WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **November 30, 2020**

Asset allocation spotlight: Risks of holding too much cash 2

- Cash has important uses, but we believe it is not the best long-term investment option for most investors. Over long periods of time, inflation can erode the purchasing power of cash.
- Our research has found that investors, on average, hold more cash in their portfolios than we would recommend. Investors can use dollar-cost averaging for allocating free cash.

Equities: Adding more cyclicality to our model portfolios 4

- We expect the global economy to continue its recovery in 2021, which should benefit economically-sensitive asset classes and sectors.
- We recently added more cyclicality to our model portfolios by upgrading the Materials and Industrials sectors, while downgrading the Information Technology sector.

Fixed Income: High-yield municipal bonds remain attractive 5

- We believe high-yield (HY) municipals still present an opportunity for those investors looking to enhance their sources of yield while diversifying into other sectors of the municipal space.
- At this time, we believe HY municipal defaults still remain low and we expect to remain close to this level because there is not much debt outstanding in those sectors with more risk of default.

Real Assets: OPEC+ meeting — steady as she goes? 6

- Oil prices have surged recently on encouraging COVID-19 vaccine announcements.
- We suspect that OPEC+[1] will support recent price gains by announcing this week an extension of their existing production cuts.

Alternatives: Global merger and acquisition (M&A) activity continues to recover 7

- While risks remain, there is a surprising level of optimism among deal-makers that 2021 will be a strong year of deal activity.
- Potential top sectors for deals in the next year are automotive, health care, technology, consumer products, and financial services.

[1] The Organization of the Petroleum Exporting Countries and others like Russia.

Asset allocation spotlight

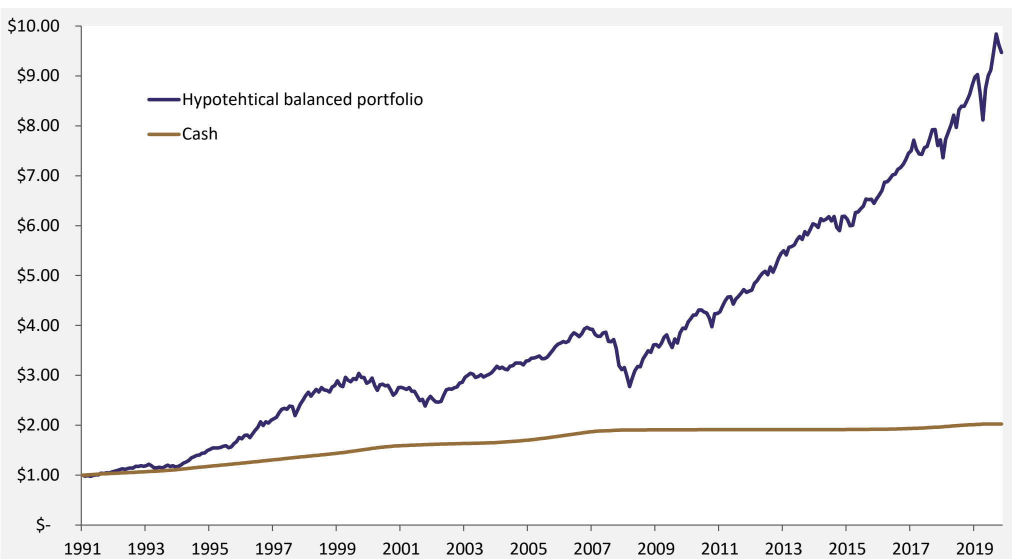
Michael Taylor, CFA
Investment Strategy Analyst

Risks of holding too much cash

Cash has important uses, but do not believe it is the best, long-term investment option for most investors. Cash can be a temporary parking place for funds awaiting investment, but over long periods of time, inflation can erode its purchasing power. We believe cash and cash alternatives have a place in a portfolio. But how much cash should an investor hold in their portfolio? The answer can be complicated, especially in times of market uncertainty. We suggest that investors set aside three to six months of living expenses in an emergency fund. But the amount of recommended liquid assets can depend on a variety of factors including market conditions, major life events, job security, and unexpected events.

