WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee — September 14, 2020

Real Assets Spotlight: Oil can't wait for 2021 2

- We expect oil prices to be range-bound for the rest of 2020.
- 2021 may be a different story, however, as supply could become an issue.

Equities: No good news for Energy stocks 4

- We continue to see structural earnings headwinds for the Energy sector, and we retain our most unfavorable view of this sector.
- Energy stocks typically offer investors higher-than-average dividend yields. Yet, weakening cash flows pose risk to future dividends for some firms in the Energy space.

Fixed Income: Leveraged loans — caution warranted 5

- There are embedded risks in this fixed-income class, particularly since they are not part of the Federal Reserve's (Fed) specifically supported debt classes and because we expect higher default rates in the near term.
- We prefer to allocate assets to high-yield corporate bonds and other fixed-income classes with above-average yield potential.

Alternatives: Rising from the ashes — convertible bond arbitrage 6

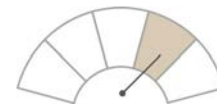
- Convertible bond arbitrage has faced a challenging decade, but we see early signs of a resurgence.
- Trends in net issuance recently have accelerated sharply as volatility has risen. We believe that these trends mean that the environment for convertible arbitrage is as attractive as it has been in years.

Investment and Insurance Products: NOT FDIC Insured ▶ NO Bank Guarantee ▶ MAY Lose Value

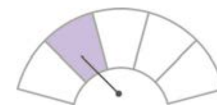
© 2020 Wells Fargo Investment Institute. All rights reserved.

Real Assets Spotlight

John LaForge
Head of Global Real Asset Strategy



Favorable
Commodities



Unfavorable
Private Real Estate

"Prosperity is a great teacher; adversity is greater." — William Hazlitt

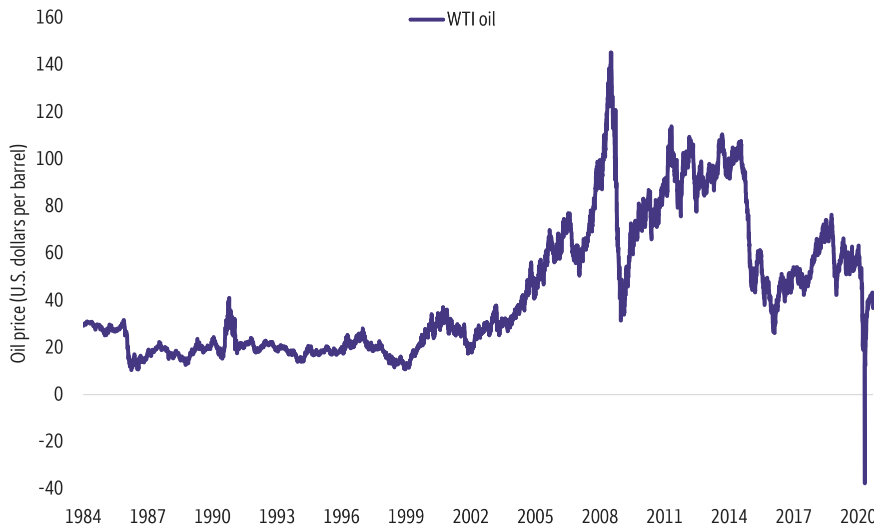
Oil can't wait for 2021

2021 is almost here! Or better said, 2020 is fortunately coming to a close. No asset wants 2020 to end more than U.S. oil. To say that this year has been ugly would be woefully underestimating oil's plight. No major asset can claim that it has been damaged more by the coronavirus pandemic, which is quite the distinction. On April 20, the main U.S. oil benchmark price, West Texas Intermediate (WTI), closed the day at -$37.63 (per barrel). This can be seen in Chart 1. In the history of U.S. oil, which dates to 1859, never have we seen such a thing.

Since April, WTI oil prices have acted more rationally, and they have bounced to the levels that best reflect current supply and demand. For WTI, that balance is near $40 per barrel, while for Brent, it is closer to $45.

As for oil's move into year-end, our forecast is sideways. Our 2020 year-end target ranges are $35-$45 per barrel for WTI oil, and $40-$50 per barrel for Brent. They have been the same since March, and we're not inclined to change them now. Global demand has been recovering — but not fast enough to warrant much higher prices. And the world has plenty of supply available at these levels.

