WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **February 1, 2021**

Global macro spotlight

Gary Schlossberg
Global Strategist

More than just a home?

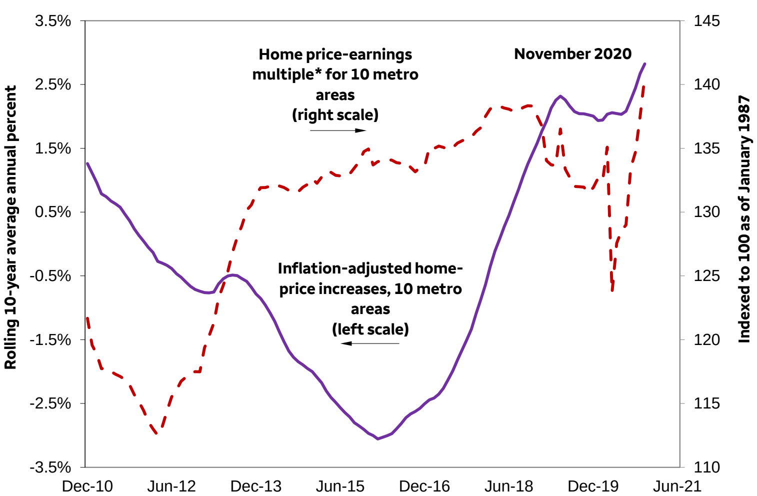
From ground zero in the last recession over a decade ago, housing is in a more familiar pole position in this economic recovery. Single-family activity's leading-edge role in the housing recovery is particularly good news, because the sector's big ripple effect on the rest of the economy is greatest in that segment of the market.[1]

Housing's surprising strength rests on reaction to last year's pandemic "shock" — boosting demand and restraining already tight supply. The upshot has been accelerating price increases responding to a drop in homes for resale to just a fraction of their long-term average back through 1999. Home price increases responded by accelerating to a six-year high by last November, encouraging a rethink of the debate on housing's dual role as both a shelter and an investment.

Well-documented drawbacks to housing's role as an investable asset include decades of price increases barely matching inflation, illiquidity, elevated carrying costs, and the absence of cash flow from occupied property.[2] Still, buyer interest in housing's investment value is on the rise again, boosted in much the same way as stock prices and other financial-asset values by ample financing and low interest rates.

In fact, the near-3% average annual rise in housing's inflation-adjusted prices over the past 10 years illustrated in the accompanying chart is the highest in over a decade. Home values haven't responded as vigorously as other assets to interest-rate declines, leaving housing valuations less stretched against stocks than they were in the run up to the housing bust over a decade ago. For example, that price-earnings (P/E) multiple for housing in the chart was 4.5% above its average of the previous five years, well short of the 26%-27% for S&P 500 stocks, and more than 23% below its peak during the housing boom 14 years ago.

Lift-off for housing prices and home values



Sources: S&P/ Case-Shiller, Wells Fargo Investment Institute, January 26, 2021. * As measured by the ratio of the S&P/ Case-Shiller home-price index, 10 metro areas to after-tax income.

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[1] "Impact of Home Building and Remodeling on the U.S. Economy," National Association of Home Builders, May 1, 2014.

[2] Kevin Mercadante, "The Truth? Your House is Not an Investment," moneyunder30.com, October 16, 2020, "Treating Housing as an Investment is a Bad Idea," Forbes Magazine, February 20, 2020.

A dual role in the economy

Housing's role as an investment asset may be debatable, but there's little doubt about its importance in the household balance sheet. Federal Reserve data show owner-occupied real estate and unrented second homes accounting for more than 22% of all household assets at the end of last year's third quarter, nearly matching stocks' 24.5% share.[3] And at a time of worsening income and wealth inequality, homes are still among the most broadly held asset across lower-middle, middle, and upper middle-income families. Homeownership ranges from 54% of all lower middle-income families to 87% of those in the upper middle-income tier.[4] The incidence of stock holdings ranges from a lower 34%-84% across middle-income groups, despite the growth of 401(k) retirement plans.