When it comes to cash, time horizon matters. In our view, investors should hold enough cash to meet short-term liquidity needs to avoid selling assets at inopportune times. But our research has found that investors may be holding more cash than we would recommend. We believe that investors holding too much cash could miss latest market recovery potential and, may hinder long-term performance. The value of cash can erode over time due to the effects of inflation. Although inflation may be low today, that may change in the future. Riskier assets, such as stocks, have the ability to outpace inflation, but they do come with an increase in volatility.

Chart 1: Cash has struggled to keep pace with inflation



Sources: © Morningstar, March 31, 2019. All Rights Reserved[1] Time frame covered: 01/31/1980–03/31/2019. Returns shown are adjusted for inflation as represented by Consumer Price Index for All Urban Consumers (CPI-U). Cash return represented by U.S. Treasury Bill 3-Month Index. The Hypothetical Balanced Portfolio is represented by 60% IA SBBI U.S. Large Stock TR Index, 40% IA SBBI U.S. Intermediate-Term Government TR Index. Consumer Price Index for All Urban Consumers is a measure that examines the changes in the price of a basket of goods and services purchased by urban consumers. U.S. Treasury Bill 3-Month Index measures the performance of direct obligations of the U.S. Treasury. Returns shown are compiled from the yields available from the weekly auction of Treasury bills with a maturity of 90 days. Ibbotson Associates Stocks, Bonds, Bills and Inflation Series (IA SBBI) U.S. Large Stock TR Index: The large-cap stock total return index is based on the S&P Composite Index. This index is a readily available, carefully constructed, market-value-weighted benchmark of large-cap stock performance. The large-capitalization stock total return is provided by S&P Dow Jones Indices, which calculates the total return based on the daily reinvestment of dividends on the ex-dividend date. Ibbotson Associates Stocks, Bonds, Bills and Inflation Series (IA SBBI) U.S. Intermediate-Term Government Bonds TR Index: one-bond portfolios are used to construct the intermediate-term government bond index. The bond chosen each year is the shortest non-callable bond with a maturity not less than five years, and it is "held" for the calendar year. Total returns of the intermediate-term government bonds for 1987 to 2014 are calculated from The Wall Street Journal prices, using the coupon accrual method. An index is unmanaged and unavailable for direct investment. Chart is for illustrative purposes only. It does not represent the performance of any specific investment. **Hypothetical and past performance is no guarantee of future results. For illustrative purposes only. Index returns do not represent investment returns or the results of actual trading. Index returns reflect general market results, assume the reinvestment of dividends and other distributions and do not reflect deduction for fees, expenses or taxes applicable to an actual investment.** Please see end of report for index definitions.

For decades it was possible for investors to earn a small, real (after-inflation) return on cash holdings. The trend has since reversed and the cash investor has been losing ground since the early 2000s. A balanced portfolio with a 60/40 percent mix of stocks and bonds has seen growth over this same period, and preserved through a few significant selloffs (Chart 1).

If we consider the recent selloff triggered by the coronavirus and lockdowns, an investor who remained invested outperformed one who did not participate. Based on our analysis, a portfolio that increased cash holdings to 15% during the recent bear market (March through mid-August 2020) underperformed one that remained at only 3% cash by roughly 7% over the recovery period.[2] A portfolio that redistributed half its equity allocation to cash over the same period underperformed one with 3% cash by 15%. Our research also has found that sitting on the sidelines also comes with risks. Our analysis shows that over 20- and 30-year time periods missing the 10 best days in the market over can reduce potential investment by 50%. And often times the best days in the market follow the worst days, making attempts to time the market nearly impossible.[3]