Chart 1. WTI Oil



Sources: Bloomberg, Wells Fargo Investment Institute. Daily data: January 3, 1984 - September 9, 2020. WTI = West Texas Intermediate oil. **Past performance is not a guarantee of future results.**

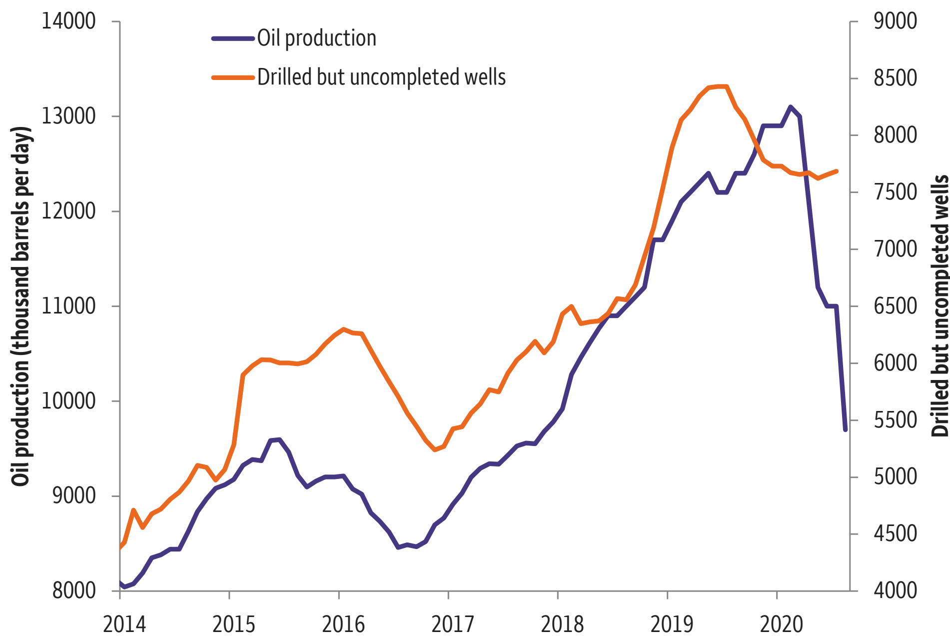
2021 could be a different story, though. Supplies are plentiful today, but if prices continue to languish under the $45 level for the remainder of 2020, the supply side could clear up quickly.

© 2020 Wells Fargo Investment Institute. All rights reserved.

The U.S. could very well lead the way in 2021 oil-supply reductions as it is one of the world's highest-cost producers. Average breakeven costs for oil in the major U.S. shale basins are approximately $40 per barrel. Prices under $40 tend to reduce production — as we saw this spring and summer. U.S. oil production began the year near 13 million barrels per day, when WTI traded between $50 and $60. Production has since dropped below 10 million barrels per day (Chart 2, dark purple line). Much of this production is of the lower-cost variety. It will likely not last forever. And remember, historically, U.S. shale wells deplete notoriously fast. U.S. oil producers eventually will likely have to turn to their cache of drilled but uncompleted wells (Chart 2, orange line). These wells are not being produced today for a reason. That reason is cost. These are the higher-cost wells that generally require higher oil prices to complete.

We believe the longer oil prices stay below $45 in 2020, the higher the likelihood that 2021 could see oil prices of $50 or more, if not $55 or more, to entice increased production. In September 2020, it's likely too early to position for this yet. It is a trend worth watching, though, as oil exits its ugliest year — ever.

Chart 2. Drilled but uncompleted wells versus production



Sources: Bloomberg, Energy Information Administration (EIA), Wells Fargo Investment Institute. Monthly data: January 31, 2014 – August 31, 2020.

© 2020 Wells Fargo Investment Institute. All rights reserved.

