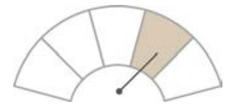
WELLS FARGO
Investment Institute

Investment Strategy

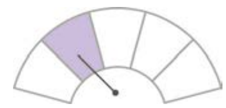
Weekly guidance from our Investment Strategy Committee January 19, 2021

Real Assets spotlight

Austin Pickle, CFA
Investment Strategy
Analyst



Favorable
Commodities



Unfavorable
Private Real Estate

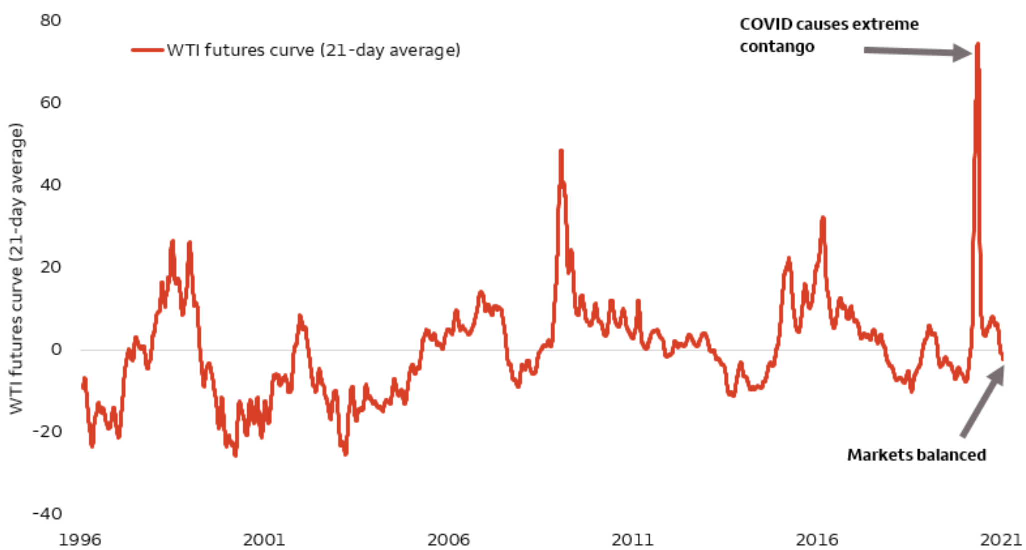
"If life were predictable, it would cease to be life and be without flavor." — Eleanor Roosevelt

The Saudi surprise

On January 5, Saudi Arabia shocked the oil world by announcing that it would unilaterally cut oil production by 1 million barrels per day in February and March. This was in stark contrast to market expectations that Saudi Arabia, along with the rest of OPEC+,[1] would announce a 500,000 barrels per day increase in February production or at least keep production flat. Oil prices popped nearly 5% on that day alone. Today we discuss: Why was this such a surprise? Why would Saudi Arabia cut at all? What does this mean for oil markets? What do we expect in 2021?

A little back story first. As the de facto leader of OPEC, Saudi Arabia was instrumental in negotiating the historic 9.7 million barrels per day OPEC+ production cut agreement announced in April 2020.[2] At the time, the pandemic had gripped the globe, lockdowns were widespread, and the world economy and oil demand came to a virtual hard stop. These cuts, along with production declines in other oil producing nations like the U.S., were vital in bringing the oil market back to balance. The chart below shows this evolution of the oil market from being severely oversupplied (extreme contango), to a tight balance today (slight backwardation).

West Texas Intermediate (WTI) futures curve



Sources: Bloomberg, Wells Fargo Investment Institute. Daily data: January 2, 1996 – January 13, 2021. WTI futures curve is calculated as the percentage away the price of the 12-month WTI futures contract is from the spot price. Contango refers to a situation where the future spot price is below the current price, and people are willing to pay more for a commodity at some point in the future than the actual expected price of the commodity. Backwardation refers to a situation where the futures price is below the expected future spot price. Above "0" indicates a market in contango, below "0" indicates backwardation.

