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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee

December 7, 2020

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- Strong gains in a 1-month period can be a reflection of turning points in fundamental support for equity markets and historically have led to higher subsequent 6- and 12-month returns.
- Risks are still present in markets, and diversification can help to moderate volatility. Holding too much cash can hinder longer-term investment goals. We suggest investing excess cash in a globally diversified portfolio and rebalancing back to long-term targets.

Equities: Recent cabinet nominations have no impact on our sector positioning...4

- President-elect Biden's recent nomination of Janet Yellen as Treasury Secretary by itself doesn't pose more concern for Financials. We maintain a neutral view of the sector.
- The potential for increased regulation could be a headwind for some mega-cap growth companies, but it's unclear how aggressive the Biden administration would be. Improving fundamentals keep us favorable on the Consumer Discretionary and Communication Services sectors.

Fixed Income: Yield curve trends 5

- The interest rate curve has been steepening, which suggests that the economic cycle is improving. Should the curve meaningfully flatten, we would be concerned that the economic expansion could slow.
- For fixed-income investors, we favor lower credit quality and higher-yielding segments of the bond market.

Real Assets: Bitcoin — 2020's best performing and most volatile...............6

- Cryptocurrency currently involves more speculating than investing, but that could change.
- We will be discussing the digital asset space more in 2021 — its upside and downside.

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- Private equity transaction activity is likely to decline this year to a multiyear low.
- The share of private equity investments involving information technology and healthcare companies continue to rise.

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Asset Allocation spotlight

Tracie McMillion, CFA
Head of Global Asset Allocation Strategy

Receding uncertainties

As November approached, there were numerous reasons for investors to reduce portfolio risk. A contentious presidential election, COVID-19 cases on the rise, and further fiscal stimulus potentially at risk were all good motives to sell equities and hold cash until those uncertainties receded. Doing so, however, meant missing out on one of the best months in decades as all major asset classes rose.

Throughout the month of November, the financial markets found reasons to move higher. Persistently low rates, ample liquidity, and the economic benefits of prior fiscal stimulus packages contributed to a sizable rebound from the March 2020 bear market lows. The positive surprises that propelled markets higher in November were the unexpected outcome of the Senate election and several COVID-19 vaccines on the horizon that were more effective in trials than anticipated. Fixed-income markets added to already sizable year-to-date gains, real assets chipped away at year-to-date losses, and equity markets logged gains in just one month that generally exceeded the historical return for an average full year. In fact, the S&P 500 Index posted its 10th best month since World War II, rising 10.75%.

Strong one month returns have historically led to strong subsequent returns

10 best months' performance for the S&P 500 Index (since WWII)				S&P 500 Index return (mos. following)		
				1M	6M	1Y
1	10/31/1974	73.9	16.30%	-5.32%	18.13%	20.49%
2	1/30/1987	274.08	13.18%	3.69%	16.27%	-6.21%
3	4/30/2020	2912.43	12.68%	4.53%	12.28%	N/A
4	1/31/1975	76.98	12.28%	5.99%	15.29%	31.02%
5	1/30/1976	100.86	11.83%	-1.14%	2.56%	1.16%
6	8/31/1982	119.51	11.60%	0.76%	23.89%	37.56%
7	12/31/1991	417.09	11.16%	-1.99%	-2.15%	4.46%
8	10/29/1982	133.71	11.04%	3.61%	22.97%	22.32%
9	10/31/2011	1253.3	10.77%	-0.51%	11.54%	12.68%
10	11/30/2020	3621.63	10.75%	N/A	N/A	N/A

1 month average	6 month average	1 year average
1.07%	13.42%	15.44%

Source: Bloomberg, LLP, December 1, 2020. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Where do we go from here?

As the table illustrates, the 10 months with the highest gains were often followed by further gains over a 1-, 6-, and 12-month period. While the 1-month outcome was mixed, the 6- and 12-month periods were higher in 9 of 10 instances — often significantly so. This seems to imply that the sizable one-month returns were the result of a fundamentally positive turning point. Perhaps the news of several effective vaccines was just such a turning point in this market.