Equities

Ken Johnson, CFA
Investment Strategy Analyst

No good news for Energy stocks

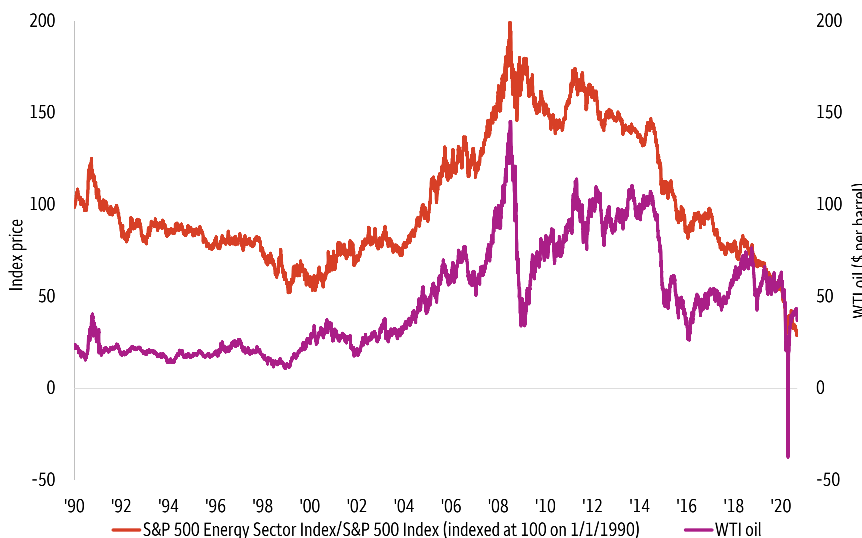
The S&P 500 Energy sector is up 43.2% since the March 23 trough through September 9, but the good news seems to end there. Returns have been negative for 1-year, 5-year, 10-year, 20-year, and year-to-date (YTD) periods through September 9, 2020. Performance has been negatively impacted by lower oil prices, resulting from a supply/demand imbalance.

Since the early 1980s, WTI's oil price has crashed by 40% or more 10 different times. Between 2014 and 2016, WTI oil plunged from $107 per barrel to $26. On September 10, WTI oil stood at approximately $38 per barrel. The average breakeven price for U.S. shale producers is $40 per barrel of oil, so today's prices may present sustainability risk for many firms.

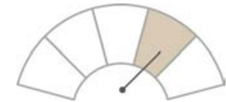
The Energy sector has been undergoing consolidation as companies seek to adjust to lower oil prices. Still, these persistently low oil prices have weakened Energy companies' cash flow generation capabilities, further comprising many firms' already poor balance sheets and jeopardizing future dividends for some companies.

We believe that the Energy sector will see more consolidation before it can fully recover. We expect to see more staff downsizing and a reduction in capital spending. Additionally, mergers, acquisitions, and bankruptcies have increased this sector's concentration risk. Today, two firms make up approximately 50% of the S&P 500 Energy sector's market capitalization. Going forward, we expect these factors to lead to more volatility. We retain our most unfavorable Energy sector view.

Energy stocks have underperformed the S&P 500 Index as oil prices have declined



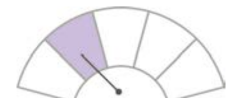
Sources: Wells Fargo Investment Institute, Bloomberg, September 9, 2020. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**



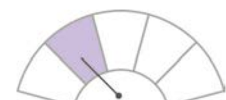
Favorable
U.S. Large Cap Equities

Favorable
U.S. Mid Cap Equities

Most unfavorable
U.S. Small Cap Equities



Unfavorable
Developed Market
Ex-U.S. Equities



Unfavorable
Emerging Market Equities

© 2020 Wells Fargo Investment Institute. All rights reserved.