[1] The Organization of the Petroleum Exporting Countries and others like Russia.
[2] The cut amount has been tapered as demand has improved. As of January, OPEC+ was withholding 7.2 million barrels per day. Accounting for Saudi Arabia's cut and small allotments for Russia and Kazakhstan to increase production the cut agreement amount totals 8.125 million barrels per day in February and 8.05 million in March.

Saudi's unilateral cut announcement surprised for a number of reasons:

1. As noted above, oil markets had tightened considerably,

2. Market participants were not pressuring the group for a cut — in other words oil prices did not sell off in the days leading up to the meeting,

3. Cuts would boost prices and resuscitate battered U.S. shale producers, and

4. The choice to willingly lose market share to protect price was out of character — this is the same country that started a price war and flooded the oil market a mere 10 months ago, the last time Saudi Arabia didn't get it's way at an OPEC+ meeting.

So why would the Saudis do it? The decision to unilaterally cut production likely circles back to the current realities of demand. Demand remains depressed below pre-pandemic levels, and COVID-19 can still wreak havoc. Cases continue to increase, and there is a risk that mobility restrictions could become more widespread. Throw in the unpredictability of new virus strains, the potential for vaccine disappointment, and lessons learned from its early 2020 price war, and we get a picture of why Saudi Arabia decided to take a "better safe than sorry" approach this time.

What now? Oil markets are obviously celebrating the cuts with prices near 11-month highs. Besides just the physical market improvements of restraining supply, the announcement provides confidence. Confidence that Saudi Arabia is committed to supporting price and will err on the side of caution in terms of when the kingdom will boost supply. The fact that the majority of OPEC+ members requested to hold production flat rather than increase it is another sign that OPEC+ as a whole "gets it" and won't unleash an oil tidal wave. All in all, oil markets are flying high on a combination of vaccine and economic growth optimism, a tight oil market, and confidence that OPEC+ will remain price supportive.

A tight oil market is encouraging, yet it is important to note that today's tightness is manufactured. In other words, OPEC+ members are *voluntarily* withholding supply. Anything done voluntarily can be reversed voluntarily. While signs point to OPEC+ taking a measured approach to bringing barrels back to market, nonetheless there is a risk that either OPEC+ missteps or the cut agreement breaks down. It is worth reiterating that it was only 10 months ago that the OPEC+ agreement unraveled and Saudi Arabia itself decided to flood oil markets.

With that being said, we expect OPEC+ to behave itself and demand to improve as 2021 rolls on. It will take time though for excess inventories and substantial spare capacity to be worked through. In our view, until that excess is resolved, prices are unlikely to move substantially higher.

Equities

Chao Ma, PhD, CFA, FRM
Global Portfolio and Investment Strategist

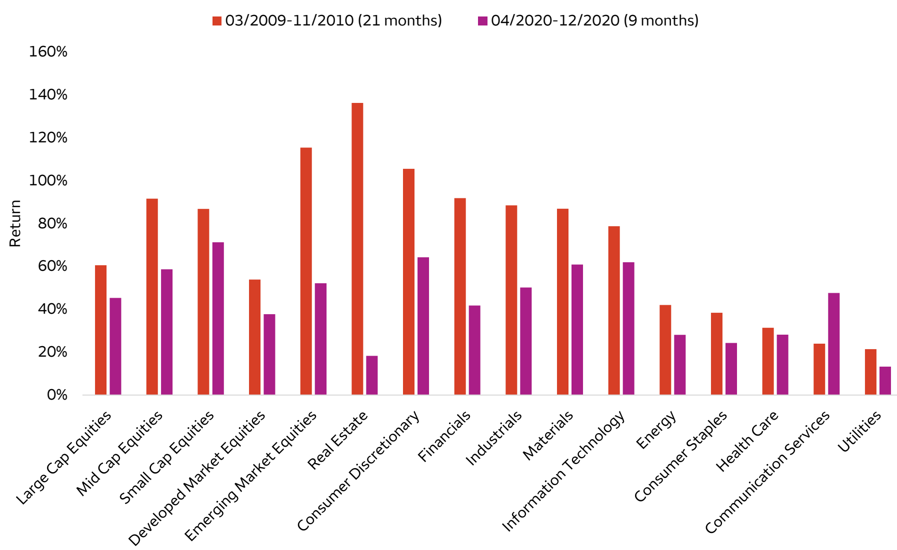
Cyclical sectors in a reflationary environment

