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Five Ways the Pandemic Changes the Investment Landscape

A new priority for safety and flexibility will shape opportunities and risks.

Deeper analysis of investment trends and topics

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Key takeaways

- Our 2020 Midyear Outlook report introduced five secular themes that we believe the COVID-19 pandemic created, accelerated, or permanently altered.
- This report focuses on five main ways in which investment opportunities may arise. We believe that some of these opportunities will come from preexisting trends that COVID-19 has accelerated; still others will come from new trends.
- New risks also come with these five themes, but we offer some systematic ways to think about risk and reward, and we recall that resilience can be a useful investment tool.

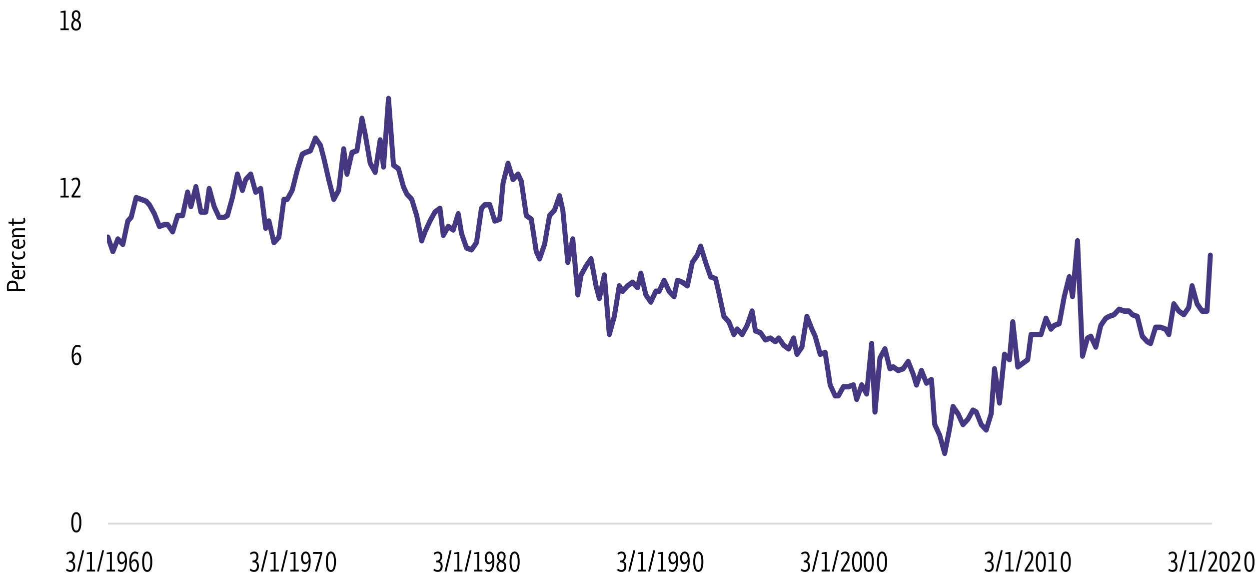
Our 2020 Midyear Outlook report introduced five secular themes that we believe the COVID-19 pandemic created, accelerated, or permanently altered. This report deepens our analysis of these themes—and their impacts on the investment markets and economy—along with important stakeholder implications. While these themes admittedly are still evolving, our conviction is that they will dictate new factors that investors may want to consider as potential opportunities emerge into mid-decade.

Theme 1—Consumers will likely become more frugal, choosy, and home-oriented

The pandemic will likely favor more saving: In a mid-April 2020, Pew Research Center study, only about 23% of respondents had cash savings to cover three months of emergency expenses; roughly 32% of respondents said they would be unable to pay their bills that month.[1] In general, U.S. household saving is far below its pre-1975 level, although the rate has started to rise again in recent quarters (Chart 1).

