WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **August 30, 2021**

- We believe that municipal bonds (munis) remain an attractive asset class and continue to view them favorably. Munis continue to enjoy popularity, as evidenced by strong capital inflows. Also, an eventual change in tax policy may result in even stronger demand for munis, which also supports our favorable view on this asset class.
- Municipal-to-Treasury yield ratios are hovering near all-time lows — this makes municipals bond valuations appear expensive. Municipal credit spreads also continue to tighten across credit ratings, and we believe that this trend will remain as investors continue to search for yield and as additional fiscal stimulus continues to roll out.

- The current bull market for the S&P 500 Index is now 17 months old with a total return of more than 100%.
- We believe we're still in the early innings of the cycle and that strong economic and earnings growth and relatively low rates through 2022 should support higher equity prices and sustain the bull market.

- We suspect that China will not be the main source of demand growth this time around and hence will not matter as much to the current commodity bull super cycle.
- Yet, China developments should be closely watched for their impacts over the tactical (6- to 18-month) time frame.

- Long/short equity and credit strategies can help investors diversify their equity risk while also potentially delivering attractive risk-adjusted returns.
- We believe that an improvement in short alpha coupled with a potential trough in credit markets stress is signaling an attractive entry point for hedge fund investors.

Fixed Income Spotlight

Flows and sentiment underpin municipal bonds

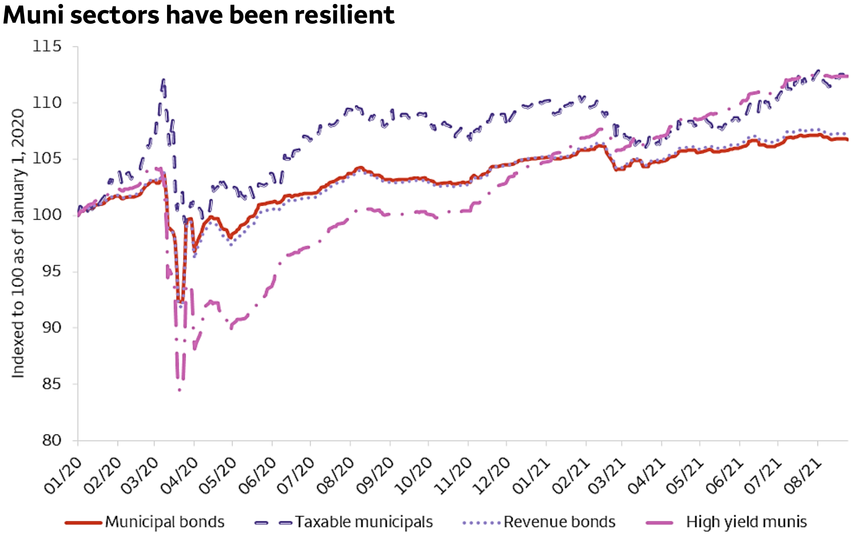
U.S municipal bonds (munis) have been a resilient asset class for fixed-income investors over the past few years. 2021 has been no exception, as munis have provided modest positive returns year-to-date[1] while many other fixed-income asset classes have lagged.

Munis continue to enjoy popularity, as evidenced by strong capital flows into this space. Year-to date inflows have increased to nearly $79 billion, extending the inflow streak to 65 of the past 66 weeks.[2] If this pace continues, 2021 is on track to record the highest calendar-year cumulative fund flows since 1992.

Supply, on the other hand, has been scarce. The summer reinvestment demand, coupled with the negative net supply due to coupon and principal redemptions, have continued to create an imbalance between supply and demand. In addition, a large portion of new issuance in 2021 has been skewed toward taxable municipal bonds, further exacerbating the issue. It is our belief that the combination of lower supply of traditional municipal bonds and strong demand will continue to underpin this asset class.

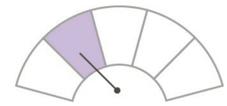
However, if measured only by valuations, municipal bonds appear somewhat unattractive. Intermediate U.S. Treasury yields have climbed higher from last August's lows, while intermediate municipal yields have remained flatter. This has caused municipal-to-Treasury yield ratios in the longer part of the curve to hover near all-time lows, making munis look more expensive relative to where they had been in previous years. We expect taxable yields to climb higher in the remainder of the year, which should also translate into higher tax-exempt yields, potentially creating better entry points for investors looking to increase exposure.

