

2021 Outlook

Forging a path forward

December 2020

A letter to investors from Darrell L. Cronk

December 2020



I was channeling my love for history when I began reading the stories of Hannibal. He was a great commander and tactician of ancient Carthage who commissioned his generals to embrace the impossible and cross the Alps through Italy by elephants to defeat superior Roman forces during the Second Punic War. In perhaps not so dissimilar ways, 2020 felt like navigating treacherous steep mountain paths via pachyderms, with as many difficult and unpredictable twists and turns.

To illustrate: This past year brought the most widespread global health pandemic in over 100 years, some of the most polarized politics witnessed yet, social unrest, unprecedented weather events around the globe, and the first economic recession and equity bear market in over a decade. All challenged investors' fortitude and left them feeling a little exhausted at the year's end journey.

As we turn the calendar into 2021 and simultaneously exhale (albeit through our masks), serious questions call for clarity and resolution. When can we leave distancing and masks behind us and return to more stable social and economic activity? How will economic priorities and tax policies change under new Washington leadership? Will a growing Wall Street and Main Street disconnect reconcile itself in 2021, and if so, how? Let's explore:

- COVID-19 vaccines and therapeutics are coming but will face questions about timing, availability and the impact of possible virus mutations. Markets will quickly and efficiently arbitrate their effect on economic growth, confidence, and consumption. Much will depend upon this critical path in 2021.
- The postelection picture in Washington could well result in changed policies. A reset of pre-2017 regulation levels (or new ones) for many industries, more limited fiscal spending initiatives, or higher corporate and individual tax rates but a more multilateral approach to international trade policy may be in the offing for 2021. Any changes in policies will be closely monitored by markets for their cascading influence.
- Wall Street recovered quickly, but many parts of Main Street are struggling to overcome the pandemic's economic costs. History teaches us that the two often don't diverge for long periods of time. Therefore, economic policy and priority alignment will be critical to reconciling both onto a similar recovery path this year.

Patience and perseverance have a magical way of encouraging progress. Still, one can be forgiven for feeling fatigued from the challenges of this past year. Almost always, economic recoveries have arisen from dark points in our history, and investors know well that some of the best investment opportunities often present themselves from non-consensus ideas. These patterns are developing again. Our report highlights how these potential investment opportunities may arise in 2021.

On behalf of my Wells Fargo Investment Institute colleagues, I want to thank you for the trust you extend to us as our clients. We look forward to blazing the rugged trail of this recovery with you in 2021 — and beyond. Keep up the good fight.



Darrell L. Cronk, CFA

President, Wells Fargo Investment Institute

Chief Investment Officer, Wealth and Investment Management

*"I will either find a way
or make one."*

— Hannibal, the great Carthaginian
commander (218 BCE)

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Global economypage 4

- We anticipate uneven global growth in 2021, but strengthening over the course of the year if and when coronavirus vaccines are distributed. We expect China and the U.S. to remain on the leading edge of the global recovery throughout the year. We view global inflation's projected rise through the end of next year more as catch-up from 2020's pandemic-depressed rate than a fundamental change in the low-inflation environment of recent decades.
- We expect the dollar to extend its depreciation in 2021, especially versus the euro, as the recovery in U.S. growth is countered by high and rising U.S. trade and budget deficits, interest rates that are suppressed by the Federal Reserve (Fed), and ultralow currency hedging costs for foreign investors.

Global equitiespage 6

- We expect the economic recovery to continue in 2021, which should support an earnings rebound, sending equity prices to record highs.
- We favor high-quality asset classes (U.S. large- and mid-cap equities) and sectors (Communication Services, Consumer Discretionary, Health Care, and Information Technology) while increasing exposure to select cyclical sectors (Materials and Industrials) that can take advantage of the economic recovery.

Global fixed incomepage 8

- Low rates are likely to persist. While we may see some modest pressure on longer-term rates, we expect that any sell-off in rates will be contained.
- Significant levels of cash on the sidelines are likely to be redeployed in 2021, lifting risk assets. We suggest that fixed income investors look for opportunities to add yield in the current environment.

