WELLS FARGO
Investment Institute

FROM THE DESK OF DARRELL L. CRONK

State of the Markets

June 22, 2021

Darrell L. Cronk
President, Wells Fargo Investment Institute

Chief Investment Officer, Wealth & Investment Management

Darrell L. Cronk is the president of Wells Fargo Investment Institute, which is focused on delivering the highest quality investment expertise and advice to help investors manage risk and succeed financially.
Mr. Cronk leads global investment strategy and research including equity, fixed income, real assets, and alternative investments. He also serves as chief investment officer for Wealth & Investment Management, a division of Wells Fargo & Company that includes Wells Fargo Private Bank, Wells Fargo Advisors, and Abbot Downing.

Tomorrow's battles

"The victors of the battles of tomorrow will be those who can best harness thought to action." — B.C. Forbes

Last week's Federal Open Market Committee meeting statement took "easy" out of the equation in more ways than one. The Fed didn't just call into question the future path of "easy' monetary policy — it also removed "easy" from the equation markets use to predict the direction and trajectory of foundational asset price markers. The meeting surprised markets to the hawkish side, leading to a quick rise in the short end of the yield curve and a simultaneous fall in longer-term interest rates. This, along with a rise in the U.S. dollar, left risk assets such as equities and commodities in a precarious state of attempting to chart out the future. It has been apparent since late 2020 that the portfolio strategies investors used to navigate last decade's markets may not be the same strategies they will need to fight the market battles of tomorrow.

The median Fed dot plots now imply two 25-basis-point[1] rate hikes by the end of 2023, according to 13 of 18 members, and 7 of the 18 think a first rate hike is warranted in late 2022. That is a major departure from the view that inflation risks were so limited, the Fed could focus almost exclusively on its mandate to return the economy to full employment —the U.S. is still short of pre-pandemic employment highs by 7 to 8 million Americans. And while 2023 is a long way off to some people who are just now emerging from a 16-month pandemic lockdown, it is apparently not too far away for bond and equity investors to take notice and begin pricing in new expectations.

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

[1] 100 basis points equal one percent.

© 2021 Wells Fargo Investment Institute. All rights reserved.

Ultimately, almost all assets, especially risk assets such as equities and commodities, are forward-looking instruments. Therefore, anything that changes tomorrow's outlook should impact today's valuations and valuation models. However, on the back of the Fed's seemingly greater focus on where inflation is and has been, than on where it might be going, the notion that the Fed may raise rates from 0% to 0.5% over the next two years hardly seems to us that it would have substantial impact at all on the economy. And indeed, some have postulated that the Fed holding rates near zero for most of last decade helped keep the gross domestic product growth rate stubbornly below 2% most of the time.

Perhaps a more salient question to ask today is this — whether holding interest rates at zero, along with $4 billion a day of asset purchases, is compatible with a U.S. economy growing at the fastest two-year clip since 1965-66; assets prices like equities, real estate, and commodities at or close to all-time highs; a consumer price index annualizing at the highest rate in three decades; and fiscal stimulus recently expanding at the fastest clip in modern history. If this is the state of play, it would actually suggest recent Fed actions are quite rational, perhaps even necessary.

Stepping back from recent Fed-generated market gyrations and the great debate about the future path of inflation, investors would be wise to recognize that many of the market trends of the past decade have shifted materially — even if their portfolios may have not. For reference:

- Growth stocks trounced value stocks for 10 years; now, in 2021, value stocks are once again outperforming growth stocks.
- For a decade, large-cap stocks overwhelmed small-cap stocks; now small-cap stocks are consistently beating large-cap stocks.
- International equities underperformed U.S. equities for 10 years; now international stocks are exhibiting strong gains once again.
- Commodities returned negative annualized returns for 10 years; now, they are one of the best performing asset classes with one of strongest starts to a calendar year on record.
- The U.S. dollar for 10 years has generally been strengthening; it has reversed and weakened for much of last year and this year.
- Interest rates and inflation have been low and basically declining for 10 years; now they are both on the rise.
- The largest proposed corporate and individual tax plan changes since 1968 are edging their way through the political engine, with the potential to alter capital market dynamics and positioning for years to come.

As the durable proverb made famous by Winston Churchill states, generals are always prepared to fight the last war. So also, investors facing new situations and changing variables tend to bring along historical baggage, prior battle scars, and strategies they wish they had used during the last market cycle. History teaches us that fighting the last war as a method of winning future wars may make us feel good, but is rarely successful. It is important to recognize that the battle lines have shifted within capital markets — some in rather seismic ways. We view these shifts in market trends as nothing less than a clarion call for investors to ensure that they aren't marching toward tomorrow's battles armed with yesterday's portfolio.

© 2021 Wells Fargo Investment Institute. All rights reserved.

Risk Considerations

All investing involves risk including loss of principal. Past performance is no guarantee of future results.

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. There are no guarantees that growth or value stocks will increase in value or that their intrinsic values will eventually be recognized by the overall market. The return and principal value of stocks fluctuate with changes in market conditions. The growth and value type of investing tends to shift in and out of favor. **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. 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.

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 Wealth and Investment Management, a division within the Wells Fargo & Company enterprise, provides financial products and services through bank and brokerage affiliates of Wells Fargo & Company. Brokerage products and services offered through Wells Fargo Clearing Services, LLC, a registered broker-dealer and non-bank affiliate of Wells Fargo & Company. Bank products are offered through Wells Fargo Bank, N.A.

Abbot Downing, a Wells Fargo business, offers products and services through Wells Fargo Bank, N.A. and its various affiliates and subsidiaries.

Wells Fargo Private Bank offers products and services through Wells Fargo Bank, N.A. and its various affiliates and subsidiaries. Wells Fargo Bank, N.A. is a bank affiliate of Wells Fargo & Company.

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 0621-03033

© 2021 Wells Fargo Investment Institute. All rights reserved.