There is, however, the potential for some disappointments along the way to a more normalized economic environment. But investors should not allow these to derail their longer-term investment plan by holding too much cash. While the election results thus far point to a divided government that is likely to restrain market-unfriendly policies like tax increases and additional regulation, Senate control remains an outstanding question. Some market volatility could arise in early January with the Georgia runoff results.

Vaccines are coming, and — by all accounts — they have been effective in trials. Even so, we expect the pandemic to get worse before it gets better. There's a chance that markets will take a more nearsighted view at some point in the coming months.

Fiscal stimulus may only partially bridge the gap for many of the hardest-hit areas of the economy. Market participants expect stimulus to be enacted sometime after the inauguration, but lawmakers could act sooner if the market falters due to rising COVID-19 caseloads or other risks. Even with further stimulus, the potential for some volatility exists if the stimulus package proves insufficient to prevent a series of bankruptcies and financial system strain.

For investors holding excess cash, we suggest investing into a globally diversified portfolio — perhaps systematically over the next three months. Investors can attempt to manage risk by rebalancing into other asset classes if equity target weights are getting heavy relative to long-term targets. The double-digit market gains we saw in November may not be repeated anytime soon, but they are a good reminder that even in the face of potential market adversity, there is the opportunity to add significantly to long-term returns by remaining fully invested according to a carefully constructed investment plan.

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Equities

Ken Johnson, CFA
Investment Strategy Analyst

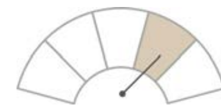
Krishna Gandikota
Investment Strategy Analyst

Recent cabinet nominations have no impact on our sector positioning

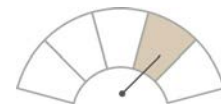
As President-elect Joe Biden establishes his cabinet, investors have questioned what this may mean for firms, particularly as it relates to anti-trust and increased regulation. Whereas some of the nominations have created concern, the recent nomination of Janet Yellen as Treasury Secretary has largely been taken positively. That said, there are still a set of appointments and policy options to come which could still make it tougher on Financials. Even so, historically, companies have figured out ways to deal effectively with regulators — regardless of the party in power. Regulation aside, the big factors that we are watching for Financials — specifically banks — continue to be credit demand, interest rates, and loss cycles. We continue to see the risks as balanced for the sector and maintain a neutral view.

In October, the House Judiciary committee released a report noting that large firms, primarily in the Consumer Discretionary and Communication Services space, abused their stature — by setting and often dictating prices and rules for commerce, search, and advertising. Social media firms have faced additional threats related to Section 230 of the Communications Decency Act, which could render them as publishers of content instead of content distributors. We anticipate these firms will likely come under increased scrutiny under the Biden administration, but it may be difficult to enact any significant changes within the industry.

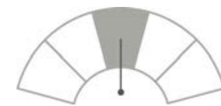
Using history as a guide, additional investigations or hearings could take years to complete and may only result in greater enforcement remedies. These risks are largely borne by the firms themselves, not the shareholders. We believe if these companies are ultimately broken up into separate businesses, they can run the separate businesses fairly effectively — and perhaps even more efficiently — potentially creating increased shareholder value. We will continue to monitor the regulatory environment, but improving fundamentals continue to support our favorable view on the Consumer Discretionary and Communication Services sectors.