Global real assets page 10

- Post-pandemic realities leave us generally unfavorable on publicly traded real estate investment trusts, or REITs, but we do see opportunities in some REIT subsectors.
- We expect that a 2021 rebound in demand and a delayed supply response will support a continued bounce in Commodities. We remain favorable.

Global alternative investments* page 12

- For hedge funds, we continue to favor equity hedge but anticipate a favorable environment for relative value and event driven strategies as well.
- Private capital strategies such as value-add and opportunistic real estate, as well as special situations private debt, can potentially capitalize on COVID-19 induced pricing pressure.

Economic and market forecasts page 14

Risks to our outlook page 15

Top 5 portfolio ideas for 2021 page 16

Selected year-end 2021 forecasts

See pages 14–15 for our
complete 2021 economic
and market forecasts

3.8%

U.S. GDP growth

1.7%

U.S. inflation
Consumer Price Index

3,800–4,000

S&P 500 Index

0.00%–0.25%

Federal funds rate

1.00%–1.50%

10-year U.S. Treasury
note yield

\$45–\$55

West Texas Intermediate
crude oil per barrel

Sources: Wells Fargo Investment Institute and
Wells Fargo Securities Economics Group,
December 7, 2020. GDP = Gross Domestic Product.

Forecasts and targets are based on certain
assumptions and on our current views of market and
economic conditions, which are subject to change.

*Alternative investments are not suitable for all investors and are only open to “accredited investors” or “qualified investors” within the meaning of the U.S. securities laws. They are speculative, highly illiquid, and designed for long-term investment and not as trading vehicles.

Please see pages 18 and 19 for important definitions and risk considerations.

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A bumpy transition year in 2021

Key takeaways:

- We expect the pandemic's lingering fallout to sustain uneven global economic growth accompanied by firmer but sub-2% inflation for most of 2021.
- We expect aggressive Fed stimulus to lead to further dollar declines in 2021, mainly versus the euro. Among emerging markets, currencies in Asia may gain, but those in other regions may struggle to rally sustainably.

What it means for investors:

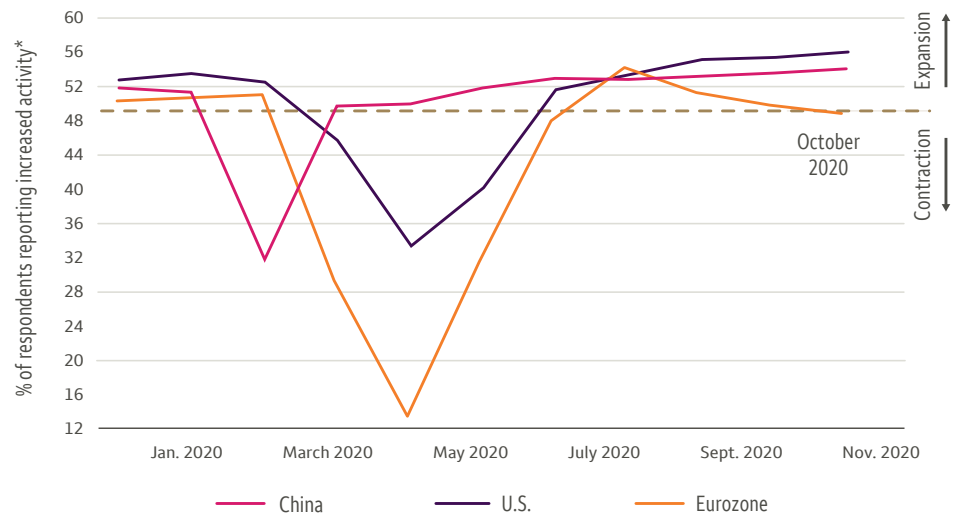
- Ongoing recovery from the upheaval of the past year should provide a supportive backdrop for the asset markets in 2021. Moderate economic growth and subdued inflation are consistent with adequate earnings growth and historically low interest rates, favoring gains in stocks and limiting the threat to bonds. Dollar weakness against the euro should help ease global deflationary pressures while boosting dollar-denominated returns on European investments.