We started the year of 2021 with continued fiscal stimulus and supportive monetary measures from the federal government and the Federal Reserve (Fed). These measure are expected to increase economic activity and output, stabilize financial markets and consumer confidence, as well as support industries that were negatively impacted by the COVID-19 recession.

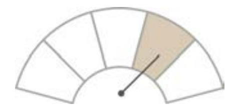
Such reflationary support can typically facilitate the recovery and early expansion of the economy after the trough and can — in turn — positively impact the stock markets. In particular, the cyclical areas of the economy may experience more upside driven by more noticeable business and earnings expansion. The period after the Great Financial Crisis was a case in point, when similar reflationary measures were implemented, and, subsequently, major stock markets recovered between 50% and 120% in the first 21 months after the S&P 500 Index bottomed. Further, cyclical areas such as U.S. Small Cap stocks, as well as the Consumer Discretionary, Financials, Industrials and Material sectors, scored impressive performance.

A similar price trend has developed in recent months, and we believe this cyclical risk-on trade will continue in the year of 2021. However, history doesn't repeat in the same way, and we expect some secular trends, such as the virtual experience economy and manufacturing on-shoring, to continue. For example, the real estate sector may see both tailwinds from the reflationary environment and headwinds due to the disruptions to the retail and working-from-home situation caused by the pandemic. As a result, we recommend evaluating market opportunities in the context of both macro and investment-specific factors.

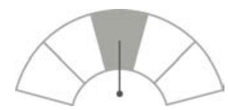
Stock market returns during recent reflation periods



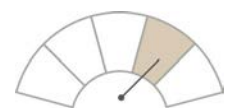
Sources: Bloomberg, Wells Fargo Investment Institute. Sectors are sorted by return in the first period. Equity sectors are based on S&P 500 sector indices. . An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**



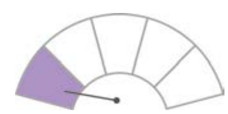
Favorable
U.S. Large Cap Equities



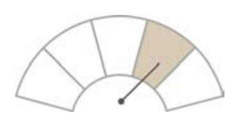
Neutral
U.S. Mid Cap Equities



Favorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities



Favorable
Emerging Market Equities

Fixed Income

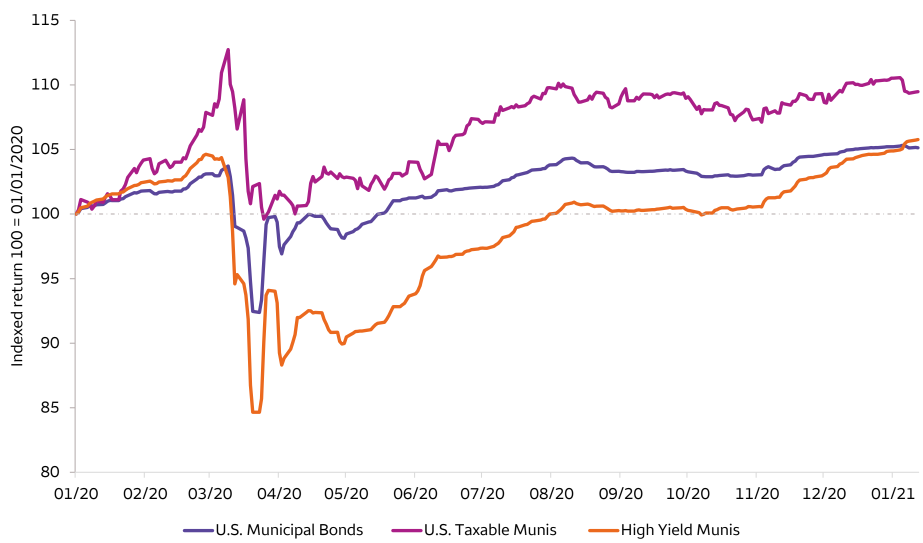
Rising Treasury yields have consequences for municipal bonds