A generational facet appears in another study, in which 75% of Americans surveyed said they felt financial regret.[2] Yet, the silent generation (over age 85) and older Baby Boomers (ages 65-73) felt little or no financial regret. The difference suggests that those who, directly or through their family history, experienced economic hardship and wartime rationing already were more frugal. Today's pandemic is not a global economic depression or a world war, but the cumulative uncertainty of two major economic crises in 12 years is likely to lead younger generations to prioritize frugality, and it may reinforce a preference for meaningful experiences over acquiring goods.

Chart 1. U.S. personal saving as a percent of disposable personal income



Sources: Bloomberg and Wells Fargo Investment Institute, June 2020. Quarterly averages of monthly data, January 1959 – March 2020.

Consumers will likely become more frugal and choosier: As consumers become more frugal, we believe that greater consumer selectivity will follow. This would include an enduring attachment to consumption-at-home trends, which were already in place but that the lockdown accelerated. Digital fulfillment models and curbside pickup have done years' worth of expansion in a few weeks. Grocery e-commerce penetration was previously 3%; it was already roughly 8-10% through April.[3] These trends may show persistence if, as we expect, consumer habits will be sticky and difficult to alter. One survey indicates that consumers intend to keep these new habits, including 56% for buying online and 45% for grocery delivery.[4]

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[1] "About Half of Lower-Income Americans Report Household Job or Wage Loss Due to COVID-19", Pew Research Center, April 21, 2020, by Kim Parker, Juliana Horowitz, and Tanya Arditi.
[2] "Lack of Emergency Savings Among Biggest Financial Regrets", Plansponsor, May 29, 2020, by John Manganaro.
[3] "Redefining Value and Affordability in Retail", McKinsey, by Rich Fox, Maura Goldrick, Carson Green, Aaron Rettaliata, June 2020.
[4] "Adapting to the Next Normal in Retail", McKinsey, by Holly Briedis, Anne Kronschnabl, Alex Rodriguez, and Kelly Ungerman, May 2020.

A sampling of other buy-from-home trends includes:[5]

- **A rise in streaming entertainment and gaming**: These activities grew substantially during the lockdown, and these trends may deepen as online content grows and some workers find themselves at home for longer.
- **An increase in online learning and digital collaboration tools**: The large increase in unemployment appears to have delivered strong interest in online learning, particularly reskilling for adults, along with demand for tools that enable teams of workers to maintain their collaboration.
- **A transition to exercising at home**: Home exercise options and equipment have become mainstream since the pandemic.[6]
- **Increased use of telemedicine and other remote health care options**: Telemedicine allows fast check-ins and online or audio consultations for non-urgent issues. Telehealth also is quickly spreading as an option for lifestyle coaching, chronic condition management, and physical and behavioral therapy.[7]

Choosier consumers should challenge businesses to broaden product offerings. For example, grocers could expand private-label brands for price-sensitive shoppers, and they could expand higher-end products that help consumers to substitute for dining out. New technology applications are expected as well. Instead of trying to predict exactly how consumer demand may change, businesses likely will upgrade their analytical capabilities to track how purchases respond to changes in price and perceived value. Even if economic conditions eventually worsen, an analytics team should help to reveal customer buying patterns and allow timely marketing and product adjustments.

Investment implications

Consumer trends point to increased saving and more selectivity. This is not unusual during and after a recession. But the broad set of options available in online services from food and dining out to entertainment favors firms that have well-developed internet purchase options. In-person shopping should remain, but successful merchants may split their sales models between efficient online ordering and strong customer service for in-store shoppers. As consumers rely on online consumption more, faster and more efficient internet connections and data storage will likely dominate. We believe these trends favor opportunities in the Information Technology, Communication Services, and Consumer Discretionary sectors. All of these sectors are among our current tactical preferences.