Cash on the sidelines

Cash can provide a temporary parking place for funds awaiting investment. When an investor has a large sum of cash from the sale of a house or from an inheritance, we do not recommend rushing to invest it. Instead, for portfolios with cash holdings above our suggested allocation, we encourage investors to consider investing it thoughtfully and ease into the market. One potential strategy is dollar-cost averaging — a systematic approach of investing cash incrementally over time to take advantage of market fluctuations. Dollar-cost averaging overlooks day-to-day market fluctuations that make it difficult to pinpoint the optimal time to invest. Instead of investing a lump sum into the markets, a fixed dollar amount is invested regularly over a period of time. This involves investing equal portions of the cash sum on a monthly, bi-monthly, or quarterly basis. We believe this approach can help to average out the purchase prices of assets. While dollar-cost averaging does not guarantee a profit or protect a portfolio from a loss, the strategy focuses on asset accumulation in a systemic way.

Determining whether dollar-cost averaging is an appropriate strategy for an investor requires an evaluation of financial situation, risk tolerance, and investment objectives. We encourage investors to talk with an investment professional to see if dollar-cost averaging may be an appropriate strategy.

[2] 3% cash portfolio is comprised of 3% cash, 37% fixed income, and 60% equity. 15% cash portfolio is comprised of 15% cash, 37% fixed income and 48% equity. (March 23, 2020 – August 18, 2020.) Indexes used in the analysis were: Bloomberg Barclays U.S. Aggregate Bond Index, Bloomberg Barclays U.S. Treasury Bills (1–3 Month) Index and S&P 500 Index. See end of report for definitions.

[3] "The Perils of Trying to Time Volatile Markets", Global Asset Allocation Strategy Team, Wells Fargo Investment Institute, March 20, 2020.

Equities

Chris Haverland, CFA
Global Asset Allocation Strategist

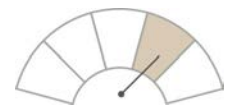
Adding more cyclicality to our model portfolios

We expect improving, sustainable global economic growth in 2021. This should benefit economically-sensitive asset classes and sectors, prompting us to add more cyclicality to our model portfolios. In addition to our recent upgrade to Emerging Market Equities, we also upgraded the Materials and Industrials sectors, while downgrading the Information Technology sector.

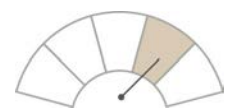
Materials (Neutral to Favorable) – We look for sales and earnings to grow by double-digits in 2021 as global industrial production activity recovers. We view a weakening U.S. dollar and the potential for increased infrastructure spending are positives for the sector. Although price/earnings (P/E) valuation has risen, we believe it remains inexpensive, relative to the S&P 500 Index.

Industrials (Unfavorable to Neutral) – Industrials, which is one of most sensitive sectors to economic growth, should benefit from our expectations for a rebound in the economy and industrial production. Fundamentals for airlines and commercial aerospace are improving more slowly than the rest of the sector. However, we look for sentiment to improve once an effective COVID-19 vaccine is widely available. P/E valuation is above average, but as earnings visibility improves, we expect valuations to become more reasonable.

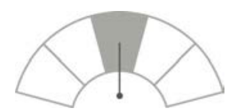
Information Technology (Most Favorable to Favorable) – Fundamentals remain strong for the sector, but as economic growth picks up, investors may shift focus to sectors that are more sensitive to a recovery. We still believe that Information Technology can outperform the broader market and can offer investors exposure to high-quality stocks with strong growth characteristics. The reduction in guidance creates an opportunity to lock in some gains and reposition toward more cyclical sectors.



