Q&A—Where Markets May Go From Here

Key takeaways

- The recent run to levels above our year-end 2020 targets leaves equity markets trading close to what we believe to be fair value.
- While monetary and fiscal stimulus have been the main drivers of the market’s rebound, we believe further gains will be harder to achieve.

What it may mean for investors

- Investors should continue to maintain allocations in line with their investment plan and focus on higher quality areas, such as U.S. large- and mid-cap equities, and the Information Technology, Communication Services, Health Care, Consumer Discretionary, and Financials sectors.

What should investors do about equity markets trading above our year-end 2020 forecast targets?

Our year-end 2020 target prices have been surpassed, and we would anticipate more limited upside going forward, along with a bumpier road in the months ahead. While we expect the economy to improve in the second half of 2020 from the second-quarter shutdown, we believe a full recovery will prove long, slow, and uneven. This aligns with our tactical guidance to be overweight commodities and fixed income and underweight on equities. For investors with equity allocations above recommendations, now may be a good time to consider trimming exposure, especially in areas we disfavor, such as U.S. small-cap, developed-market, and emerging-market equities and the Energy, Materials, Industrials, and Real Estate sectors.
Do we still expect a re-test of March lows? And if so, do we think investors should consider generating cash at these levels to potentially take advantage of an expected pullback?

Recent market action continues to track the past three recessions very closely in many ways. The S&P 500 Index rebounded 36% between March 23 and May 20 (its recent high). In the initial rebound rallies associated with the past three recessions, the S&P 500 rallied back 34% on average. Market breadth, while extremely narrow early in the current rebound rally, is slowly but consistently improving. We will need to see durability of expanding market breadth if markets are to move meaningfully higher from here.

While the immense amount of liquidity infused by the Federal Reserve (Fed), and the possibility of further fiscal measures, make a full retest of the March 23 lows (2192) less probable, we also take note of the expanding divergence between the market’s V-shaped recovery and the U.S. economy’s slower, more sanguine recovery path. Investors should prepare for equity markets that trade in a wide band without making much progress until there is greater clarity on COVID-19 related economic impact. Currently, we are closer to the upper end of that trading range, in our view, and we believe investors should rebalance back to recommended allocations, while preparing for the next bout of price weakness. Wells Fargo Investment Institute has a neutral rating on cash and would not recommend holding large allocations to low-yielding cash. We would favor Intermediate Fixed Income and Commodities as destinations for excess equity allocations.

What factors do we expect to drive the market’s direction going forward in the near term?

- **Fiscal and monetary stimulus.** The size of stimulus and the degree of difficulty getting more support from Congress and the Fed will be important for the markets, in our opinion.

- **Reopening progression.** Equity markets are beginning to build in positive assumptions for a “return to normal”. Data and activity levels would need to confirm this in coming weeks.

- **Vaccine hopes.** Swift moves to the upside and disappointments to the downside on daily vaccine breakthroughs may be the norm for the near term as scientists race to accelerate testing and markets scrutinize plausible outcomes.

- **Signs of economic activity bottoming out.** High-frequency data denoting any kind of near-term trends or themes in the data are watched more closely than ever before.

- **Expectations for a big earnings rebound in 2021.** We believe earnings estimates for next year remain too high and need to come down—these potential revisions are not yet priced in.

What obstacles must be overcome in the intermediate term to continue the recent rally?

- Tighter lending standards

- 36 million unemployed workers need to be able to seamlessly return to work

- A growing spotlight on the November presidential and Congressional elections—with many key risks still looming large

- Supply and demand questions: Simply reopening business—a supply push—does not ensure consumers return at the same consumption and confidence level—a demand pull.
How can we be favorable on U.S. large and mid-cap equities, while current index values are above our 2020 year-end targets?

As mentioned above, we are currently underweight equities as an asset group, due to our expectations for further volatility in markets. Within the equities asset group, however, we favor higher quality U.S. large- and mid-cap equities and the Information Technology, Communication Services, Consumer Discretionary, Financials, and Health Care sectors.

Do we still favor the U.S. over international markets?

Yes. Our global macro team believes that the U.S. economy was the strongest global economy entering this recession and that it will emerge as the strongest coming out. Therefore, we believe the best opportunities remain in the U.S. at this point. Our equity strategy work suggests that sector composition and earnings prospects also favor U.S. large-cap equities over international developed and emerging market peers.

Why is Growth outperforming Value by so much?

Growth-style investments tend to have heavier concentrations in Information Technology, and Value-style investments tend to have higher concentrations to Financials. The outperformance of Information Technology stocks relative to Financials has been the main driver of Growth besting Value through this crisis. While we favor both sectors, we prefer Information Technology over Financials and believe Growth may continue to outperform over a tactical (6- to 18-month) horizon.

Why do we still like Financials?

The Financials sector has struggled due to concerns about a flat yield curve, which constrains the profitability of financial companies, and the possibility of a sharp rise in loan-related losses, which accompany recessions. But we believe Financials’ cheap valuations discount both of these issues. Interestingly, the yield curve has already started to steepen, thanks to the Fed’s rate cuts. The fast actions by the Fed and Congress may help soften the blow from an economic downturn, and the recent improvement in the absolute performance of Financials may suggest a bottom is near.
Risks Considerations

Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change. Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns.

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 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. There are no guarantees that growth or value stocks will increase in value or that their intrinsic values will eventually be recognized by the overall market. The return and principal value of stocks fluctuate with changes in market conditions. The growth and value type of investing tends to shift in and out of favor. 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.

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.

Definitions

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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