Fixed Income

Luis Alvarado
Investment Strategy Analyst

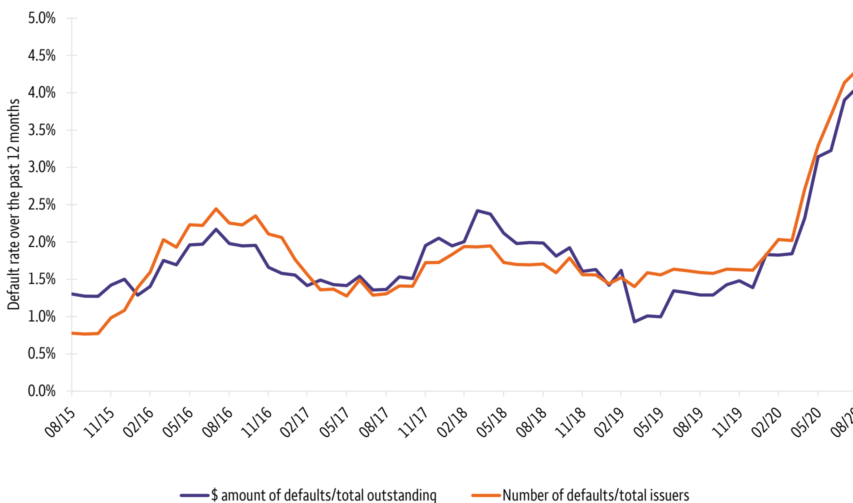
Leveraged loans—caution warranted

Leveraged loans are senior secured loans made to companies that have a below-investment-grade rating, often outside the banking sector. Collateralized loan obligations (CLOs) are established to hold and manage pools of these loans. A recent Federal Reserve (Fed) report offered a snapshot of the U.S. CLO investor base.[1] It concluded that institutional investors own nearly 80% of U.S. CLOs outstanding. Insurance companies lead with 33%, while other nonfinancial entities and households own 8.1%.

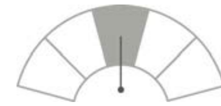
It also is interesting to see how each of these investors allocates exposure to the CLO tranches by credit quality: senior notes (lowest risk in the space), mezzanine and junior notes (moderate risk), and equity notes (highest risk). For institutional investors, approximately 50% or more is in senior notes; equity note exposure ranges from 1% to 13%. Nonfinancial entities and households had 38.8% of exposure in senior notes and 20% in equity notes. Although these are estimates, this suggests that some individual investors may have sizeable exposure to riskier CLO tranches.

Although leveraged-loan returns have been keeping pace with high-yield-corporate bond returns this quarter, we see several key risks in this fixed-income class, particularly since these loans are not part of the Fed's supported debt classes and because we expect higher default rates to materialize toward year-end.[2]

U.S. leveraged loan default rates



Sources: S&P Leveraged Commentary and Data, August 31, 2020. Monthly data: August 2015 - August 2020.

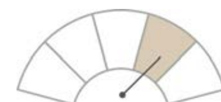


Neutral
U.S. Taxable Investment Grade Fixed Income

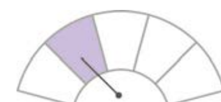
Neutral
U.S. Short Term Taxable Fixed Income

Neutral
U.S. Intermediate Term Taxable Fixed Income

Neutral
U.S. Long Term Taxable Fixed Income



Favorable
High Yield Taxable Fixed Income



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

Neutral
Emerging Market Fixed Income

[1] DeMarco, Laurie, Emily Liu, and Tim Schmidt-Eisenlohr (2020). "Who Owns U.S. CLO Securities? An Update by Tranche," FEDS Notes, Board of Governors of the Federal Reserve System, June 25, 2020.
[2] Return of S&P LSTA Leveraged Loan Index versus performance of Bloomberg Barclays U.S. Corporate High Yield Index.

© 2020 Wells Fargo Investment Institute. All rights reserved.

Alternatives

Justin Lenarcic
Senior Global Alternative Investment Strategist

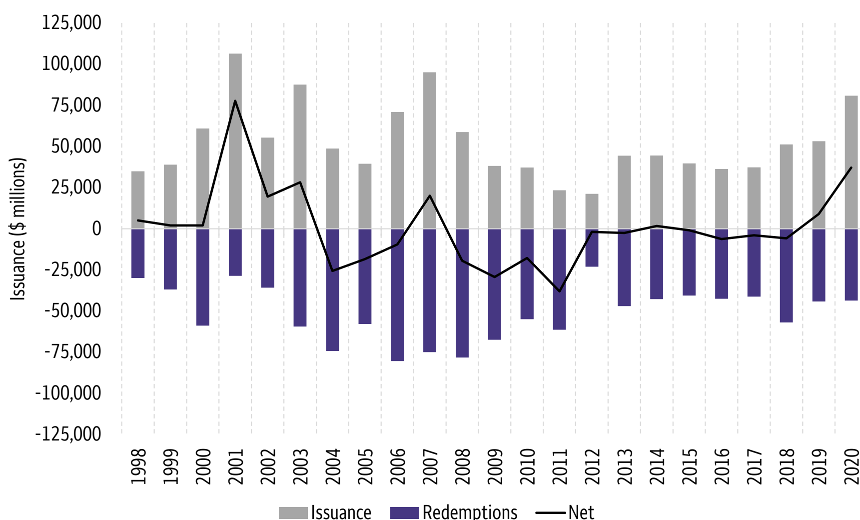
Rising from the ashes — convertible bond arbitrage[3]