Homes as a core asset in the household balance sheet make them an important influence on consumer spending, through the liquidation of home equity or its use to backstop borrowing. Housing's "dry-powder" support for consumer spending is at a 30-year high, measured by the 65% share of home equity (i.e., net of mortgage debt) in the value of owner-occupied real estate.[5] Of course, housing's link to the economy cuts both ways. Its collapse over a decade ago undercut economic activity directly and indirectly, through its support to consumer spending. It also weighed on the subsequent recovery as balance sheets were slowly rebuilt. Subdued mortgage rates and a fundamentally stronger housing market make that extreme outcome less likely in this cycle.

Much the same can be said of the asset markets. We believe that the modest rise in interest rates and stronger second-half growth anticipated by us will be supportive of the stock market's economically sensitive sectors that extend to housing and housing-sensitive sectors of the stock market. The group ranges from upstream lumber and other building materials to downstream appliances and home furnishings, along with home building, banking, and real estate services in between.

[3] "Financial Accounts of the United States," Federal Reserve Board, December 10, 2020.
[4] "Survey of Consumer Finances, 2019," Federal Reserve Board, September 28, 2020.
[5] WFII calculations based on data from "Financial Accounts of the United States," December 10, 2020.

Equities

Chris Haverland, CFA
Global Asset Allocation Strategist

Prices and earnings up, valuations down

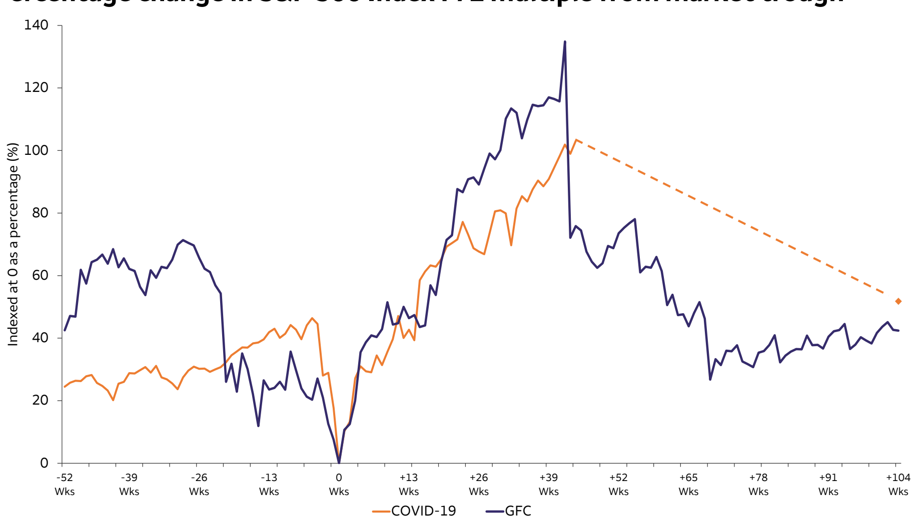
With trailing equity price-to-earnings (P/E) multiples near historic highs, some investors are questioning the sustainability of current stock prices. As with most recessionary periods, stock prices have tended to recover earlier than earnings, leading to elevated valuations. However, as earnings rebound post-recession, they often have grown faster than prices, allowing P/E multiples to decline even with equity values rising.

In 2020, the S&P 500 Index gained 16%, while earnings per share (EPS) is expected to have contracted by nearly 20%. In 2021, we are projecting that the S&P 500 Index will rise approximately 9% in price and that EPS could grow by more than 20%. This will cause trailing P/E multiples to decline from close to 30 times today to roughly 23 times by year-end 2021.

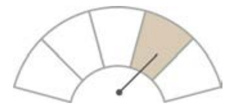
A similar dynamic occurred after the 2008 Great Financial Crisis (GFC). Returns in 2009 were driven by multiple expansion, while in 2010, earnings caught up, driving P/E valuations lower. The chart below shows the multiple growth post-GFC, which is greater than the multiple growth experienced since March 2020. After the initial surge in valuations, there was a normalization of P/E as earnings recovered.