Muni sectors have been resilient

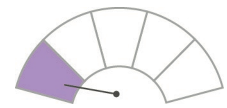


Sources: Wells Fargo Investment Institute, Bloomberg, August 25, 2021. Daily data from January 1, 2020 to August 25, 2021

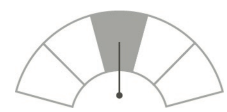
Luis Alvarado
Investment Strategy Analyst



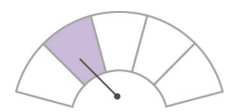
Unfavorable
U.S. Taxable Investment Grade Fixed Income



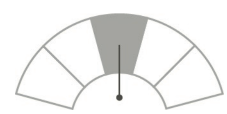
Most unfavorable
U.S. Short Term Taxable Fixed Income



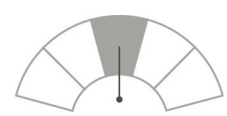
Neutral
U.S. Intermediate Term Taxable Fixed Income



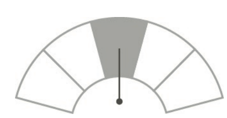
Unfavorable
U.S. Long Term Taxable Fixed Income



Neutral
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

[1] Bloomberg as of August 25, 2021.
[2] Lipper as of August 18, 2021.

Municipal credit spreads also continue to tighten across credit ratings, and we believe that this trend will remain as investors continue to search for yield and as additional fiscal stimulus continues to roll out. For investors for whom it is appropriate, we currently favor above benchmark-level exposure to BBB-rated municipal credits. We believe that issues in the BBB credit rating can help raise yield potential and potentially provide better returns given the strong demand for munis as the recovery continues to take hold.

We also believe that high-yield municipal securities continue to present a good potential opportunity for investors seeking to enhance their sources of yield, while diversifying into other sectors of the municipal bond space. However, selectivity and careful credit research remain crucial in the muni space.

Opportunities for crossover exist all across the curve, given the overall decline in municipal yields. Since we expect taxable yields to move modestly higher in the months ahead, crossover opportunities will remain a viable option for investors, in our view. However, we recommend investors remain aware of the differences in credit quality between municipal and corporate issues as they attempt to cross over. Also, in some cases, municipal bonds will continue to offer the additional benefit of being exempt from state and local taxes, which will favor the purchase of state-specific municipal bonds versus corporates, particularly in states with higher tax rates like California and New York.

We remain favorable on investment grade (IG) Municipals and neutral on High Yield (HY) Municipals. An eventual change in tax policy may result in even stronger demand for municipal bonds, which also supports our favorable view on this asset class. Selectivity remains key as some states and sectors carry higher credit risks than others, but overall, we expect positive single-digit returns for both IG and HY municipals for the remainder of 2021 and into 2022.

We believe that municipal bonds should remain on strong footing in the months ahead even as the Federal Reserve prepares to embark on a new round of tapering asset purchases and an eventual increase of policy rates in 2023. In previous Fed tightening cycles, munis have displayed positive absolute and relative returns versus Treasuries, and we expect that to be the case this time, as well.

Equities

Chris Haverland, CFA
Global Equity Strategist

Bull market aging, but still in early innings

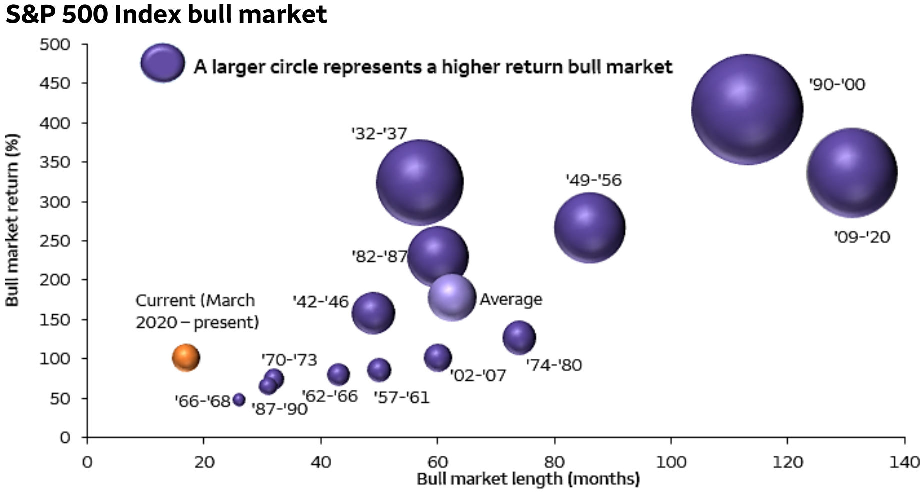
Despite being in the middle of a seasonally weak period, the S&P 500 Index continues to grind higher. Robust earnings growth across all sectors in the first half of 2021 has propelled the index to record highs. Around this time last year, the benchmark hit an all-time high (surpassing the pre-pandemic peak reached on February 19, 2020), signaling a new bull market.

