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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **June 15, 2021**

Asset Allocation spotlight: It may be time to reevaluate risk tolerance 2

- Investor risk tolerance has been put to the test over the past year and a half as the S&P 500 Index has faced sharp ups and downs and volatility remains above pre-2020 levels.
- Determining the level of risk one is willing to take in an effort to achieve their investment goals within the stated time horizon can be important.

Equities: Investing in inflationary environments 4

- Equities and Commodities may be a good option for investors and provide price appreciation in environments of rising inflation.
- We favor emphasizing U.S. equities as well as cyclical sectors in investment portfolios.

Fixed Income: All eyes on the upcoming Fed meeting..................................5

- Investor expectations around the next steps for the Federal Reserve (Fed) and the timing on when changes may begin to occur have intensified. We do not believe the Fed will offer any new clues around the timing of tapering nor on implementation mechanics at the upcoming meeting.
- We do expect to get more insights around the progress that the economy has made towards the Fed's goals. We anticipate this to be reflected in the updated summary of economic projections along with the views from participants on the federal funds rate level over the next few years.

Real Assets: A curious thing about oil...6

- Oil prices have hit $70, but many U.S. oil producers are hesitating.
- If it continues, oil prices may head higher still.

Alternatives: Direct lending in a low interest rate environment 7

- We believe that direct lending has the potential to provide investors with an additional source of stable, diversified, and uncorrelated returns, all of which can be important in today's low-rate, low-return environment.
- There are abundant opportunities for direct lending funds to finance companies that, despite their strong fundamentals, no longer have access to the public markets. We favor funds raised after the COVID-19 pandemic peaked in March and April of 2020.

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Asset Allocation spotlight

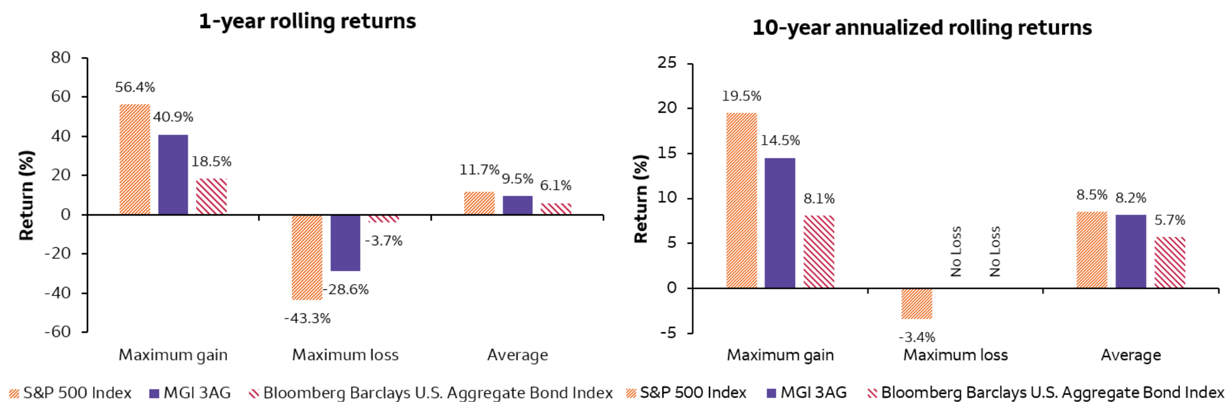
It may be time to reevaluate risk tolerance

Veronica Willis
Investment Strategy Analyst

Investor risk tolerance has been put to the test over the past year and a half as the S&P 500 Index plummeted into a bear market in early 2020, only to post the quickest recovery on record and reach new highs by August. Volatility has since quieted from March 2020 highs, but it remains slightly above the pre-2020 low volatility. As investors readapt to the more normal levels of volatility and as we expect the market to move higher, now may be a good time to assess risk tolerance as it relates to time horizon. Risk tolerance can range from conservative to aggressive or lie somewhere in-between. Conservative investors have lower risk tolerances and tend to invest in assets with less potential volatility, like fixed income. Meanwhile, investors with aggressive risk tolerances are willing to take on more volatility in their asset allocation in an effort to achieve their investment objectives. Deciding the appropriate level of risk can be key to setting the strategic asset allocation.

