 percent of the index.

Bloomberg Agriculture Subindex is a commodity group subindex of the Bloomberg Commodity Index. It is composed of futures contracts on coffee, corn, cotton, soybeans, soybean oil, soybean meal, sugar and wheat. It reflects the return of the underlying commodity futures and is quoted in USD.

Bloomberg Energy Subindex is a commodity group subindex of the Bloomberg Commodity Index. It is composed of futures contracts on crude oil, ultra-low sulfur diesel, unleaded gasoline, low sulphur gasoil, and natural gas. It reflects the return of the underlying commodity futures and is quoted in USD.

Bloomberg Industrial Metals Subindex is a commodity group subindex of the Bloomberg Commodity Index. It is composed of futures contracts on aluminum, copper, nickel and zinc. It reflects the return of the underlying commodity futures and is quoted in USD.

Bloomberg Precious Metals Subindex is a commodity group subindex of the Bloomberg Commodity Index. It is composed of futures contracts on gold and silver. It reflects the return of the underlying commodity futures and is quoted in USD.

FTSE NAREIT All Equity REITs Index is designed to track the performance of REITs representing equity interests in (as opposed to mortgages on) properties. It represents all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets, other than mortgages secured by real property that also meet minimum size and liquidity criteria.

FTSE NAREIT Health Care Index is a free float adjusted market cap weighted index that includes all tax qualified health care REITs listed in the NYSE, AMEX, and NASDAQ National Market. Total return accounts for dividends reinvested in the index.

FTSE NAREIT Industrial Index is a free float adjusted market cap weighted index that includes all tax qualified industrial REITs listed in the NYSE, AMEX, and NASDAQ National Market. Total return accounts for dividends reinvested in the index.

FTSE NAREIT Lodging Index is a free float adjusted market cap weighted index that includes all tax qualified lodging/resorts REITs listed in the NYSE, AMEX, and NASDAQ National Market. Total return accounts for dividends reinvested in the index.

FTSE NAREIT Office Index is a free float adjusted market cap weighted index that includes all tax qualified office REITs listed in the NYSE, AMEX, and NASDAQ National Market. Total return accounts for dividends reinvested in the index.

FTSE NAREIT Residential Index is a free float adjusted market cap weighted index that includes all tax qualified residential REITs listed in the NYSE, AMEX, and NASDAQ National Market. Total return accounts for dividends reinvested in the index.

FTSE NAREIT Retail Index is a free float adjusted market cap weighted index that includes all tax qualified retail REITs listed in the NYSE, AMEX, and NASDAQ National Market. Total return accounts for dividends reinvested in the index.

FTSE NAREIT Self Storage Index is a free float adjusted market cap weighted index that includes all tax qualified self storage REITs listed in the NYSE, AMEX, and NASDAQ National Market. Total return accounts for dividends reinvested in the index. An index is unmanaged and not available for direct investment.

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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