Theme 2—Businesses will reassess how to add flexibility while maintaining efficiency

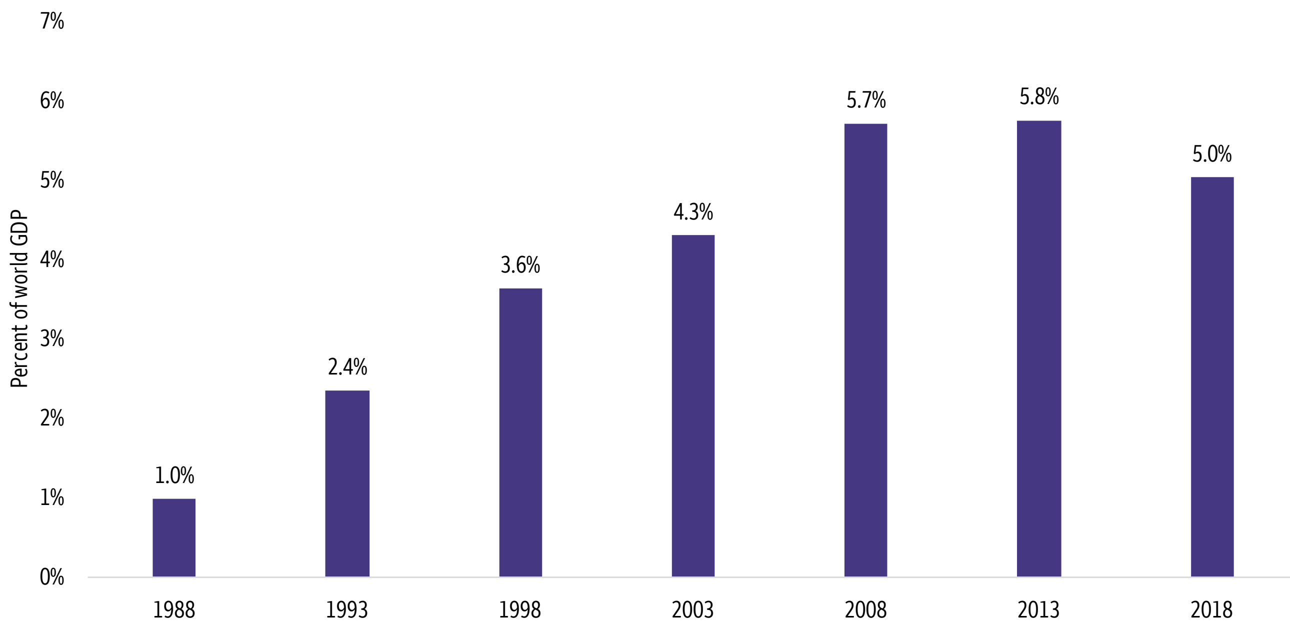
The management challenge—build flexibility but stay competitive: Following the worldwide economic lockdown, businesses are reassessing how to continue operating in the event that workers or supplies abruptly become unavailable. Managers can increase flexibility by adding or expanding technology that helps the company to use less office space, reduce travel, and automate customer service, marketing, and supply chain processes. Some firms seeking better control of their production and distribution may choose more vertical operations, such as those of e-commerce firms that take orders and then deliver packages themselves.

Some jobs may disappear. But, on balance, we expect more—not fewer—jobs that will demand new skills and flexibility. Restaurant waitstaff may manage pickup windows instead of taking orders from dine-in customers, for instance. Instead of production-line jobs, there may be more positions in logistics, warehousing, programming, and data analytics. Cyber risks and regulatory compliance also should open new positions.

[5] See, Laura Chau: "Six consumer tech trends to watch in a post-COVID world", Canaan Partners, April 28, 2020; and "What New Consumer Habits Will Stick Post-Covid-19? China Offers Clues", Forbes, May 19, 2020.
[6] "Americans bulk up on home gym equipment to stay fit while staying at home", May 14, 2020, Reuters, by Aleksandra Michalska.
[7] "For 2019, Employers Adjust Health Benefits as Costs Near $15,000 per Employee", by Stephen Miller, Society for Human Resource Management, August 13, 2018.

Supply-chain management is at the heart of the challenge: Businesses have been rewarded for quickly developing globally based supply chains that eschew large inventories—and deliver components just in time for production. Comparatively low foreign wages reduce production expenses, while just-in-time production cuts inventory costs. To illustrate, between 1988 and 2013, trade in intermediate goods rose nearly five-fold as a share of world economic output, slowing only in 2018 as global trade tensions flared (Chart 2).