Time horizon can influence an investor's willingness to take on risk — it is one component that can help to align investment goals with risk tolerance. Investors with shorter time horizons may be unable to tolerate sizeable drawdowns in their portfolios and may be forced to sell at an inopportune time. Looking out to a 10-year horizon, the potential for loss is diminished as market cycles evolve and short-term losses eventually may turn into long-term gains. Investors with shorter time horizons often select allocations with lower expected volatility, while investors with longer time horizons often are willing to take on more risk and may choose a growth-oriented allocation.

Hypothetical annualized rolling 1-year and 10-year returns



Sources: Morningstar Direct and Wells Fargo Investment Institute. Data from January 1, 1990 to May 31, 2021. MGI 3AG = Wells Fargo Investment Institute Moderate Growth & Income Three Asset Group portfolio. For illustrative purposes only. The MGI 3AG Portfolio is hypothetical and does not reflect an actual investment. Index returns are not fund returns and are not forecasts of expected gains or losses a portfolio may achieve. 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. An index is unmanaged and not available for direct investment. **Hypothetical and past performance are no guarantee of future results.** Please see the end of this report for the composition of the MGI 3AG Portfolio, the definitions of the indices and the risks associated with the representative asset classes.

Note: Over a 10-year rolling period, neither the MGI 3AG nor the Bloomberg Barclays U.S. Aggregate Bond Index showed a loss. In fact, their minimum rolling returns were positive, 3.2% and 3.3% respectively, on an annualized basis.

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There is greater potential reward in an equity-heavy allocation, but the risk is higher. There is lower potential reward in allocations that contain more fixed-income assets, but the risk typically is lower. A diversified asset allocation that combines these asset groups historically has captured much of the upside in equities without generating a loss over any 10-year rolling period since 1990. Over the same period, average annualized returns for the hypothetical Moderate Growth & Income Portfolio have kept up with the S&P 500 Index and have outpaced the Bloomberg Barclays U.S. Aggregate Bond Index.

For investors with longer time horizons, rebalancing regularly can be an important strategy to maintain the desired level of risk in a portfolio. Failing to rebalance during an up-market typically results in higher allocation to riskier assets, like equity, than an investor may have intended. Regular rebalancing helps to avoid this portfolio drift and can increase the likelihood that the portfolio will act as expected during downturns and corrections. Rebalancing during a down-market can be just as important. Failing to rebalance during a bear market can leave the portfolio at risk for a longer recovery time. Regular rebalancing can enhance portfolio performance over time as it maintains an investor's desired risk profile. This, in turn, can help a portfolio weather market selloffs and could lead to a speedier recovery after a market correction.

Determining risk tolerance and time horizon can be important steps that can help lead to long-term financial success. If an investor's time horizon is short or equity market volatility is unnerving, we favor a more conservative, fixed-income-focused asset allocation, favoring intermediate-term maturities over longer maturities while long-term interest rates are rising. For investors with a longer time horizon who may be willing to take on more risk, we favor a more equity-focused, growth-oriented allocation, favoring cyclically oriented U.S. Large Cap Equities as well as U.S. Small Cap and Emerging Market Equities. For investors whose time horizon and risk tolerance are somewhere in between (like many investors), a reasonable balance between growth assets, real assets, income-producing assets, and, where appropriate for qualified investors, alternative assets can help to smooth out performance over time. We recommend reviewing a portfolio's asset allocation with an investment professional on a regular basis, regardless of market conditions, to make sure it continues to align with investment goals, risk tolerance, and time horizon.

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Equities

Investing in inflationary environments

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

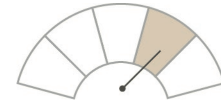
The Federal Reserve believes the current high inflation reading is transitory in nature and is driven by both the supply chain bottlenecks and the low Consumer Price Index (CPI) baseline level from a year ago. We believe the 10%–15% cumulative increase in CPI that took place in periods of rising inflation over the past two decades can be a good reference to anticipate what may happen this time. Our research shows that investments associated with tangible assets may be a good option for investors concerned with high inflation.

Equities, as a group, generated impressive returns in periods of rising inflation with levels that significantly surpassed the impact of inflation. Post-2000, rising inflation typically happened in environments of economic expansion and rising interest rates, a backdrop a lot like what we see now. Equities outperformed fixed income during these periods with the exception of certain specialized areas in fixed income, such as Treasury Inflation-Protected Securities (TIPS).