In recent years, convertible bond arbitrage has been an overlooked strategy — believed to be a remnant of the late-1990s and early 2000s "golden age" for hedge funds. Since the global financial crisis, net convertible bond issuance has been relatively low by historical standards (see chart below). When this was combined with muted equity volatility and low interest rates, it drastically diminished the opportunity set for convertible bond arbitrage. In fact, over the past decade, many of the dedicated convertible arbitrage funds have either morphed into ubiquitous "opportunistic credit" funds or been absorbed into multi-strategy firms. But we sense a rebirth for this unique strategy, driven by a potent combination of significantly higher convertible bond issuance this year and our expectation for a gradual shift into an environment with higher credit and equity volatility.

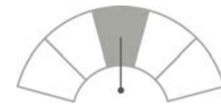
Year to date through August 31, the HFRI Relative Value: Fixed Income Convertible Arbitrage Index is up 5.2%, outperforming the Bloomberg Barclays U.S. Corporate High Yield Index by 3.5%. With many companies needing to repair pandemic-related balance sheet damage, we recently have seen significant acceleration in convertible bond issuance. We believe many of these bonds are priced at attractive levels, given the urgency for the issuers to raise capital. Further, spreads for many small- and mid-cap issuers remain wider than similarly rated investment-grade or high-yield bonds.

For the remainder of this year and next, we expect convertible bond arbitrage to benefit from further credit-spread tightening, an increase in equity market volatility, and the potential for issuers to convert debt to equity, should equity markets continue to appreciate significantly.

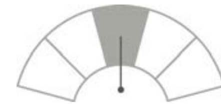
Convertible bond net issuance is returning to early 2000s levels



Sources: Bank of America Merrill Lynch, Wells Fargo Investment Institute. Data is as of August 31, 2020.

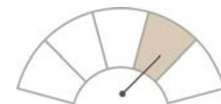


Neutral
Private Equity



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.

[3] Convertible bond arbitrage is an investment strategy that involves the simultaneous purchase of convertible securities and the short sale of the same issuer's common stock.

© 2020 Wells Fargo Investment Institute. All rights reserved.

Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. **Leveraged loans** are generally below investment grade quality ("high-yield" securities or "junk" bonds). Investing in such securities should be viewed as speculative and investors should review their ability to assume the risks associated with investments which utilize such securities. In addition to the risks associated with investment in debt securities, **collateralized loan obligations (CLOs)** are subject to other risks, including, among others, the risk that the CLOs may have a limited trading market; the possibility that distributions from collateral securities will not be adequate to make interest or other payments; the quality of the collateral may decline in value or default; and the possibility that the investments in CLOs are subordinate to other classes or tranches. **Convertible bonds** have complex exposures to interest rates, the issuer's credit quality, liquidity spreads, the issuer's stock price and the implied volatility of the embedded option. This makes them difficult to price since their price is affected by both interest rates and share prices. 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.

Definitions

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

HFRI Relative Value: Fixed Income-Convertible Arbitrage Index includes strategies in which the investment thesis is predicated on realization of a spread between related instruments in which one or multiple components of the spread is a convertible fixed income instrument. Strategies employ an investment process designed to isolate attractive opportunities between the price of a convertible security and the price of a nonconvertible security, typically of the same issuer. Convertible arbitrage positions maintain characteristic sensitivities to credit quality the issuer, implied and realized volatility of the underlying instruments, levels of interest rates and the valuation of the issuer's equity, among other more general market and idiosyncratic sensitivities.

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.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market.

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

© 2020 Wells Fargo Investment Institute. All rights reserved.

S&P/LSTA Leveraged Loan Index – Bank loans represented by the S&P Leveraged Loan Index are intended to reflect the largest facilities in the leveraged loan market. It mirrors the market-weighted performance of the largest institutional leveraged loans based upon market weightings, spreads and interest payments.

An index is unmanaged and not available for direct investment.

General Disclosures

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS' opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability or best interest analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon. The material contained herein has been prepared from sources and data we believe to be reliable but we make no guarantee to its accuracy or completeness.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company. CAR 0920-01669

© 2020 Wells Fargo Investment Institute. All rights reserved.