WELLS FARGO
Investment Institute

Investment Strategy

Weekly Guidance from our Investment Strategy Committee June 29, 2020

[1] Wells Fargo Investment Institute, Real Assets Quarterly Guidance, May 4, 2020.

Equities Spotlight

Mark Litzerman, CFA
Head of Global Portfolio Management

Rising targets and falling earnings

Two hallmarks of the current economic and pandemic crisis have been the rapid pace of change in markets and data—and the uncertainty of the impact of those changes. For equities, the sand has shifted quickly for investors as new information is digested that is often quite different from expectations.

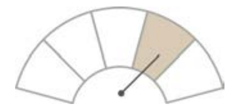
In our recently released 2020 Midyear Outlook report, we noted that we have become more optimistic on longer-term expectations and that we have raised our year-end equity target prices for 2020, while introducing higher targets for 2021. A question that we have heard on our 2020 S&P 500 Index price target is: "what, if anything, has changed since we previously raised this target?"

In fast moving markets such as these, the investment landscape can change quickly with new information and data. Here are some major developments since our last round of target changes in early June:

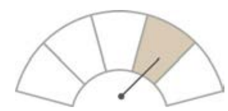
Economy—The U.S. labor market has shown sharp improvement as the May jobs report (payroll data) came in much better than was expected. Initial jobless claims also likely have peaked. Retail sales recently showed a higher-than-expected increase, suggesting that consumer wallets may be opening up sooner than was anticipated, due to pent-up demand. Consumer confidence, small business optimism, and purchasing manager index (PMI) data all seem to be bottoming and/or rebounding, which is an important sign of future activity. These improvements led Wells Fargo Investment Institute to upgrade its economic growth forecasts as the economy seems to be recovering more quickly than was expected.

Policy—We have seen a slew of additional measures undertaken by the Federal Reserve (Fed), global central banks, and government officials since early June, including the recent mention of possible infrastructure spending and additional federal stimulus bills. During the Fed's most recent meeting, we saw forecasts that policy rates may remain close to zero for years to come, which has a major and direct impact on risk premiums and valuation multiples. It also is worth noting how resolved Fed Chair Powell has been in his recent testimony about continued Fed accommodation for some time to come.

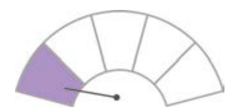
COVID-19—Headwinds do remain for the pandemic in the U.S. as several states have registered recent spikes in cases. While we have not yet seen a rise in cases that is severe enough to lead to a resumption of economic shutdowns, the potential for this is something that we are monitoring closely given the recent increases in cases. Additionally, in early June, five candidates made it to the second round of U.S. vaccine-related efforts, and recent research suggests promising treatment results using an existing drug.



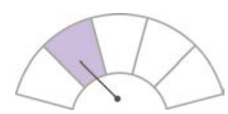
Favorable
U.S. Large Cap Equities



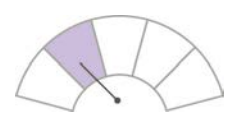
Favorable
U.S. Mid Cap Equities



Most Unfavorable
U.S. Small Cap Equities



Unfavorable
Developed Market Ex-U.S. Equities

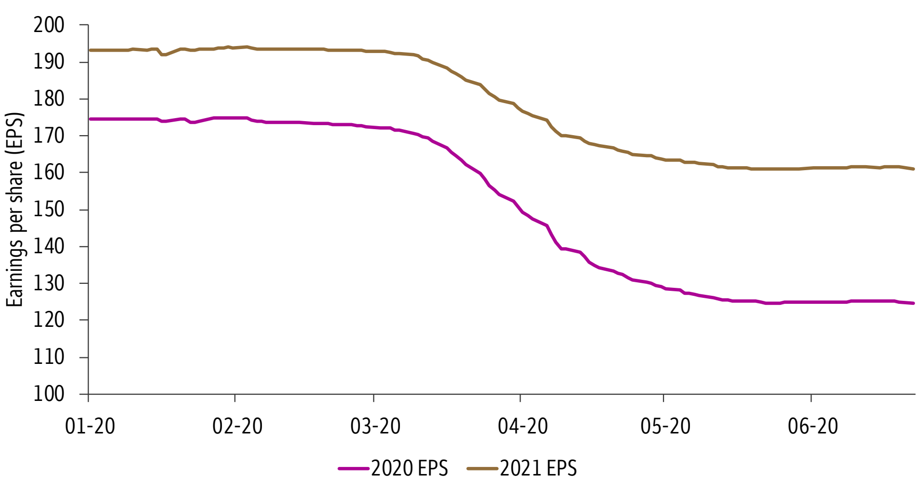


Unfavorable
Emerging Market Equities

Sentiment, trends, and markets—Many market and financial conditions have shown improvement since early June. These include tighter spreads (for both investment-grade and high-yield corporate bonds), steeper yield curves, higher nominal interest rates, wider equity market breadth, a U.S. dollar peak, and bottoming earnings per share revisions, to name just a few.