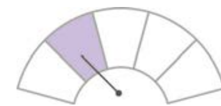
Favorable
U.S. Large Cap Equities



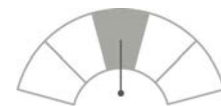
Favorable
U.S. Mid Cap Equities



Neutral
U.S. Small Cap Equities



Unfavorable
Developed Market Ex-U.S. Equities



Neutral
Emerging Market Equities

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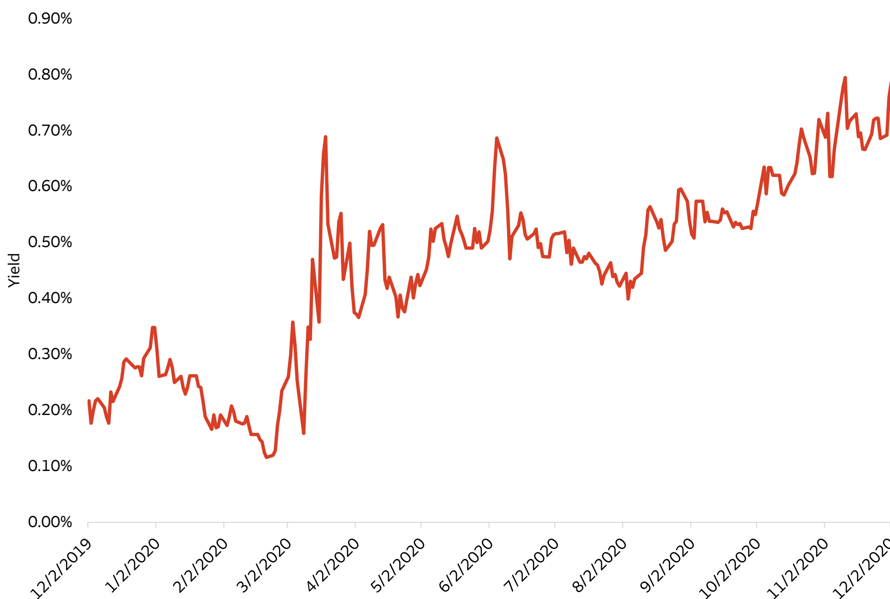
Fixed Income

Yield curve trends

The yield curve follows fairly predictable, long-term trends — steepening early in an economic recovery before flattening and finally inverting into an eventual economic downturn. This pattern has been repeated consistently over the last 30 years. Predictably, every cycle, theories abound to explain why this time is different — from the impact of quantitative easing to global relative value. Also quite predictably, the yield curve continues to send accurate signals as to the future state of the economy. Our expectation of improving economic conditions in 2021 is confirmed by the yield curve, which has been slowly steepening.

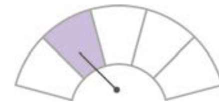
With short-term rates anchored near zero — likely for years — we believe that we will remain in a positively-sloped yield curve environment. This suggests that we are in the early phases of an economic expansion. We expect the yield steepening will be gradual. If the yield curve were to quicken its pace of steepening, it would likely be indicative of a faster-than-expected economic recovery. With the potential for higher long-term rates, a steepening yield curve, and a continued economic recovery, we favor higher-yielding segments of the bond market, such as high-yield and preferred securities.

Yield curve steepening

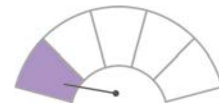


Sources: Bloomberg, Wells Fargo Investment Institute, December 2, 2020. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. **Past performance is no guarantee of future results**

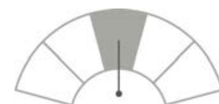
Brian Rehling, CFA
Head of Global Fixed Income Strategy



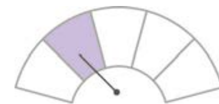
Unfavorable
U.S. Taxable Investment Grade Fixed Income



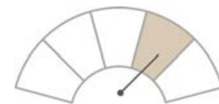
Most unfavorable
U.S. Short Term Taxable Fixed Income



Neutral
U.S. Intermediate Term Taxable Fixed Income

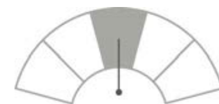


Unfavorable
U.S. Long Term Taxable Fixed Income



Favorable
High Yield Taxable Fixed Income

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



Neutral
Emerging Market Fixed Income

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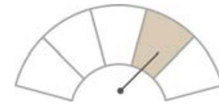
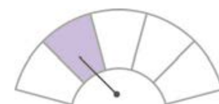
Real Assets