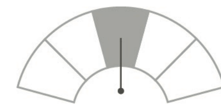
Within equities, historically the impact of inflation hasn't necessarily resulted in much of a difference. Both capital-heavy cyclical stocks as well as high-growth companies have been able to maintain a high level of market return in this environment.

Another area that has thrived in environments of rising inflation is Commodities, including oil and gold. The prices of Commodities are typically indexed to inflation, so they are can be good hedging assets — the value of these assets typically rises as demand builds up and inflation spikes.

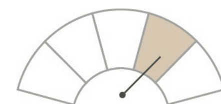
Overall, we believe equities are favorable investments to focus on in the current environment of economic expansion and rising inflation. They offer the potential for both long-term price appreciation and a desirable level of income. We prefer U.S. equities, particularly cyclical sectors.



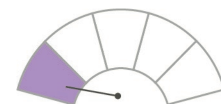
Favorable
U.S. Large Cap Equities



Neutral
U.S. Mid Cap Equities



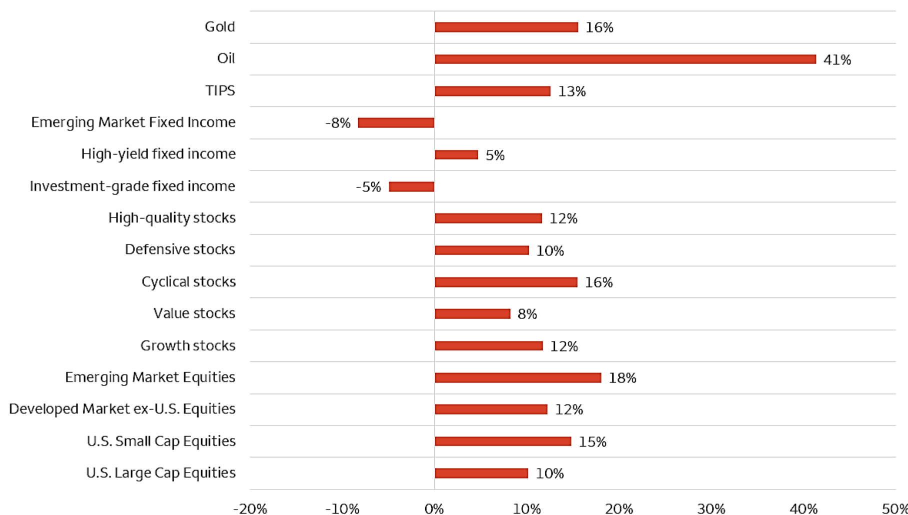
Favorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities

Favorable
Emerging Market Equities

Annualized average asset return during periods of rising inflation, post-2000



Sources: Wells Fargo Investment Institute and Bloomberg. Data as of June 8, 2021. Periods of rising inflation are defined as months when the month-over-month CPI increase is above 0.3%. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** Please see end of report for index definitions and risk considerations.

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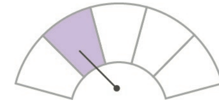
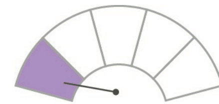
Fixed Income

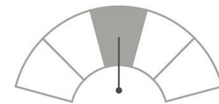
Luis Alvarado
Investment Strategy Analyst



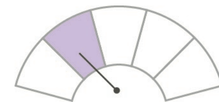
Unfavorable
U.S. Taxable Investment Grade Fixed Income



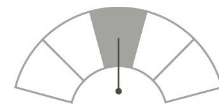
Most unfavorable
U.S. Short Term Taxable Fixed Income



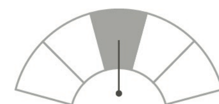
Neutral
U.S. Intermediate Term Taxable Fixed Income