In contrast to these positive developments, we are about to enter the second quarter earnings season, which we expect to represent the trough in earnings for the recession. Current consensus earnings estimates show S&P 500 earnings dropping 40% from 2019's second quarter.[2] Nine of 11 equity sectors should reflect second-quarter earnings declines, with Financials, Industrials, and Materials expected to be the hardest hit. The good news is that earnings expectations for 2020 and 2021 have stopped falling and have settled at more optimistic levels than our own conservative estimates. As earnings results come in, we hope to see positive signs that may lead us to an upward bias for our own estimates in the weeks to come.

Consensus analysts' earnings estimates for the S&P 500 Index



Sources: Wells Fargo Investment Institute, Bloomberg, June 2020. Data is as of June 22, 2020. 2020 and 2021 earnings per share (EPS) reflect analysts' consensus S&P 500 earnings estimates. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

As long as the Fed remains supportive, we believe that U.S. equity valuations can remain elevated. Even so, we expect that valuations will recede as earnings grow toward (and may eventually exceed) 2019 levels as the recovery takes hold in 2021 and 2022. A major reason that we decided to roll out year-end 2021 targets earlier than we have in the past is to help focus investors on the economic and earnings recovery that we believe lies beyond the near-term uncertainty and volatility, along with what we anticipate is the probability of further equity gains over longer time horizons.

[2] Bloomberg, June 2020.

Fixed Income

Peter Wilson
Global Fixed Income Strategist

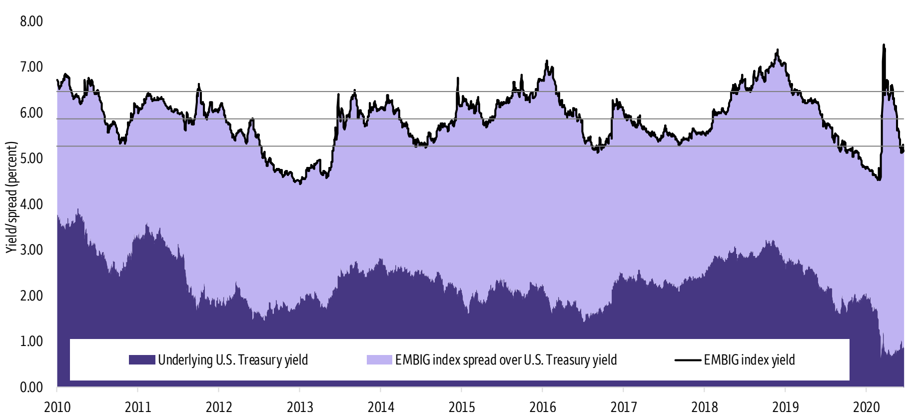
Can emerging market debt yields fall further?

Like other global credit markets, dollar-denominated emerging market (EM) sovereign debt has reflected high volatility during the COVID-19 crisis. Before the coronavirus hit, JP Morgan Emerging Markets Bond Index yields of around 4.50% matched the lowest levels seen in the past decade (see chart). In early March, these yields rose to almost 7.50%, jumping from the bottom of the 10-year yield range to the top in a mere two weeks. Once Federal Reserve (Fed) support for U.S. credit markets was seen, emerging market bonds joined the rally, and EM sovereign yields swiftly returned to the 5.00% - 5.50% range.

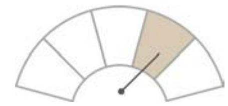
Although the Fed is not directly supporting EM debt, investor demand is encouraged by the strong risk-appetite recovery galvanized by the Fed's actions. Further, now that U.S. Treasury yields have joined Japanese and eurozone government bond yields at levels below 1%, the global search for yield has intensified as the pool of even moderately-yielding assets is shrinking.

We remain neutral on EM debt and believe that it is reasonably valued at these levels. Yet, we doubt that EM yields can push much lower. Yields above 5% are attractive to investors, but any spread widening (increases) from here could result in capital losses that undercut total returns. Prices of weaker-credit sovereign bonds have room to fall if concern increases about defaults. We do not believe that conditions exist for the large-scale defaults seen in past EM crises, but it is likely that Argentina, Lebanon, and Ecuador—for which debt is already in restructuring—will be joined by some smaller and lower-rated sovereigns over the coming year.