U.S. Treasury yields have climbed higher over previous weeks on better growth prospects ahead. Although good for the economy, higher yields do have consequences for fixed-income assets, and municipal bonds are not exempt. Furthermore, municipal yields have remained flat in comparison to taxable yields, which makes them look relatively more expensive. Municipal-to-Treasury yield ratios are hovering near or at all-time lows across the curve. This is a stark contrast to last March, when they were approaching all-time highs as pandemic-related issues were causing a liquidity havoc in this space.

Although municipal bonds appear somewhat unattractive if measured only by valuations, there are other indicators that still make them attractive. Strong technicals continue to affirm that demand (measured by flows into municipal funds) remains strong at a time when tax-exempt issuance appears to be somewhat constrained for at least the next couple of months. Additionally, prospects for a more supportive fiscal and legislative environment have increased, which we believe should be beneficial for those states and municipalities most affected by the pandemic.

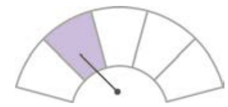
We remain favorable on investment-grade (IG) and high-yield (HY) municipals, as they still offer higher tax-adjusted yields relative to corporate securities with similar credit ratings. In many cases, they can offer the additional benefit of being exempt from state and local taxes. Selectivity remains key as some states and sectors display higher credit risks than others. Overall, we expect positive single-digit returns for both IG and HY municipals in 2021.

Strong demand continues to support municipal bond performance

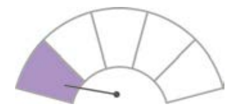


Sources: Wells Fargo Investment Institute, Bloomberg, January 13, 2021. Daily indexed return data from January 1, 2020 to January 12, 2021. U.S. Municipal Bonds = Bloomberg Barclays Municipal Index; U.S. Taxable Municipal Bond = Bloomberg Barclays Municipal Index Taxable Bonds Index; High Yield Municipals = Bloomberg Barclays Municipal High Yield Bond Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

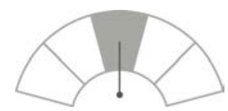
Luis Alvarado
Investment Strategy Analyst



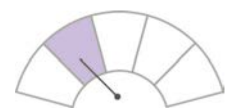
Unfavorable
U.S. Taxable Investment Grade Fixed Income



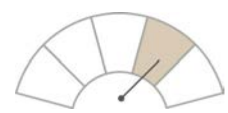
Most unfavorable
U.S. Short Term Taxable Fixed Income



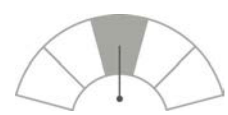
Neutral
U.S. Intermediate Term Taxable Fixed Income



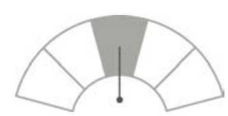
Unfavorable
U.S. Long Term Taxable Fixed Income