Unfavorable
U.S. Long Term Taxable Fixed Income



Neutral
High Yield Taxable Fixed Income



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

Neutral
Emerging Market Fixed Income

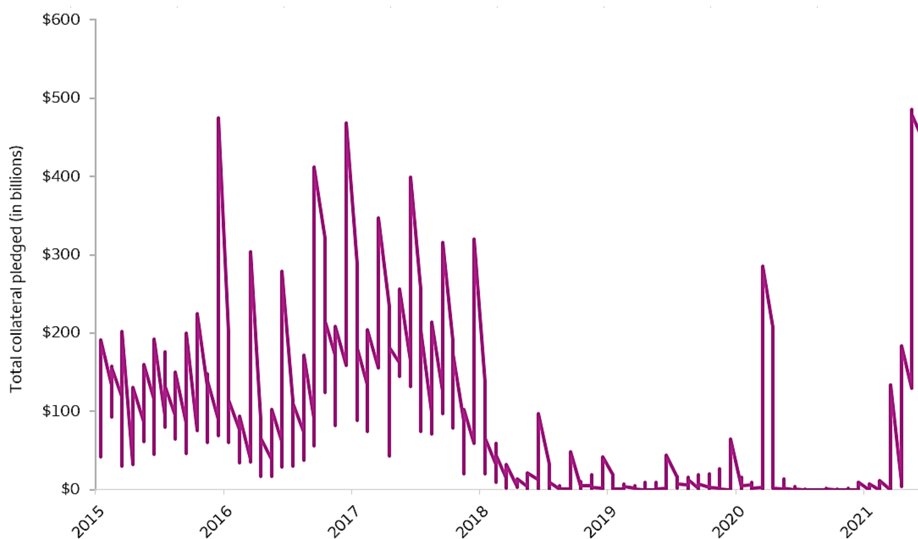
All eyes on the upcoming Fed meeting

Improving U.S. economic activity over the past two months has intensified investor expectations around the next steps for the Federal Reserve (Fed) and the timing on when changes may begin to occur. Most of the recent attention has revolved around the scaling back of bond purchases (tapering) and the potential effects on yields and fixed-income markets. We do not believe the Fed will offer any new clues around the timing of tapering nor on implementation mechanics at the upcoming meeting. We believe it will begin to talk about this topic sometime after the Jackson Hole Economic Symposium at the end of August with the actual tapering not beginning until 2022.

However, we do expect to get more insights around the progress that the economy has made towards the Fed's goals. We anticipate this to be reflected in the updated summary of economic projections along with the views from participants on the federal funds rate level over the next few years. Another key topic will be the use of the word transitory when referring to inflation pressures in the economy. This will be discussed as market participants continue to assess what portion of inflationary pressures are persistent versus only transitory and how that may affect yields in the near term.

Lastly, Fed participants may be able to address some of the concerns in the ultra-short-term markets. Supply-demand imbalances continue to add pressure to rates, which are already at the zero bound. Also, record usage of the Overnight Reverse Repurchase Agreement facility has garnered some attention in regards to capacity and overall functioning of these markets.

Fed's Overnight Reverse Repurchase Agreement facility attracts strong demand



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of June 9, 2021. Daily data from January 1, 2015 to June 9, 2021. Chart shows the daily collateral pledged on the Fed's Overnight Reverse Repurchase Agreement facility.

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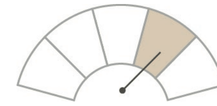
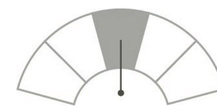
Real Assets

John LaForge
Head of Real Assets Strategy

"A man can get information and education at any age; you only get wisdom with experience."
— Louis L'Amour