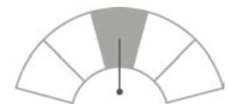
EM sovereign yields—near the lower end of the past decade's range



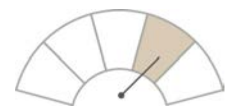
Sources: JP Morgan indices, Wells Fargo Investment Institute, June 23, 2020. The index used is the JP Morgan Emerging Markets Bond Index Global (EMBIG). See disclosures for index definition. Gray lines represent the average yield over the whole period (January 1, 2010 to June 23, 2020) and a one standard deviation band on either side of this average.



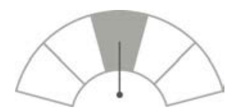
Favorable
U.S. Taxable Investment Grade Fixed Income



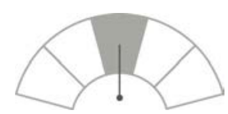
Neutral
U.S. Short-Term Taxable Fixed Income



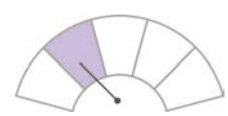
Favorable
U.S. Intermediate Term Taxable Fixed Income



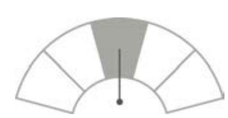
Neutral
U.S. Long-Term Taxable Fixed Income



Neutral
High Yield Taxable Fixed Income



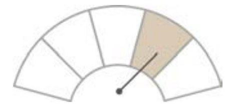
Unfavorable
Developed Market Ex.-U.S. Fixed Income



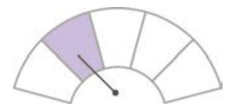
Neutral
Emerging Market Fixed Income

Real Assets

Austin Pickle, CFA
Investment Strategy Analyst



Favorable
Commodities



Unfavorable
Private Real Estate

"Life can only be understood backwards; but it must be lived forwards." —Soren Kierkegaard

A REIT is a REIT is a REIT, right? No. A look at our REIT subsector guidance.

Publicly traded real estate investment trusts, or REITs, have long held a special allure for some investors. They tend to offer higher income distributions than most stocks, and they allow relatively easy real estate exposure without exorbitant capital requirements. REITs come in all shapes and sizes—a REIT that specializes in data centers is wildly different from a REIT that specializes in malls or office buildings. To help investors navigate "REIT land," we provide REIT subsector guidance. Let's take a look at our current REIT subsector guidance, and how it has fared.

The table below shows our current REIT subsector guidance, the inception date of that guidance, and the REIT subsector return *relative* to the REIT benchmark. Successful investing is all relative. Would we consider a 10% actual return for an investment to be good or bad? It depends—10% would be great if the benchmark returned -5% but bad if the benchmark returned 30%. To more accurately illustrate the success or failure of our REIT subsector calls, the returns in the table are relative. The 53.3% Infrastructure REIT "current guidance" inception to date (ITD) return means that the Infrastructure REIT index has returned 53.3% *more* than the REIT benchmark since we turned favorable.

For more details on the rationale for each of our ratings and to track any future changes, please see our Real Assets Quarterly Guidance Report.

REIT subsector guidance

Subsectors	Current guidance	Current guidance inception date	Subsector returns relative to the benchmark	
			YTD	ITD
Infrastructure REITs	Favorable	2/26/2019	30.30	53.30
Data Center REITs	Favorable	2/26/2019	31.39	50.52
Manufactured Home REITs	Favorable	2/26/2019	5.21	23.62
Single Family Home REITs	Favorable	2/26/2019	9.65	23.39
Industrial REITs	Favorable	10/31/2019	13.72	14.35
Residential REITs	Favorable	4/26/2019	-4.38	-3.39
Office REITs	Unfavorable	2/26/2019	-10.31	-13.69
Health Care REITs	Unfavorable	1/30/2020	-13.32	-14.03
Retail REITs	Unfavorable	7/25/2019	-22.98	-27.14
Lodging REITs	Unfavorable	2/26/2019	-33.87	-47.74

Sources: Bloomberg, Wells Fargo Investment Institute, June 23, 2020. ITD = current guidance "inception" to date. The REIT subsectors' benchmark is the total return of the FTSE NAREIT All Equity REITs Index.