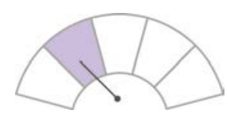
Favorable
U.S. Large Cap Equities



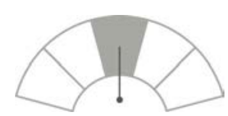
Favorable
U.S. Mid Cap Equities



Neutral
U.S. Small Cap Equities

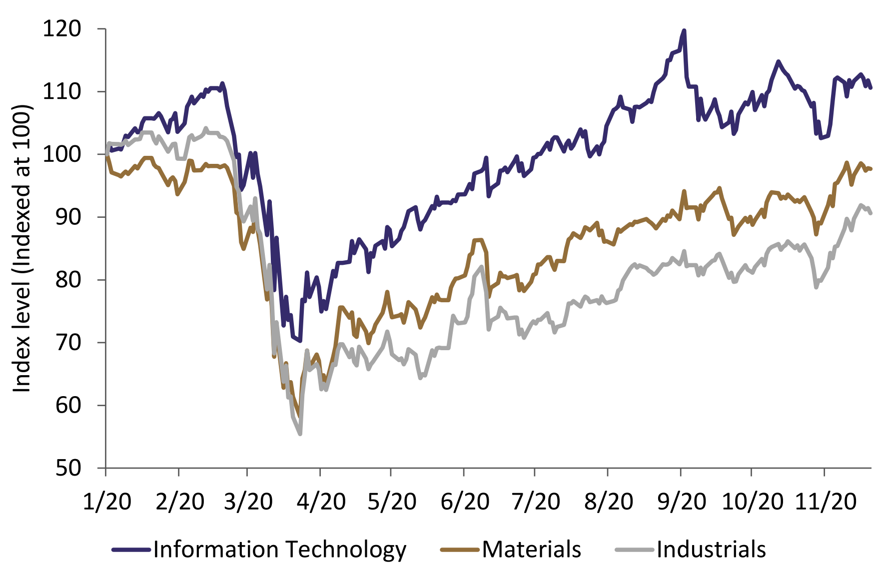


Unfavorable
Developed Market Ex-U.S. Equities



Neutral
Emerging Market Equities

Key sector performance in 2020



Sources: Wells Fargo Investment Institute, Bloomberg, November 20, 2020. Indexes were indexed to 100 as of 10/31/20. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.** See Index definitions at the end of report in Definitions section.

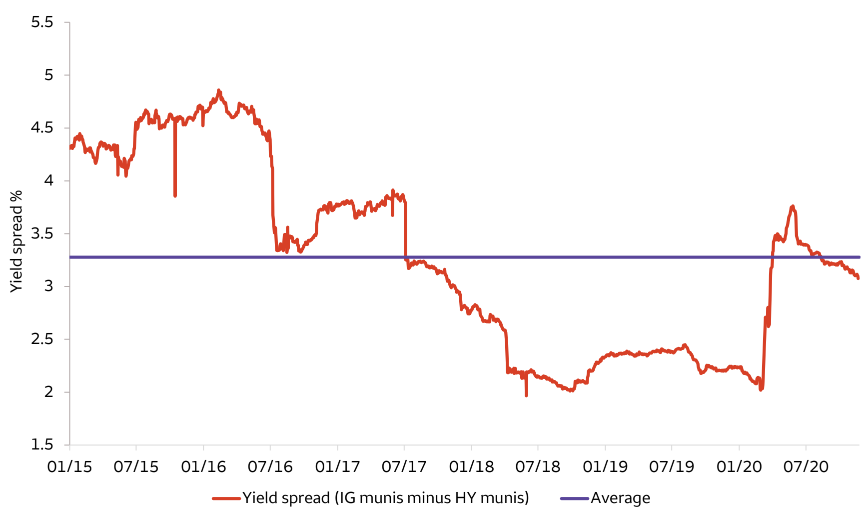
Fixed Income

High-yield municipal bonds remain attractive

Many fixed-income investors continue facing a yield dilemma as they search for income-producing assets. We believe high-yield (HY) municipals still present an opportunity for those investors looking to enhance their sources of yield while diversifying into other sectors of the municipal space. Sectors in this space are more concentrated than in investment grade (IG) municipals and have lower trading volumes. Hence, liquidity could become constrained if issues were to arise. Also, if the second wave of COVID-19 worsens, this could deteriorate HY municipal credits further, which could lead to a significant pickup in defaults. At this time, defaults still remain low (around 1%) and are expected to remain close to this level over the next year because there is not much debt outstanding in sectors more affected by the pandemic.[4]