Favorable
Commodities



Neutral
Private Real Estate

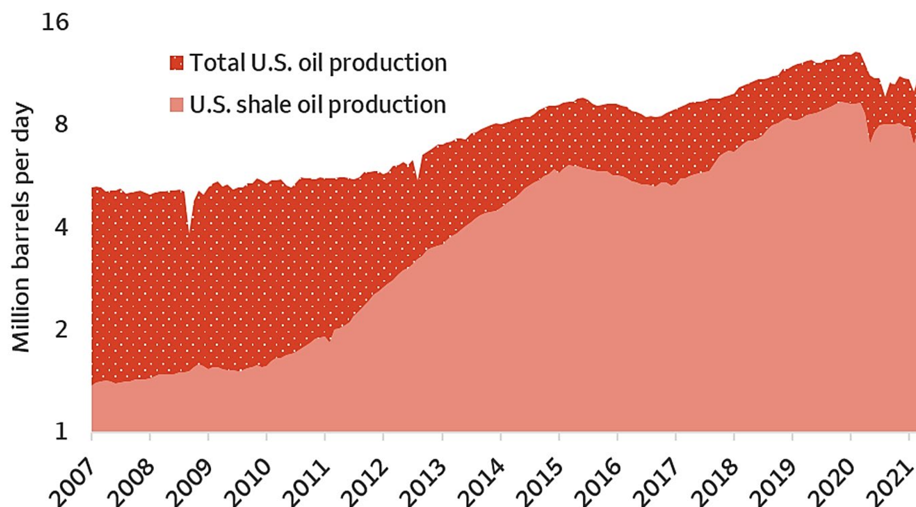
A curious thing about oil

A curious thing is happening in the oil markets: oil prices are rising, but U.S. crude oil production is not. Pre-coronavirus, in February 2020, the U.S. was notching all-time record crude oil production of 13.1 million barrels per day with the price of West Texas Intermediate (WTI) near $50 per barrel. Today, WTI sits at $70 per barrel, yet U.S. production cannot seem to push higher than 11 million barrels of oil per day (Chart below). Just as interesting is the fact that the average breakeven cost in U.S. shale basins is only $45 per barrel. The profit potential looks high, yet many U.S. oil producers are hesitant to maximize production.

So what is happening? Traditional fossil fuel-related companies are being forced, by consumers and investors, to change their definition of success. The bottom line is no longer the bottom line. Profit comes second to being environmentally and socially responsible. Consumers and investors have pushed environmental, social, and governance investing for years, and big changes have arrived. U.S. oil producers not maxing-out crude oil production at $70 per barrel is one example. Another recent example is the shocking election of three environmental activists to the board of directors of one of the U.S.'s largest traditional energy companies.

Keep in mind that getting to a green future was never going to be easy. 87% of the world's energy continues to come from fossil fuels, and we expect that a lot of these hydrocarbons will be needed to jumpstart global economies in 2021 and 2022. If global oil supplies continue to lag demand, $70 per barrel may look cheap a year from now.

U.S. shale oil production versus total production



Sources: Bloomberg, Energy Information Administration, Rystad, and Wells Fargo Investment Institute. Data as of May 31, 2021.

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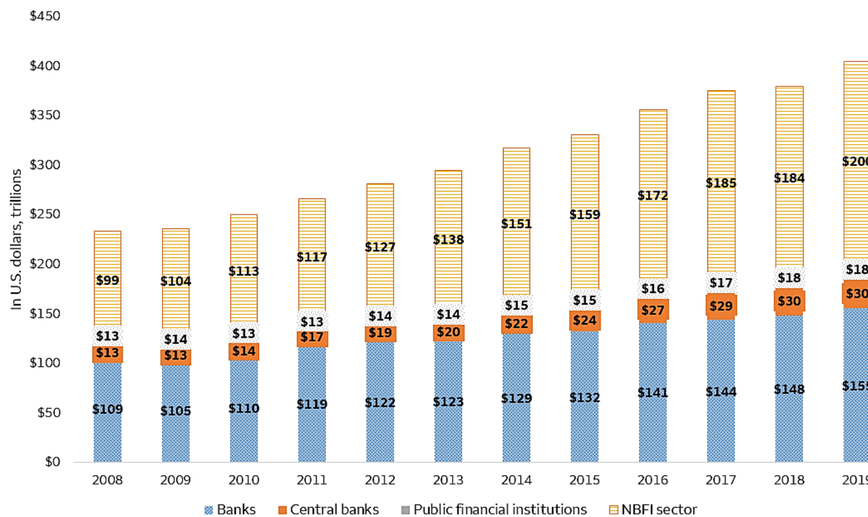
Alternatives

Direct lending in a low interest rate environment

Following the Global Financial Crisis (GFC) of 2008–2009, new regulations forced banks to boost their capital and liquidity levels. This reduced their ability to keep their newly issued loans on their balance sheets. Increasingly, they have relied instead upon an originate-to-distribute model, where loans are written and then sold to third parties. This has resulted in the non-banking financial intermediaries (NBFI) sector, which is comprised mainly of pension funds, insurance corporations, and other financial intermediaries (OFIs)[1], growing faster than the banking sector over the past decade, including in 2019. The financial assets of the NBFI sector amounted to $200.2 trillion and accounted for nearly half of the global financial system in 2019, up from 42% in 2008. This has allowed non-bank financial institutions such as private debt direct lending managers to become increasingly important players in the market.