Alternatives

Ryan McWalter, CAIA
Global Alternative Investment Strategist

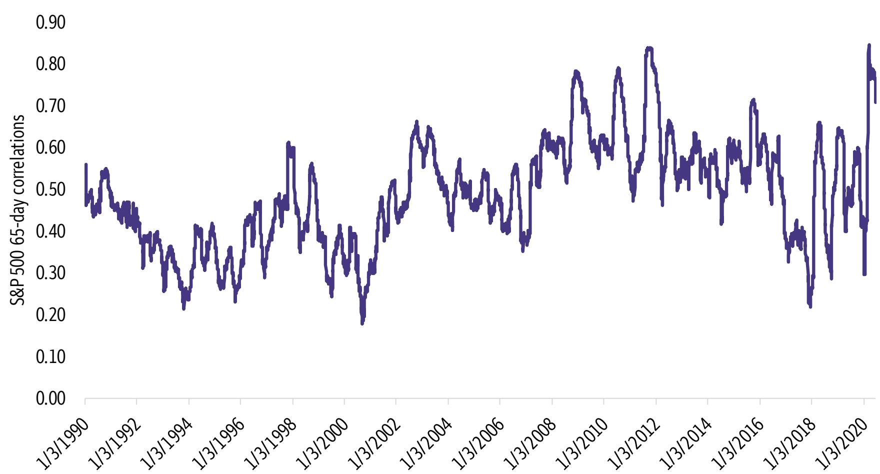
Maintaining conviction in Equity Hedge amid headwinds

Stock correlations can be a good measure of the opportunity for Equity Hedge managers to separate winners from losers—and to possibly generate excess returns from long and short positioning— particularly when correlations are low. Yet, when correlations are high as they recently have been with the pandemic-driven risk off, risk on environment, company fundamentals are not necessarily reflected in stock prices. Stocks can instead be more influenced by short-term, broader market sentiment, which has been extreme as investors have struggled to forecast the coronavirus' economic fallout. While higher stock correlations are a headwind for the Equity Hedge strategy, we believe that correlations will moderate as investors parse through the actual COVID-19 impacts on the economy and individual companies.

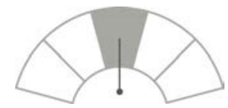
We continue to favor Equity Hedge managers with lower-net exposure that can tactically adjust their positioning in volatile markets and offer downside protection. Net exposure simply takes a manager's (or strategy's) aggregate long exposure and deducts the short exposure—which can provide a measure of a manager's long or short bias.

During the last three recessions (1990-1991, 2001, and 2007-2009), the HFRI Equity Hedge (Total) Index outperformed the S&P 500 Index by an average of 9.86%. Outperformance during recessionary periods can help to smooth out an equity allocation's volatility, with the potential to limit drawdowns and enhance long-term returns. As a result, we continue to favor lower-net Equity Hedge strategies that can participate in market upside and protect capital during the bouts of volatility that can occur during economic downturns.

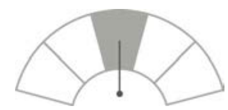
S&P 500 equity correlations have risen since the pandemic began



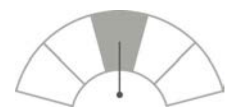
Sources: Strategas, June 24, 2020. Chart shows S&P 500 Index 65-day correlations from January 1990 through May 2020. Past performance is no guarantee of future results.



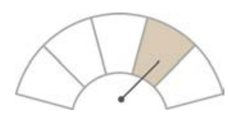
Neutral
Private Equity



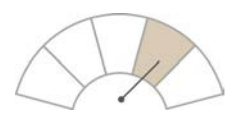
Neutral
Hedge Funds – Macro



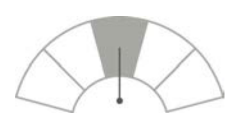
Neutral
Hedge Funds – Event Driven



Favorable
Private Debt



Favorable
Hedge Funds – Equity Hedge



Neutral
Hedge Funds – Relative Value

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

Risk Considerations

Forecasts and targets are based on certain assumptions and on 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. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

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.

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.

Office REITs – 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.

Industrial REITs - 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.

Retail REITs - 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.

Lodging REITs - 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.

Residential REITs - 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.

Health Care REITs - 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.

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

Single Family Homes REITs - FTSE NAREIT Single Family Homes Index is a free float adjusted market cap weighted index that includes all tax qualified single family homes REITs listed in the NYSE, AMEX, and NASDAQ National Market. Total return accounts for dividends reinvested in the index.

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

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

HFRI Equity Hedge (Total) Index maintains positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios.

Note: HFRI Indices have limitations (some of which are typical of other widely used indices). These limitations include survivorship bias (the returns of the indices may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information self-reported by hedge fund managers that decide on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.

JPMorgan Emerging Markets Bond Index Global (EMBI Global), which currently covers 27 emerging market countries. Included in the EMBI Global are U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

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.

General Disclosures

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