John LaForge
Head of Real Asset Strategy



Favorable
Commodities



Unfavorable
Private Real Estate

"Speak the truth but leave immediately after." — Slovenian Proverb

Bitcoin — 2020's best performing and most volatile

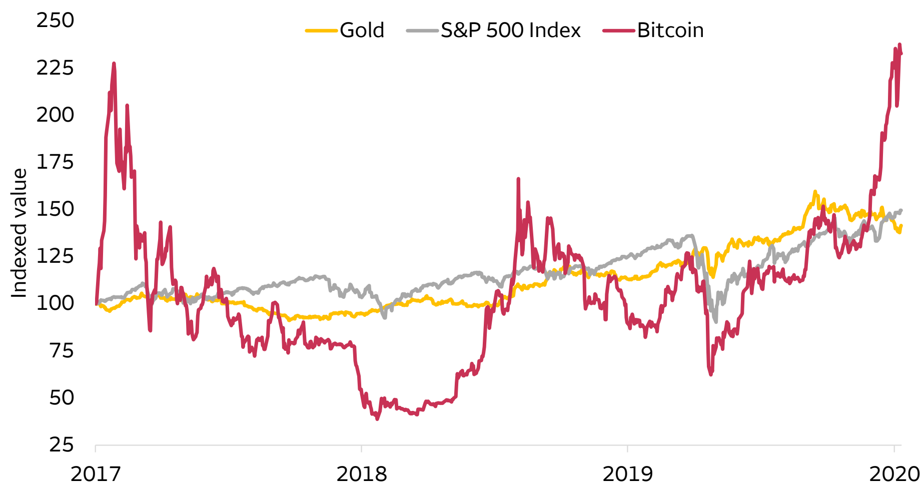
2020 has been a wild and crazy year, so it is only fitting that the best-performing asset group in 2020 has the craziest-sounding name — cryptocurrencies. Bitcoin, the largest cryptocurrency, is up 170% this year — that's on top of the 90% gain it had in 2019.

If you feel left out of the craziness, don't. Most investors have heard of cryptocurrencies, but few have ever bought or used one. They attract lots of attention, but not necessarily lots of investment money. The entire cryptocurrency market is worth roughly $560 billion, which is about one-fourth the size of the S&P 500 technology company with the largest market capitalization.

And if you feel left out of the gains, don't. The chart highlights that bitcoin has indeed outperformed gold and the S&P 500 Index over the last three years, but look at the volatile journey bitcoin investors had to endure to get there. Up until only two months ago, three-year total returns were pretty much the same among the three assets, but volatility differed. Cryptocurrency investing today is a bit like living in the early days of the 1850's gold rush, which involved more speculating than investing.

Cryptocurrencies could become investment-worthy one day, though. Over the past 12 years, they have risen from literally nothing to $560 billion in market capitalization. Fads don't typically last 12 years. There are good reasons for this — reasons that every investor should hear. As we roll into 2021, we'll be discussing the digital asset space more — its upside and downside.

Bitcoin, gold, and S&P 500 Index performance



Sources: Bloomberg, Wells Fargo Investment Institute. Daily data: November 23, 2017 – December 2, 2020. Indexed to 100 as of the start date. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment.