Chart 2. Worldwide exports of intermediate goods



Sources: World Bank, Wells Fargo Investment Institute, June 2020. Annual data. Intermediate goods are products used in the production of other goods. Shown as a percentage of worldwide gross domestic product (GDP).

The pandemic has exposed weaknesses in this complex, just-in-time supply approach, but we do not believe that many supply chains soon will reshore (return to the U.S.). It is true that COVID-19 shut down large portions of Asia in January, which closed access to component part supplies for many U.S. firms. However, the potentially high cost of U.S. wages remains a major disincentive to reshoring. Alternatively, moving from China to another emerging Asian economy may lower the wage bill, but it entails large costs to rebuild plants and shipping hubs, train new workers, and deal with different environmental and labor regulations. Still other supply chains are unlikely to relocate because their production and inventories are located in the markets that they serve.

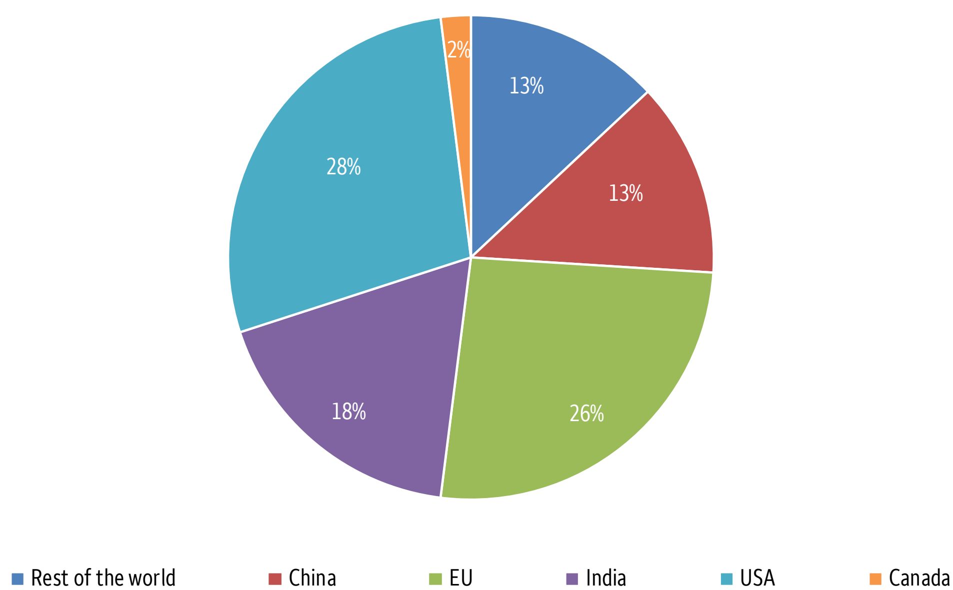
Instead, we expect that firms will seek greater flexibility by better managing the risks to their supply chains. As an illustration, consider a U.S. automobile manufacturer that relies on an overseas vendor for windshield wiper blades. The carmaker likely will take steps to create redundancy among suppliers, and to anticipate weather, political, and other risks to supplies. Other contingency plans could include prearranging space on freight carriers, carrying extra inventories of key parts (or even finished components), and even purchasing components to mitigate any potential "out of stock" situation at their vendors.

Those supply chains we believe are most likely to reshore are those involving products considered to be essential to U.S. security. Notably, U.S. dependence on China for essential public health supplies or key technology already has attracted federal government interest. Chart 3 illustrates that 13% of active pharmaceutical ingredients in U.S. prescription drugs comes from China. The U.S. government may require reshoring of these China supply chains to help mitigate the risk that trade tensions or another virus may interrupt future supplies.

Investment implications

The data and analytics to drive business flexibility efforts are expected to come predominantly through Information Technology, Health Care, and Communication Services—our most favored, and favored, sectors, respectively. Opportunities in Real Estate should follow industrial centers (e.g., warehouses for e-commerce) and locations related to the cloud (for remote data storage).