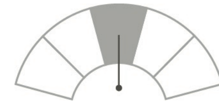
Entering the second half of 2021, investors' search for income is robust as yields trend to historical 40-year lows. Non-bank direct lending has replaced bank lending, particularly for middle-market corporates, and we believe that these trends are likely to accelerate after the COVID-19 pandemic. We are constructive on the direct lending strategy because: (1) loans are often issued to companies backed by private equity sponsors; (2) loans are typically senior-secured and therefore first in line for payment in the event of default; (3) they can provide non-traditional income, targeting 8%–10% annualized yield, that is attractive in today's lower-rate environment; and (4) we expect the fundamental and technical backdrop for loans to remain supportive.

Non-banking financial intermediaries sector assets surge since GFC

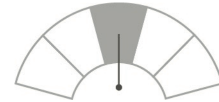


Sources: Financial Stability Board (FSB), "Global Monitoring Report on Non-Bank Financial Intermediation 2020", December 16, 2020.

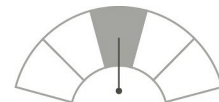
James Sweetman
Senior Global Alternative Investment Strategist



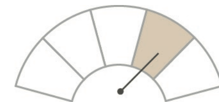
Neutral
Private Equity



Neutral
Hedge Funds – Macro



Neutral
Hedge Funds – Event Driven



Favorable
Private Debt

Favorable
Hedge Funds – Equity Hedge

Neutral
Hedge Funds – Relative Value

Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not appropriate for all investors and are only open to "accredited" or "qualified" investors within the meaning of U.S. securities laws.

[1] OFIs include all financial intermediaries that are not central banks, banks, public financial institutions, insurance corporations, pension funds or financial auxiliaries. They include mainly investment funds, captive financial institutions and money lenders, central counterparties, broker-dealers, finance companies, trust companies, and structured finance vehicles.

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Risk Considerations

Asset allocation and diversification cannot eliminate the risk of fluctuating prices and uncertain returns and they do not guarantee investment returns or eliminate risk of loss including in a declining market.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is appropriate only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

Portfolio Composition:

Moderate Growth & Income Three Asset Group portfolio (MGI 3AG): 3% Bloomberg Barclays U.S. Treasury Bill (1–3 Month) Index, 32% Bloomberg Barclays U.S. Aggregate Bond Index, 6% Bloomberg Barclays U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index, 21% S&P 500 Index, 12% Russell Midcap Index, 8% Russell 2000 Index, 6% MSCI EAFE Index, 7% MSCI Emerging Markets Index.

Bloomberg Barclays Global Inflation-Linked Total Return Index measures the investment-grade, government inflation-linked debt from 12 different developed market countries.

Bloomberg Barclays US Treasury Bills (1–3M) Index is representative of money markets.

Bloomberg Barclays US Aggregate Bond Index is a broad-based measure of the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market.

Bloomberg Barclays US Corporate High-Yield Index covers the universe of fixed-rate, non-investment-grade debt.

Gold Index shows spot exchange rate of gold.

J.P. Morgan Emerging Markets Bond Index (EMBI Global) currently covers more than 60 emerging market countries. Included in the EMBI Global are U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

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.

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

MSCI USA Min Vol Index aims to reflect the performance characteristics of a minimum variance strategy applied to the large and mid cap USA equity universe. The index is calculated by optimizing the MSCI USA Index, its parent index, in USD for the lowest absolute risk (within a given set of constraints).

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MSCI USA Quality Index is based on the MSCI USA Index, its parent index, which includes large and mid cap stocks in the US equity market. The index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage.

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

Russell 2000 Value Index measures the performance of the small-cap value segment of the U.S. equity universe. It includes those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

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.

S&P 500 Growth Index is a market capitalization weighted index using only growth stocks within S&P 500 index. Growth stocks are identified based on sales growth, the ratio of earnings change to price, and momentum.

S&P 500 High Beta Index measures the performance of 100 constituents in the S&P 500 that are most sensitive to changes in market returns. The index is designed for investors initiating a bullish strategy or making a directional bet on current markets.

S&P 500 Value Index is a market capitalization weighted index using only value stocks within S&P 500 index. Value stocks are identified based on the ratios of book value, earnings, and sales to price

WTI Crude Oil Index shows West Texas Intermediate Crude Oil Prices.

An index is unmanaged and not available for direct investment.

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