The average P/E based on trailing earnings over the past 30 years is 20 times. Our year-end 2021 forecast of 23 times is modestly above the historical average and supported by extremely low levels of interest rates. While high valuations can make investors nervous, they rarely cause markets to correct. Instead, the next sizeable pullback in prices is more likely to come from a fiscal or monetary policy misstep, unwelcome news on the virus, earnings disappointments, or another exogenous event.

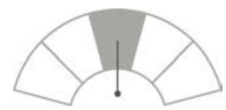
Percentage change in S&P 500 Index P/E multiple from market trough



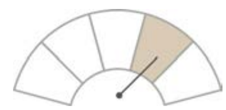
Sources: Wells Fargo Investment Institute, Bloomberg, January 26, 2021. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment. COVID-19 lines ranges from March 29, 2019 – January 22, 2021. GFC line ranges from March 14, 2008 – March 4, 2011.



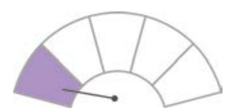
Favorable
U.S. Large Cap Equities



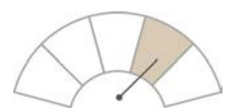
Neutral
U.S. Mid Cap Equities



Favorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities



Favorable
Emerging Market Equities

Fixed Income

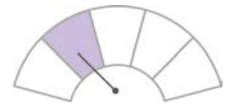
Rolling down the yield curve

A basic tenet of fixed-income investing is the inverse relationship between interest rates and the price of a bond. If interest rates move higher, prices of currently outstanding bonds fall, as investors can purchase new issues with higher coupons. The opposite occurs as interest rates fall. New issues now offer lower coupons, so investors are willing to pay higher prices for comparable bonds with higher coupons. In most interest-rate environments, the yield curve is upward-sloping. Thus, as a bond approaches maturity, the prevailing market interest rate declines. This is what is known as "rolling down the yield curve."

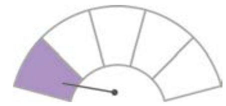
A quick look at the current interest rate curve shows that a seven-year Treasury note yields 0.73% as of January 25, 2021. If an investor purchased that bond today at par, and interest rates remain unchanged over the next five years, that investor would own a two-year bond that pays 0.73% per year. However, the market rate for a Treasury note with two years to maturity is 0.12%. Since bond prices increase in value as yields fall, the bond purchased five years ago at $100.00 would now be worth $101.21, even though the interest rate curve remains unchanged. Rolling down the yield curve can have a meaningful influence on a bond's price over time.

An additional factor to consider is that as bonds roll down the interest rate curve, they move closer to maturity and become less interest rate sensitive. If interest rates were to unexpectedly rise significantly, the roll-down effect, coupled with a bond approaching maturity, could limit the price decline an investor may experience.

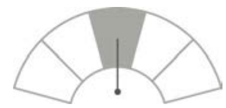
Brian Rehling, CFA
Head of Global Fixed Income Strategy



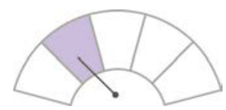
Unfavorable
U.S. Taxable Investment Grade Fixed Income



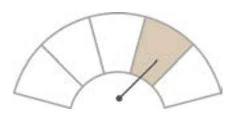
Most unfavorable
U.S. Short Term Taxable Fixed Income



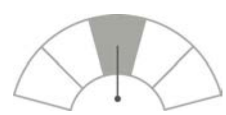
Neutral
U.S. Intermediate Term Taxable Fixed Income



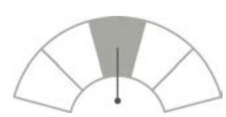
Unfavorable
U.S. Long Term Taxable Fixed Income



Favorable
High Yield Taxable Fixed Income



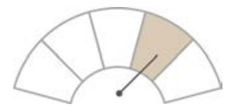
Neutral
Developed Market Ex.-U.S. Fixed Income