Chart 3. Percent of active pharmaceutical ingredient manufacturing for U.S. drugs by country or region



Sources: U.S. Food and Drug Administration, "Safeguarding Pharmaceutical Supply Chains in a Global Economy", October 30, 2019. Data is as of August 20, 2019.

Theme 3—The pandemic is likely to intensify existing stresses globally

The costs of virus containment will likely strain national budgets overseas—which already have less room for support than the U.S.: The U.S. has had significantly more trouble controlling the spread of COVID-19 than Europe or Asia have, but we believe the U.S. economy is likely to emerge stronger once again. Europe recently has taken positive steps toward a more unified fiscal policy, but outsized budget deficits risk aggravating fragile banking systems for which negative interest rates undermine profitability. Europe also lags the U.S. in technological development.

Also, mounting pandemic-related deficits could spur tax hikes in the region. European taxes on multinationals hit large, U.S. technology companies and other firms disproportionately; they thereby risk retaliatory U.S. tariffs. Moreover, moves ranging from more graduated income taxes to value-added levies and wealth-tax increases could hamper economic growth and undercut returns on international investments.

Many emerging economies lack the resources to counter the public health crisis adequately. Moreover, interest-rate reductions and central-bank securities purchases have added significant liquidity to economies that historically have been prone to currency depreciation, inflation in imported goods, and capital outflows. These low interest rates combine with large government and corporate borrowing (including U.S.-dollar borrowing) to leave financial assets vulnerable to market turbulence if rates rise even modestly or if dollars become more scarce.

A related problem in emerging markets is that state-owned, commodity-producing enterprises are starting to strain government budget deficits. The long bear market in commodities and the pandemic have exposed inefficiencies at these firms. As governments direct budgetary support to prop up these companies, government and enterprise finances can deteriorate simultaneously; leaving both vulnerable to credit-rating downgrades.

As the big get bigger, individual countries—not regions—should offer better opportunities: The U.S. and China, the world's two largest economies, have thus far weathered the pandemic's economic impact better than smaller countries. If these two economies grow larger and intensify their strategic competition, as we expect, the world likely will evolve into bipolar trading blocs or orbits. A two-sided economic situation may ultimately force smaller, trade-oriented economies to join one bloc or the other, and we expect a binary choice should limit global trade.

The greater a small country's dependence on trade, the more its standard of living may decline. This may apply most to the economies of South Asia, Latin America, and Eastern Europe. In this way, we believe the U.S.-China competition risks overwhelming sensible economic policies in some countries and aggravating policy miscues in others.

Meanwhile, China's ongoing shift to services and pursuit of self-sufficiency in technology threaten the future trade prospects of South Asian and Latin American trade partners that, until recently, have counted on China to buy their commodities. Consequently, we believe that successful emerging market investment decisions will depend more on idiosyncratic or country-specific opportunities than on regional factors. The key country factors to watch should include monetary, fiscal, and regulatory policies that control inflation and local currency values, institutional development that allows political systems to handle social issues adequately, and transparent rule of law.

Challenges to globalization and U.S. dollar strength are a double-barrel threat to trade-sensitive economies abroad: These threats to global trade and local-government finances should weaken international currencies against a U.S. dollar that relies less on trade. Dollar strength generally has had a double-barrel effect on overseas returns for dollar-based investors. First, a strong dollar can boost other countries' local-currency cost of dollar debt payments. Second, dollar strength can reduce dollar-based earnings of U.S. multinationals and foreign stock and bond returns as foreign income is converted to the U.S. currency.

Investment implications

Our first preference is for U.S. markets. Also, Northeast Asian markets (such as Japan, Taiwan, and South Korea) could offer opportunities, if they retain or increase their connectivity to the U.S. economy. China cannot be ignored as a global and growing powerhouse. If its market presence continues to grow through increased publicly traded companies and A-share classes, investors will likely need to account for the second largest economy on this planet.