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Alternatives

Yegin Chen, Ph.D
Senior Global Alternative Investment Strategist

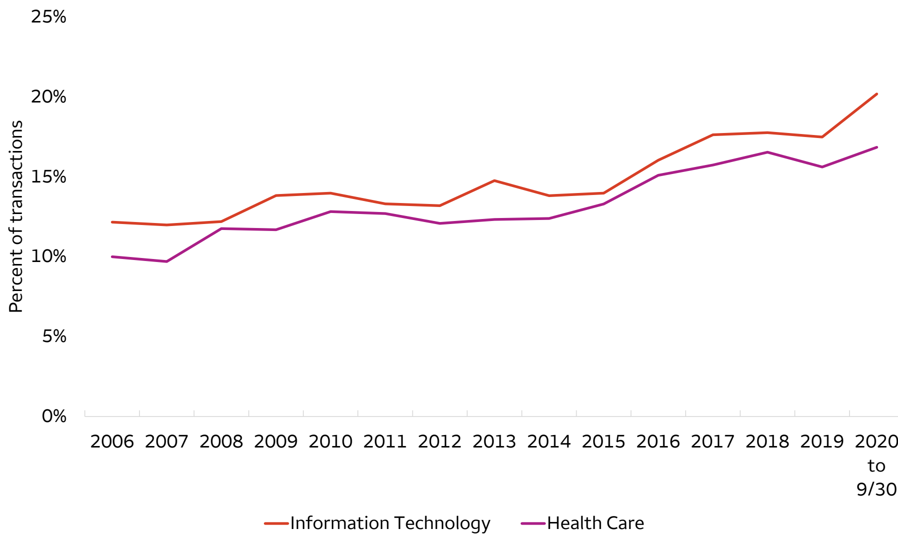
Growing private equity interest in IT and Health Care

Private equity activity has tapered off in 2020. In the first three quarters, U.S. private equity deal activity totaled some 3,444 deals for over $453 billion. On an annualized basis, these figures were down 17% and 22% (respectively) from last year's totals as market uncertainty and COVID-19-related travel restrictions dampened activity. Barring a year-end uptick, 2020 will witness the fewest completed private equity deals since 2016.

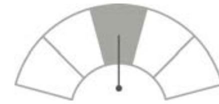
Amidst the overall investment slowdown, two industry sectors continue to garner a greater share of private equity fund investment — Health Care and Information Technology (IT). The share of transactions completed for IT and healthcare companies jumped meaningfully in 2019. As seen in the chart, through the first three quarters of 2020, some 20% of U.S. private equity transactions for the year involved IT companies, the highest percentage in at least 15 years. These IT companies generally have been in areas of secular and COVID-19-spurred demand growth such as enterprise software, cybersecurity, e-commerce, e-learning, and online gaming.

Similarly, through the first three quarters of 2020, some 17% of private equity transactions were in healthcare companies, the highest percentage in at least 15 years. These healthcare investments were generally not in capital-intensive businesses such as hospitals, but in healthcare service providers and biopharmaceutical firms expected to benefit from greater COVID-19-related priorities. As a result, we believe qualified investors should generally expect a growing percentage of private equity fund positions in dynamic IT and Healthcare companies.

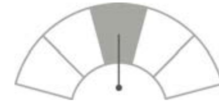
The growing share of private equity transactions in IT and Health Care



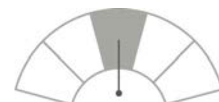
Sources: Wells Fargo Investment Institute, PitchBook as of November 4, 2020.



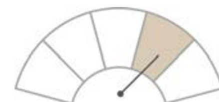
Neutral
Private Equity



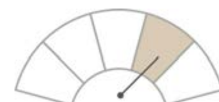
Neutral
Hedge Funds – Macro



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.

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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. **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. There are special risks associated with investing in **preferred** securities. Preferred securities are subject to interest rate and credit risks. Interest rate risk is the risk that preferred securities will decline in value because of changes in interest rates. Credit risk is the risk that an issuer will default on payments of interest and principal. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. Preferred dividends are not guaranteed and are subject to deferral or elimination.

Virtual or criptocurrency is not a physical currency, nor is it legal tender. Cryptocurrencies are sometimes exchanged for U.S. dollars or other currencies around the world, but they are not backed or supported by any government or central bank. Their value is completely derived by market forces of supply and demand, and they are more volatile than traditional fiat currencies.

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.

An index is unmanaged and not available for direct investment.

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