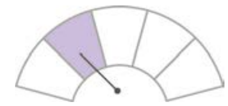
Historically, IG and HY municipals have lower default rates and higher recovery rates than taxable securities. Also, many investors continue to direct capital flows towards IG and HY municipals, and we believe there is still strong potential for more flows to go towards HY as the yield spread between IG and HY municipals remains near levels not seen since mid-2017. Given that we expect interest rates to remain low, we believe HY municipals could offer positive single-digit returns over the next 12 months, and the income received could potentially offset any negative change in prices. In our opinion, the rewards outweigh the risks in the HY muni market. Therefore, our favorable guidance remains.

Yield differential we believe makes high-yield municipals attractive as portfolio diversifiers

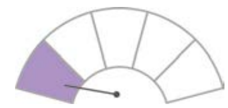


Sources: Wells Fargo Investment Institute, Bloomberg, November 23, 2020. Daily yield data from January 1, 2015 to November 20, 2020. The yield spread represents the difference in yield between the Bloomberg Barclays High-Yield Municipal Bond Index and the Bloomberg Barclays Municipal Bond Index. Please see disclosures for index definitions. **Past performance is not a guarantee of future results.**

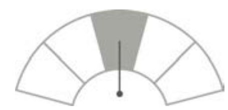
Luis Alvarado
Investment Strategy Analyst



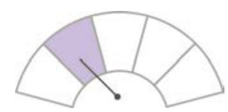
Unfavorable
U.S. Taxable Investment Grade Fixed Income



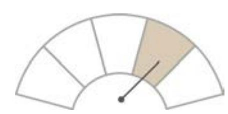
Most unfavorable
U.S. Short Term Taxable Fixed Income



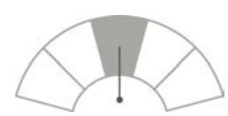
Neutral
U.S. Intermediate Term Taxable Fixed Income



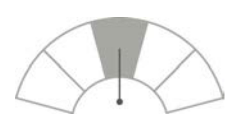
Unfavorable
U.S. Long Term Taxable Fixed Income



Favorable
High Yield Taxable Fixed Income



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

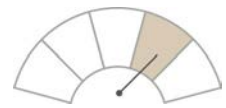


Neutral
Emerging Market Fixed Income

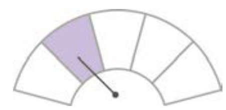
[4] Municipal Market Analytics (MMA), November 2, 2020.

Real Assets

Austin Pickle, CFA
Investment Strategy Analyst



Favorable
Commodities



Unfavorable
Private Real Estate

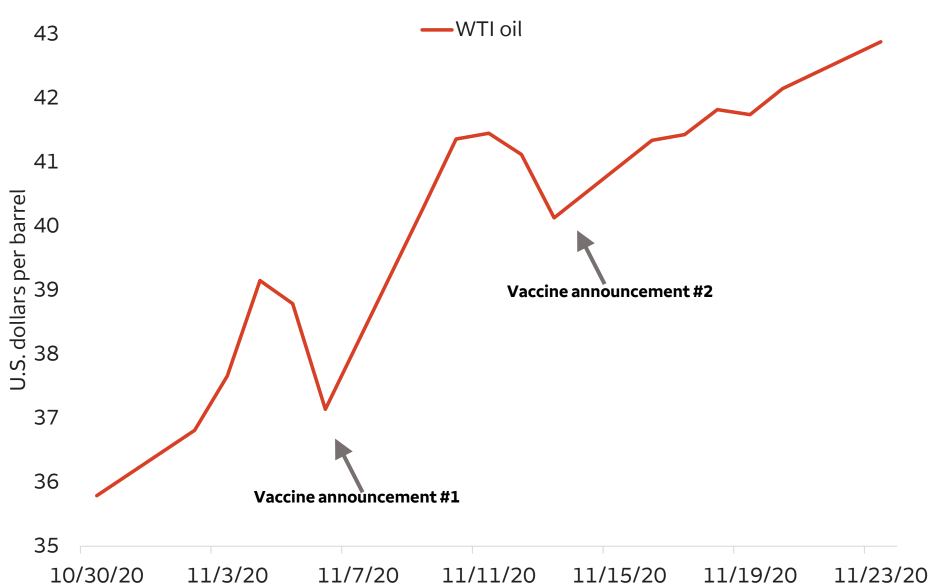
"When you practice gratefulness, there is a sense of respect towards others." — Dalai Lama