Theme 4—More direct government involvement in the economy—for better or worse

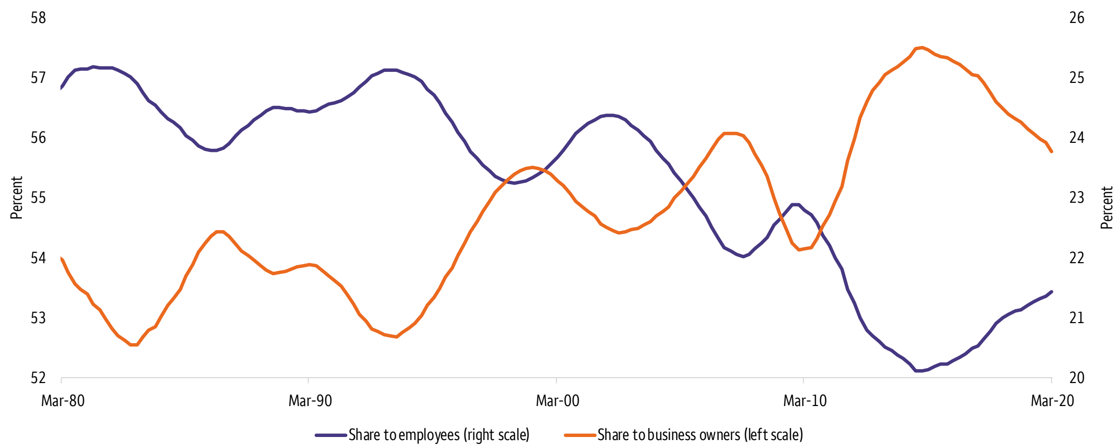
Pressure for the government to act more directly in the economy: The two panels of Chart 4 illustrate the worsening U.S. income inequality, a legacy of two deep recessions since 2008. The top panel shows the share of national income going to workers, up from its March 2015 low—but still trending lower since 1994. The annual income loss from 1994 translates to more than $5,300 per household. By contrast, the corporate share of national income remains above its long-term average (despite the fact that it is at an eight-year low).

The bottom panel may help to explain the divergence. Corporate investment in traditional industrial equipment has trailed the growth in both high-tech hardware and the broader category of intellectual property (including online applications and other software, research and development, and entertainment-related copyrights).

Investment has rotated from machines that historically boosted blue-collar productivity and wages into software and technologies for online and digital services. This new investment trend benefits traditional, blue-collar workers much less, but it steadily raises the education bar to remain competitive in the workforce.

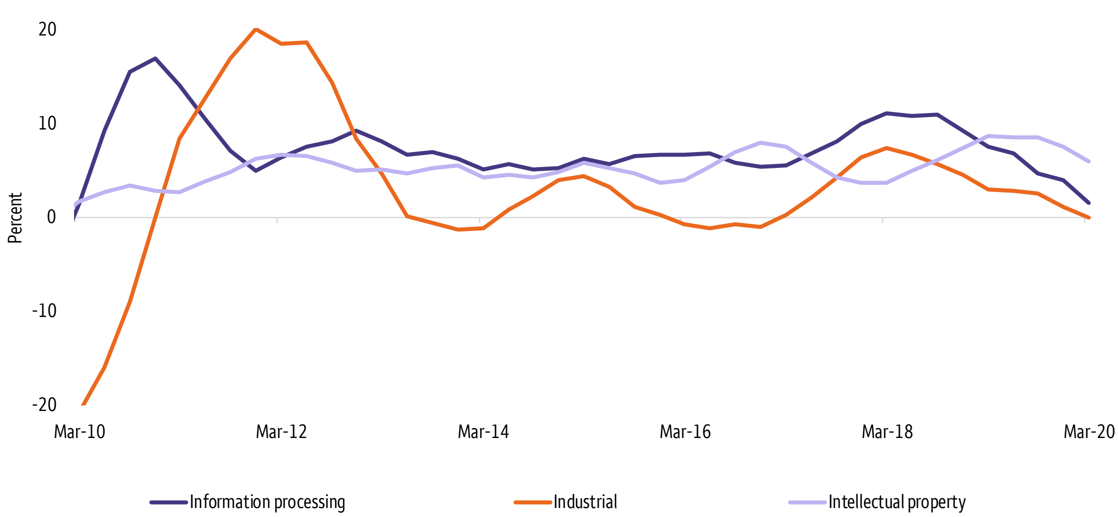
Chart 4. Economic trends correspond with increased income inequality