Although the rally began in late March 2020, a new bull market typically is not declared until the index reaches new highs. Even so, the start date of a new bull market includes the recovery period from the lows. Therefore, the latest bull market for the S&P 500 Index is now over 17 months old — with eye-popping returns of more than 100%.

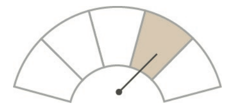
Since the market trough, the top-performing sectors have been Materials, Information Technology, and Financials. While cyclicals have benefited from global re-openings, growth sectors have proven resilient throughout the pandemic. The worst-performing sectors (Utilities and Consumer Staples) are more defensive in nature and have followed the traditional pattern of underperforming early in the cycle.

On average, bull markets have lasted 62 months with an average price return of 178%. While this has been one of the fastest recoveries in history, from a duration perspective, the current bull market is likely still in its infancy. Over the next 12 to 18 months, we forecast strong economic and earnings growth and relatively low interest rates. Unless there is a serious policy mistake, we believe these factors will support higher equity prices and sustain the bull market rally.

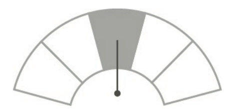
S&P 500 Index bull market



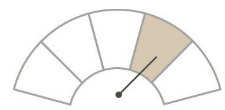
Sources: Wells Fargo Investment Institute, Bloomberg, 8/25/2021.



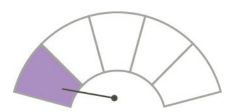
Favorable
U.S. Large Cap Equities



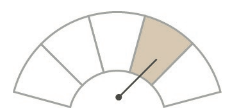
Neutral
U.S. Mid Cap Equities



Favorable
U.S. Small Cap Equities



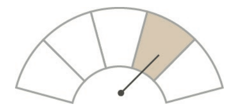
Most unfavorable
Developed Market Ex-U.S. Equities

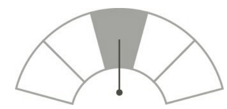


Favorable
Emerging Market Equities

Real Assets

Austin Pickle, CFA
Investment Strategy Analyst





"Though we see the same world, we see it through different eyes." — Virginia Woolf

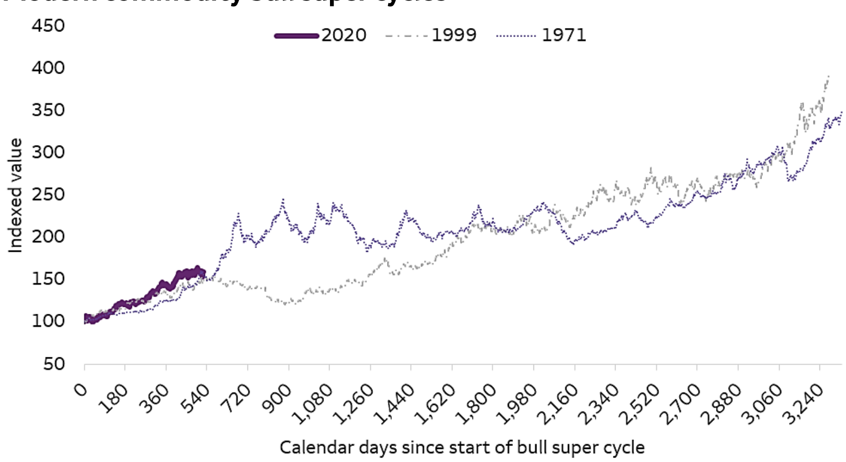
China and the commodity bull

In July, we officially called the end of the 12-year-long commodity bear super cycle and the start of the new bull. For more details on this strategic call, please reference our report.[3] Since then, we have been asked whether growth concerns and government intervention in China could derail the bull super cycle. Our view is that China matters but may not matter to the extent many think. Let's explore why.

Commodity super cycles are largely driven by marginal demand. Let's take a look at the 1999 commodity bull super cycle as an example. In 1999, China accounted for only around 10% of the world's consumption of industrial metals, but that grew to roughly 50%. That growth in demand over and above the supply response drove the commodity bull super cycle, and when that growth stopped and supply caught up 10 years later, the bull died.

We suspect that China will not be the main source of increased demand this time around and hence will not matter as much to the current bull super cycle. Yet, its sheer size means that China should not be ignored. In our view though, any China growth hiccups or government interference in the commodity markets are more likely to impact our tactical (6- to 18-month) commodity outlook than our super cycle call (~10 years). A reasonable parallel can be observed in the chart. Consider that when the commodity behemoth at the time — the U.S. — entered a recession in 2001, commodity prices struggled, but the bull reasserted itself soon after.