OPEC+ meeting — steady as she goes?

COVID-19 cases in the U.S. and abroad have surged recently, unfortunately. Unsurprisingly, we have also seen a corresponding increase in mobility restrictions. As a result, oil demand has begun to roll over. Yet, oil prices have seemingly shrugged off these developments and have spiked roughly 20% in the past month on encouraging COVID-19 vaccine announcements (see chart below). This week's OPEC+ meeting will go a long way in determining whether oil prices will be able to sustain these levels. Will OPEC+ give oil markets something to be thankful for? We think so.

OPEC+ has curtailed production this year in an effort to support oil markets. The group is currently withholding a substantial 7.7 million barrels per day. The market consensus — and our view — is that OPEC+ will extend the current level of cuts for three months or longer at this week's meeting. After the herculean effort on the part of OPEC+ this year to help balance the oil markets, we doubt the group will threaten that success by increasing production at this time. While vaccine developments are essential to a rebound in future demand, they do little to help current demand. With COVID-19 cases increasing, the risks to current oil demand are high. We suspect OPEC+ members are aware of this and will take a "steady as she goes" position and extend existing cuts. Yet, if OPEC+ disappoints, expect vaccine-inspired oil price gains to unwind as the market's focus would likely flip from future supply/demand hope to current supply/demand despair.

West Texas Intermediate (WTI) oil price



Sources: Bloomberg, Wells Fargo Investment Institute. Daily data: October 30, 2020 – November 23, 2020.

Alternatives

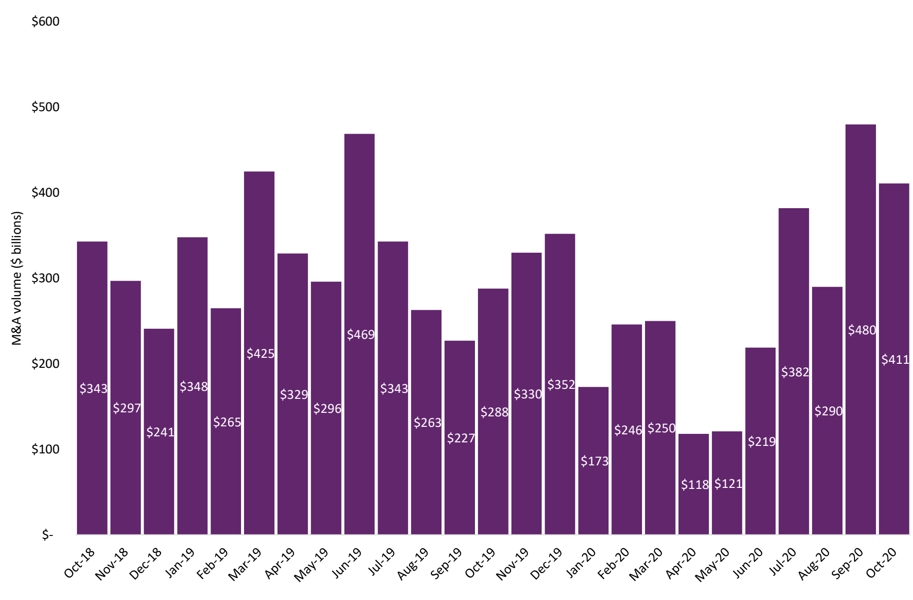
James Sweetman
Senior Global Alternative Investment Strategist