Favorable
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

Alternatives

James Sweetman
Senior Global Alternative Investment Strategist

Hedge fund strategies rebound as economy recovers

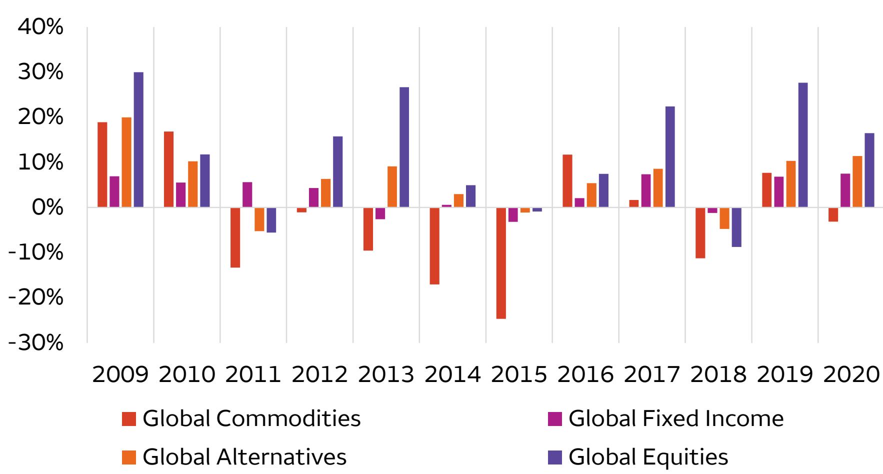
Hedge funds posted positive performance once again in December, extending strong November gains and concluding a volatile year which had been dominated by the global coronavirus pandemic, generational political uncertainty, and nation-wide protests. The HFRI Fund Weighted Composite (FWC) Index gained +4.5% for the month, increasing 2020 performance to +11.6% — the best year since hedge funds surged +20.0% in 2009. The 2020 gain for the HFRI FWC Index marks an impressive recovery from the -11.6% decline in the first quarter of 2020, when the global coronavirus pandemic and resulting lockdowns were in the early stages. Not surprisingly, higher equity beta strategies such as Equity Hedge and Event Driven led performance, but all four hedge fund strategies posted positive returns and, as the chart below shows, performed strongly post-market correction.

Hedge Fund Index	January - March 2020	April - December 2020	2020
HFRI Fund Weighted Composite Index	-11.6%	26.1%	11.6%
HFRI Equity Hedge (Total) Index	-14.6%	37.6%	17.5%
HFRI Event Driven (Total) Index	-14.9%	28.1%	9.3%
HFRI Macro (Total) Index	-1.7%	6.6%	5.2%
HFRI Relative Value (Total) Index	-10.3%	15.2%	3.3%

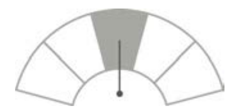
Source: Hedge Fund Research (HFR) – December 2020. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

As the chart below shows, 2020 continued the trend over the last 12 years of global alternatives being the second-best performing asset group. In fact, over the last 12 years, global alternatives has been the second-best performing strategy in 10 of those years. This is one of the primary reasons that we include hedge funds in our recommended allocations, since alternatives tend to behave differently than typical stock, bond, and commodity investments. We believe adding them to a portfolio can potentially provide broader diversification, enhance risk-adjusted returns, and increase income levels for qualified investors.

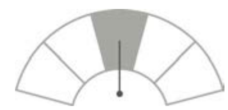
Alternatives have provided diversification and absolute returns



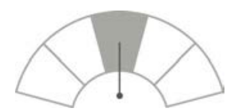
Sources: Bloomberg, Wells Fargo Investment Institute. Annual data January 2009 – December 2020. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**



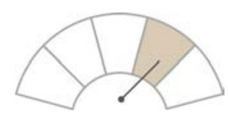
Neutral
Private Equity



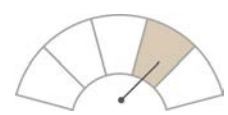
Neutral
Hedge Funds – Macro



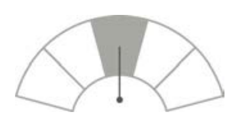
Neutral
Hedge Funds – Event Driven



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.

Risk Considerations

Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change. Diversification cannot eliminate the risk of fluctuating prices and uncertain returns.

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. 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). Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate. 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.