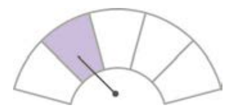
Neutral
Emerging Market Fixed Income

Real Assets

John LaForge
Head of Real Asset Strategy



Favorable
Commodities



Unfavorable
Private Real Estate

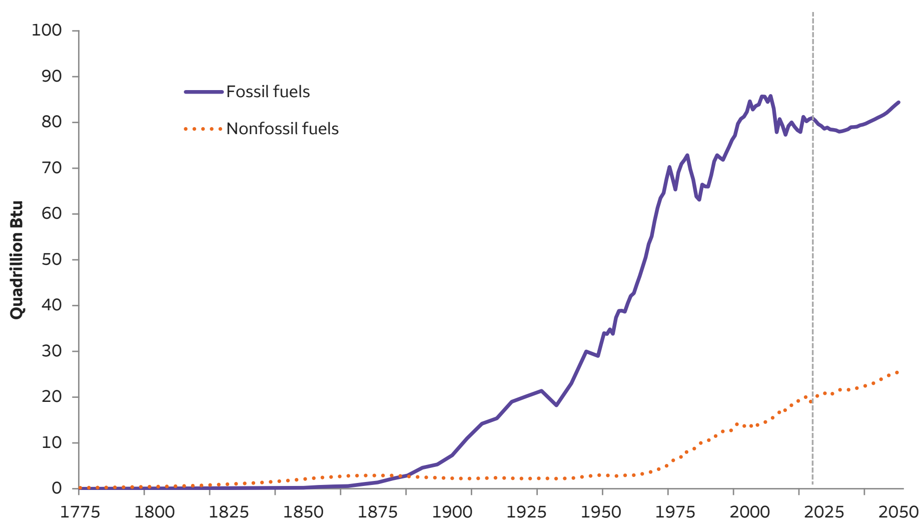
"I have never let my schooling interfere with my education." — Mark Twain

2021 year of green

If 2020 was the year of red and blue, 2021 could be the year of green — green energy that is. Only a few weeks into office, the new Biden administration has already halted the completion of a major oil pipeline, rejoined the Paris Climate Agreement, and temporarily suspended oil and gas permitting on federal lands and waters. We expect to see even more "green" government-led action over the next several months.

We discussed a few months back that 2020 was very likely a tipping point for green energy. For the full report, please see *2020 – A Tipping Point for Green Energy*. We do want to remind investors, however, that replacing fossil fuels will not be easy — or quick. Fossil fuels, at 80% of total energy use, still dominate the U.S. energy landscape. This can be seen in the chart below, which splits U.S. energy consumption between fossil fuels (purple line — oil, natural gas, coal) and nonfossil fuels (orange line — wind, solar, etc.). Notice that nonfossil fuel use is rising fast, yet at the same time, fossil fuel use is rising too. Both lines are rising because the world continues to grow, and growth requires energy. To unseat fossil fuels at the top, nonfossil fuels will effectively have to do "double-time." Renewable and green technology industries, however, are still too young to absorb the world's energy needs. The point is that investors should be preparing for a green future, but they should also realize that it is a process, not an overnight fix.

U.S. energy consumption: Fossil fuels versus nonfossil fuels



Sources: U.S. Energy Information Administration (EIA), Wells Fargo Investment Institute. Yearly data: 1775 – 2050. Fossil fuels include coal, natural gas, and petroleum and other liquids. Nonfossil fuels include wind, solar, hydropower, geothermal, biomass, and nuclear.