Employees' share of national income is still historically low



Sources: U.S. Bureau of Economic Analysis and Wells Fargo Investment Institute. Quarterly data: March 1980 – March 2020. Shown as a percent of gross domestic income and presented as three-year moving averages. Share to employees is pre-tax compensation, less subsidies. Share to business owners is net operating surplus (i.e., national income less expenditure on employee compensation, depreciation, and taxes).

Business investment in intellectual property bucks the broader weakness in business equipment spending



Sources: U.S. Bureau of Economic Analysis and Wells Fargo Investment Institute. Quarterly data: March 2010 - March 2020. Data are shown as four-quarter rolling percentage changes in four-quarter moving averages of inflation-adjusted investment spending. Business investment in intellectual property includes online applications, other software, research and development, and entertainment-related copyrights.

We believe slow economic growth and worker-skill deficits should worsen income inequalities and pressure governments for remedies. Checkered results from community development and job retraining programs, along with state-directed research and development, likely will encourage new income support initiatives. The template for such new and possibly recurring payments could be the recently enhanced unemployment insurance and worker-retention loans to small businesses.

Additionally, Congress could approve public spending or tax cuts to encourage reshoring of overseas U.S. supply chains. Large incentives likely would be necessary to build new factories in the U.S. and to hire comparatively expensive U.S. workers. If they were used on a wide scale, such initiatives could produce federal budget deficits that are significantly wider than those of the past.

Choices on deficit financing: Closing the budget gap through aggressive tax increases or spending cuts likely will remain politically difficult in the foreseeable future. Generating sufficient inflation to devalue Treasury obligations also is unlikely, given the Federal Reserve's (Fed) track record of inflation control.

That leaves interest-rate restraint as the path of least resistance in financing outsized deficits in our opinion, but the implication of this would be increased subordination of monetary policy to fiscal stimulus. Recent talk of Fed interest-rate targeting, boosting purchases of government securities, and maintaining a near-zero short-term policy interest rate may effectively strengthen the link between monetary policy and government financing in a way that is unlike that of any other period since the Fed agreed to suppress government wartime borrowing costs in the 1940s.

Risks to financial markets

There are several key risks of these developments for financial markets:

1) Increasingly large bailouts in response to economic crises may lead private firms to expect a bailout and thereby underappreciate the risk of taking on more debt.
2) Government may influence—or even dictate—how managers allocate retained earnings, especially stock buyback or dividend decisions, in order to avoid or limit potential future bailouts.
3) Equity or warrants in private companies as compensation for government bailouts would increase government ownership and control of some industries, risking a back-door industrial policy that could effectively "replace the market" in choosing between winners and losers.
4) Linking monetary policy and government financing eventually could undermine investor confidence in public debt and lead to inflation and dollar devaluation.

To be clear, we do not believe all of these risks seem equally likely in the next three to five years. However, some may begin to affect corporate decision-making more immediately. For example, firms receiving federal loans under the Coronavirus Aid, Relief, and Economic Security (CARES) Act must abide by caps on executive compensation and prohibitions against dividend payouts and buybacks until a year after repaying the loan. Other corporations may voluntarily limit their use of stock buybacks to deflect public disapproval.