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. **Communication Services** companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. Risks associated with the **Consumer Discretionary** sector include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players; reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. **Consumer Staples** industries can be significantly affected by competitive pricing particularly with respect to the growth of low-cost emerging market production, government regulation, the performance of the overall economy, interest rates, and consumer confidence. The **Energy** sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. Investing in the **Financial** services companies will subject a investment to adverse economic or regulatory occurrences affecting the sector. Some of the risks associated with investment in the **Health Care** sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market. 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. **Real estate** investments have special risks, including possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions. 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. **Utilities** are sensitive to changes in interest rates, and the securities within the sector can be volatile and may underperform in a slow economy.

Definitions

An index is unmanaged and not available for direct investment.

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.

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

Bloomberg Barclays Municipal Index Taxable Bonds Index is considered representative of taxable municipal bonds.

Bloomberg Barclays Municipal Bond: High Yield Index is considered representative of non-investment grade tax-exempt bonds.

Communication Services Index: The Communication Services Index comprises those companies included in the S&P 500 that are classified as members of the GICS® communication services sector.

Consumer Discretionary Index: The Consumer Discretionary Index comprises those companies included in the index that are classified as members of the GICS® consumer discretionary sector.

Consumer Staples Index: The Consumer Staples Index comprises those companies included in the index that are classified as members of the GICS® consumer staples sector.

Energy Index: The Energy Index comprises those companies included in the index that are classified as members of the GICS® energy sector.

Financials Index: The Financials Index comprises those companies included in the index that are classified as members of the GICS® financials sector.

Health Care Index: The Health Care Index comprises those companies included in the index that are classified as members of the GICS® health care sector.

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

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

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

Utilities Index: The Utilities Index comprises those companies included in the index that are classified as members of the GICS® utilities sector.

Real Estate Index: The Real Estate Index comprises those companies included in the index that are classified as members of the GICS® real estate sector.

U.S. Large Cap Equities: S&P 500 Index is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation and financial companies.

U.S. Mid Cap Equities: Russell Midcap Index measures the performance of the mid-cap segment of the U.S. equity universe.

U.S. Small Cap Equities: Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

Developed Market: MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of 21 developed markets, excluding the U.S. and Canada.

Emerging Market: MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 23 emerging markets.

HFRI Event-Driven (Total) Index consists of Investment Managers who maintain positions in securities of companies currently or prospectively involved in corporate transactions of a wide variety, including but not limited to: mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. ED exposure contains a combination of sensitivities to equity markets, credit markets and idiosyncratic, company specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

HFRI Equity Hedge (Total) Index maintains positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios.

HFRI Macro (Total) Index consists of investment managers who trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed-income, hard currency, and commodity markets.

HFRI Relative Value (Total) Index consists of Investment Managers who maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities Manager employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative or other security types. RVA position may be involved in corporate transactions also, but as opposed to ED exposures, the investment thesis is predicated on realization of a pricing discrepancy between related securities, as opposed to the outcome of the corporate transaction.

HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2000 single-manager funds that report to HFR Database. Constituent funds report monthly net-of-all-fees performance in U.S. dollars and have a minimum of $50 Million under management or a 12-month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

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.

Global Commodities: **Bloomberg Commodity Index Total Return** (BCOM) is a broadly diversified commodity price index distributed by Bloomberg Indexes. BCOM currently has 23 commodity futures in six sectors. The weightings for each commodity included in BCOM are calculated in accordance with rules account for liquidity and production data, which ensures that the relative proportion of each of the underlying individual commodities reflects its global economic significance and market liquidity. Annual rebalancing and reweighting ensure that diversity is maintained over time.

Global Alternatives: **HFRI Fund Weighted Composite Index** is a global, equal-weighted index of over 1,400 single-manager funds that report to HFR Database. Constituent funds report monthly net of all fees performance in US Dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance.

Global Fixed Income: Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

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