Alternatives

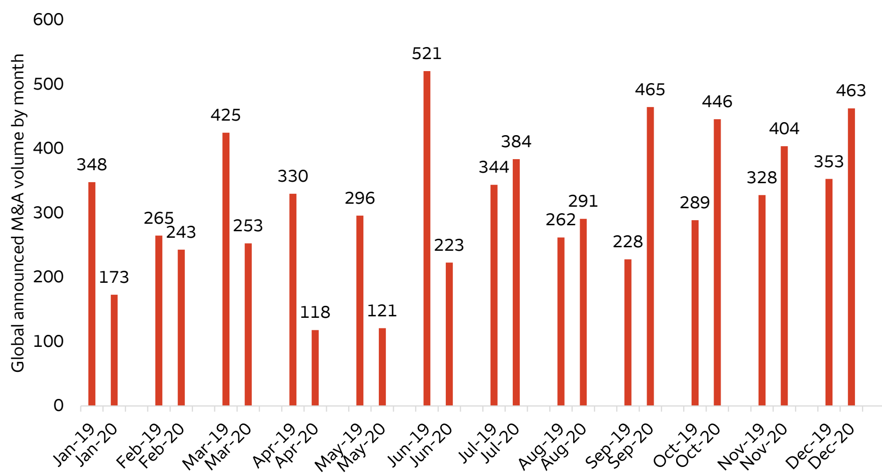
James Sweetman
Senior Global Alternative Investment Strategist

Global merger and acquisition volumes rebound strongly

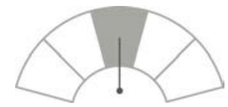
Global merger and acquisition (M&A) volumes rebounded significantly over the second half of 2020 as global equity markets recovered with news of a vaccine spreading and trillions of dollars in stimulus being injected into global economies. As the chart shows, global M&A volumes declined by 60% over the first six months of 2020 (during the height of the pandemic), but since July, volumes of deals have consistently exceeded 2019 levels. In fact, average monthly volumes since July are up 83% versus the three months preceding the COVID M&A slowdown. To properly place the rebound in the second half of 2020 in historical perspective: the third quarter of 2020 was the strongest quarter in M&A market history, while the fourth quarter ranked as the second-strongest in volume and the strongest ever for the number of $1 billion+ deals. With $2.5 trillion of announced volume, the second half of 2020 accounted for about 70% of the year's M&A activity, the largest second-half share of annual volume ever.

While the M&A road in 2021 may remain volatile, we believe there are numerous drivers for continued M&A strength in 2021. 2020 was the year of special purpose acquisition companies (SPACs), with $150 billion of announced M&A volume and 43 $1billion+ deals driving activity.[6] We expect SPACs will continue to drive deal volume in 2021 as SPACs have the potential for about $300 billion in upcoming M&A. Finally, with Tech-disruption and meaningful corporate repositioning for the future, along with record levels of private equity sponsor dry powder, 2021 may continue to ride the momentum of the second half of 2020 with mega-deals and strategic partnerships defining the landscape.

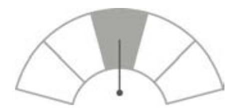
M&A volume accelerates in second half of 2020 to record levels



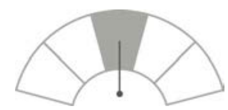
Sources: Dealogic, Wells Fargo Investment Institute. January 2021.



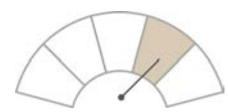
Neutral
Private Equity



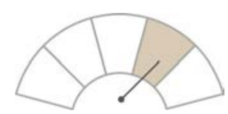
Neutral
Hedge Funds – Macro



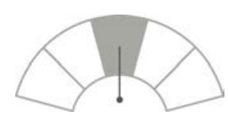
Neutral
Hedge Funds – Event Driven



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.

[6] Dealogic – January 2021.

Risk Considerations

Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

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 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

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.

S&P CoreLogic Case-Shiller® Home Price Indices measures the residential housing market, tracking changes in the value of the residential real estate market in 20 metropolitan regions across the United States. These indices use the repeat sales pricing technique to measure housing markets. First developed by Karl Case and Robert Shiller, this methodology collects data on single-family home re-sales, capturing re-sold sale prices to form sale pairs. This index family consists of 20 regional indices and two composite indices as aggregates of the regions.

An index is unmanaged and not available for direct investment.

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