Global merger and acquisition (M&A) activity continues to recover

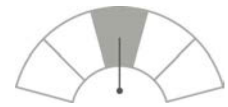
Global M&A activity tumbled to its lowest level in more than a decade in the second quarter, as companies rolled back expansion plans to focus on protecting their franchises in the wake of the coronavirus outbreak. While the “pause” button may been pressed, global M&A activity has continued to rise toward pre-crisis levels since May. Also since May, the number of $1 billion+ deals has increased for the sixth straight month, and $5 billion+ deals notched their strongest monthly tally since 2006. October recorded the second-strongest monthly-announced M&A volume this year at $411 billion — the strongest October volume since 2016. Due to the rebound in activity over the last four to five months, global M&A volumes are down only 17% year over year — versus 45% as of the end of May. Importantly, larger deals appear to be back in play. Since May, there have been 25 deals greater than $10 billion with $530 billion in volume — compared to just nine deals with $176 billion in the first five months of 2020.

Entering 2021, there appears to be a rising level of optimism that the momentum experienced over the last five months will continue. According to a survey released by Dykema Gossett in October, a record 87% of respondents said they expect M&A activity involving privately-owned companies to increase in 2021 — the most optimistic year-ahead view ever in the 16 years since survey has been conducted. We believe the top drivers for M&A in 2021 will be U.S. economic conditions, favorable interest rates, and the availability of capital.

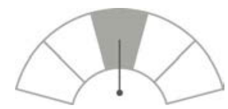
Global M&A deals continue to rebound



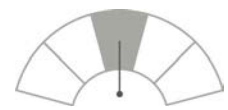
Sources: Dealogic, November 2020 and Wells Fargo Investment Institute.



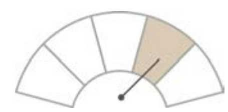
Neutral
Private Equity



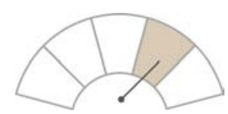
Neutral
Hedge Funds – Macro



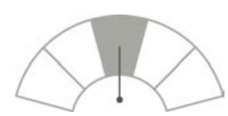
Neutral
Hedge Funds – Event Driven



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

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. Income from **municipal securities** is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT). **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.

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. 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. 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.

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

An index is unmanaged and not available for direct investment.

Bloomberg Barclays High-Yield Municipal Bond Index is considered representative of the broad market for high yield, tax-exempt bonds with a maturity of at least one year.

Bloomberg Barclays Municipal Bond Index is considered representative of the broad market for investment grade, tax-exempt bonds with a maturity of at least one year.

Bloomberg Commodity Total Return Index reflects the returns that are potentially available through an unleveraged investment in the futures contracts on 19 physical commodities comprising the Index plus the rate of interest that could be earned on cash collateral invested in specified Treasury Bills. The Index is a rolling index rebalancing annually.

Bloomberg Barclays U.S. Aggregate Bond Index is composed of the Bloomberg Barclays U.S. Government/Credit Index and the Bloomberg Barclays U.S. Mortgage-Backed Securities Index and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities.

Bloomberg Barclays U.S. Treasury Bills (1–3 Month) Index is representative of money markets.

The **Information Technology Index** comprises those companies included in the index that are classified as members of the GICS® information technology sector.

The **Materials Index** comprises those companies included in the index that are classified as members of the GICS® materials sector.

The **Industrials Index** comprises those companies included in the index that are classified as members of the GICS® industrials sector.

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.

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