Investment implications

Considering public policy more explicitly as a fundamental factor will not necessarily limit investment opportunities. We expect health policy to receive increased attention and spending, and the Health Care sector is already one of our favored equity sectors. Also, potential government initiatives such as a national infrastructure spending program could favor the Industrials and Materials sectors. Government policies may create new opportunities in value-oriented industries and sectors, which have not enjoyed sustained outperformance against growth alternatives in 15 years. In sum, investors weighing investment decisions increasingly will need to ask just what the government is trying to accomplish and how those decisions might bear on performance within and across asset classes in a balanced portfolio.

Theme 5—Health care will likely play an increasingly prominent future role

Aging populations and the fear of new pandemics underscore the political debate about how deeply and broadly public health spending will mount. Additional pressure may come from the increased frequency of coronaviruses, including SARS (2003), the bird flu (2005), the swine flu (2009), MERS (2012), and now COVID-19 (2020). The possibility of animal-to-human viral transmission may become more likely as human settlements continue to spread into uninhabited areas and people may come into contact with wildlife more frequently. Our interconnected world may accelerate the transmission of new viruses.

COVID-19's disproportionate health care industry impact leads us to anticipate new federal initiatives to increase health care system flexibility. In the future, we believe that the health care system will expand even faster to build flexibility for aging populations and possible future epidemics. As COVID-19 persists in the near term, labor costs should rise and hospital revenue may decline, especially if fears about the virus reduce emergency room visits. Some potential growth avenues for government and private initiatives include:[8]

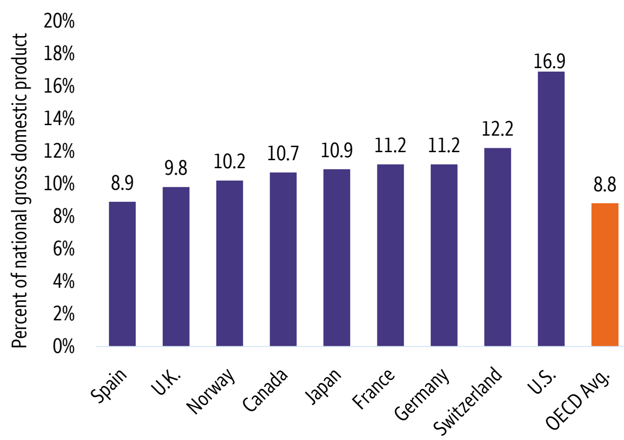
- Expanding hospital space to designate COVID-19 and non-COVID-19 areas.
- Shifting to virtual intensive care units (where the patient is at home with a nurse, and critical care specialists monitor health developments remotely).
- Integrating online-offline care (where the patient starts with an app or phone-based diagnostics, prior to seeing a doctor).

To achieve these results, public funding to expand hospitals is an obvious track in our view. Yet, regulatory changes also may gain traction to approve new treatments more efficiently and to license workers for broader approved skill sets.

The U.S. health care system was about 17% of the U.S. economy in 2018. This was nearly double the 9% average share among the world's most developed economies (see Chart 5). We expect health care to gain a much larger investment focus. Important growth drivers will likely include building stockpiles of supplies, increasing hospital capacity, and adding staffing and funding for governmental agencies that ensure health care preparedness.

The governments of Singapore, Taiwan, and South Korea took these steps after suffering through coronavirus outbreaks between 2003 and 2012. They also created systems to facilitate information sharing across government agencies—notably between immigration and public health offices.

Chart 5. U.S. health care expenditures significantly exceed those of other developed countries



Sources: Organization for Economic Cooperation and Development (OECD): Health Statistics 2019, and Wells Fargo Investment Institute, July 2019 (latest data available).

Investment implications

The pandemic is likely to accelerate trends already in place that increase the future importance of the Health Care sector in the economy. These burgeoning trends likely will impact pharmaceutical companies, biotechnology, as well as hospital and health care service providers—and induce another wave of research and development investment by the industry. It also should have important implications for technology enhancements and integration, potentially creating attractive opportunities for investors.

[8] "COVID-19 and Healthcare", McKinsey, by Axel Baur, Panco Georgiev, Imraan Rashid Munshi, and Marek Stepniak, May 2020.

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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. 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.

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. 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.

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