Modern commodity bull super cycles

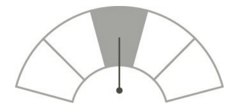


Sources: Bloomberg, Wells Fargo Investment Institute. Performance measured from October 4, 1971 - November 20, 1980, July 13, 1999 - July 2, 2008, and March 18, 2020 - August 25, 2021. Commodity performance measured by our Commodity Composite. Indexed to 100 as of the start dates. See back page for definition.

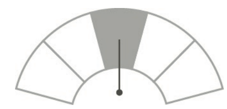
[3] The new commodity super cycle bull, 7/22/2021.

Alternatives

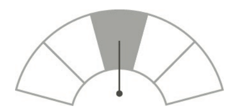
Justin Lenarcic, CAIA
Senior Global Alternative Investment Strategist



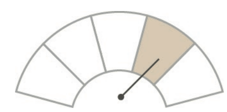
Neutral
Private Equity



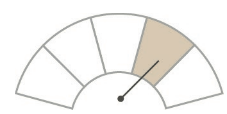
Neutral
Hedge Funds – Macro



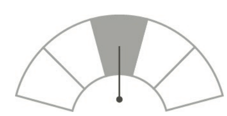
Neutral
Hedge Funds – Event Driven



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 appropriate for all investors and are only open to "accredited" or "qualified" investors within the meaning of U.S. securities laws.

Timely entry point for long/short strategies

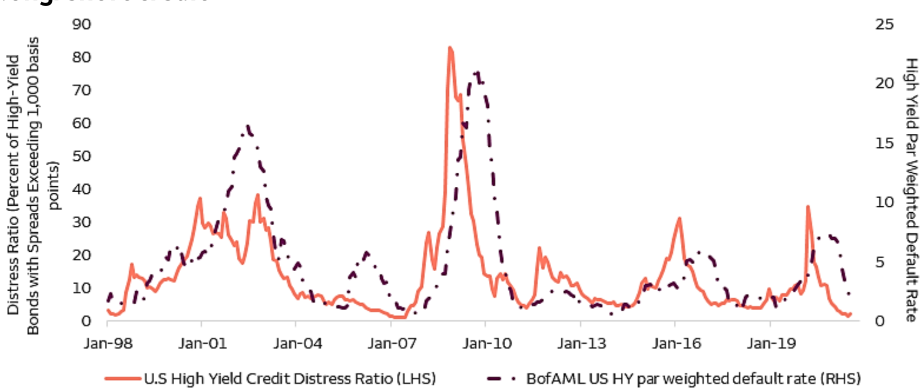
Despite equities grinding higher, credit spreads plumbing historically tight levels, and volatility rangebound, we think there are three compelling reasons that qualified investors should consider legging into both long/short equity and long/short credit strategies: an acute need for diversification; an improvement in short alpha; and a potential trough developing in the high yield distress ratio.

1. Often when diversification seems the most punitive to portfolio returns is precisely when investors should be focusing on it, especially with a negative stock-bond yield correlation. Though hedge funds are positively correlated to risk assets, they have historically acted as portfolio diversifiers that have helped increase risk-adjusted returns. Investors need not be contrarians to appreciate ways to diversify equity risk and mitigate drawdowns.

2. Recent industry prime brokerage analysis indicates that in July hedge funds delivered their best month of outperformance – or alpha – from shorting stocks since 2010. While one month does not make a trend, we are cautiously optimistic that we are returning to a better environment for shorting equity and credit securities.

3. Though still near historical lows, the U.S. high yield distress ratio ticked up slightly in July. Admittedly, it's difficult to be too bearish on credit with stimulus, lending, and rates all supportive of the asset. But this bears watching as a potential driver of increased credit dispersion.

If the distress ratio is troughing, it could signal more opportunities for long/short credit



Sources: BofAML HY Credit Chartbook, Wells Fargo Investment Institute. Data as of August 2, 2021

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.

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 appropriate 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

Commodity Composite measures a basket of commodity prices as well as inflation. It blends the historical commodity index introduced by George F. Warren & Frank A. Pearson, former academics at Cornell, collected and published commodity price data in their book, Prices, and the producer price index for commodities (PPI-Commodities), and the National Bureau of Economic Research (NBER) Index of Wholesale Prices of 15 Commodities, the Reuters Continuous Commodity Index, and the Bloomberg Commodity Index Total Return.

The Commodity Composite connects the aforementioned components at the following years:

Warren and Pearson- Prices: 1720-1932, BLS PPI-Commodities: 1933-1946, NBER: 1946-1956, Reuters Continuous Commodity Index: 1956-1999, Bloomberg Commodity Index Total Return: 1999- current.

[Include any index definitions for any indexes which have been utilized in the report]

An index is unmanaged and not available for direct investment.

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