Uneven climb ahead for global growth

We expect uneven world economic growth of 5.2% in 2021, but several contours of our outlook hide behind this global average rate. First, we expect a slow first quarter and faster thereafter. Also, cross-country differences should persist, based on widely different resources available to combat COVID-19. Finally, world economic activity starts the year from such a low level, that even moderate improvement will produce a large percentage increase. The transition to economic expansion should continue in 2021, but with challenges.

The U.S. and China are running neck and neck in the global growth derby

Although the U.S. and China show signs of recovering from the pandemic-related contraction, eurozone economic activity remains depressed.



Sources: Markit, Inc.; Bloomberg Financial News, Inc.; and Wells Fargo Investment Institute, November 18, 2020.
 *Percent of respondents reporting increased manufacturing & nonmanufacturing activity.

Projected U.S. recovery

The chart above shows that second-wave COVID-19 infections already are weighing on European economies, jeopardizing prospects for continued growth into the early months of 2021. The U.S. may face a similar threat, though both regions likely will benefit from the expected introduction of an effective COVID-19 vaccine, perhaps as soon as the winter or spring. A likely split government in the U.S. would lessen the scope for potentially disruptive policy changes, better aligning recoveries on Main Street and Wall Street. Europe still must contend in coming months with the corrosive economic effect of coronavirus containment broadening bankruptcies and layoffs beyond frontline industries, undermining credit quality and financing availability. Countering those uncertainties are low interest rates and an elevated savings rate, as well as solid gains in inflation-adjusted income and household wealth, which should support housing and consumer-led growth in the U.S. On balance, we believe sustained growth will prevail as the U.S. overcomes disruptions from the coronavirus, an uncertain election aftermath, and a fiscal stalemate to post respectable 3.8% growth, following a 3.7% decline this year.

Chinese economic revitalization and mixed emerging market growth

Our forecast for growth in emerging economies is large compared with historical rates, partly reflecting the recovery from a very low starting point after the 2020 recession. Aside from this base effect, growth in a revitalized China leads the group, fueled by manufacturing, exports, and consumer spending. Elsewhere, the same trends are emerging but are unsynchronized across countries. Regional improvements in Emerging Europe and India should reinforce the uptrend to start the new year. Latin America is the most notable economic laggard.

A subdued inflation outlook

We view global inflation's projected rise through the end of 2021 as more of a catch-up from 2020's pandemic-depressed rate than a fundamental change in the low-inflation environment of recent decades. We expect that increases much beyond 2020's pre-pandemic peak of 2.3% to 2.5% will be restrained by many of the same structural headwinds — including globalization, demographics, and technological innovations — that are complicating the efforts of the Fed to sustain inflation at or above 2%. If the new Congress splits control of the two chambers between Democrats and Republicans, as we expect, then only modest fiscal programs are likely to result. In that event, fiscal policy may not produce new inflation pressures.

Dollar drift likely to continue

We expect the dollar to extend its depreciation against the euro in 2021 despite the recovery in U.S. growth. Other factors, such as Fed policy, should matter more. Given the extent of the dollar's multiyear rise before 2020, we think it has further to fall; we expect the dollar to trade around \$1.25 against the euro by the end of 2021. However, we do not see sustained yen strength, and we believe that the pound's 2020 buoyancy will not extend into 2021 in the face of new Brexit realities. In terms of the dollar index (DXY),¹ we anticipate lower levels in the mid- to high-80s by year-end 2021.

Emerging market currencies face challenges

A global growth recovery and a slowdown in the de-globalization trend of recent years may give a boost to emerging market currencies, many of which have fallen sharply in 2020 — especially in the context of a continued dollar decline versus developed market currencies. The prospect of a faster-than-expected return to pre-COVID-19 patterns of trade and tourism should support investment flows into the sector.

¹ The dollar index (DXY) is a weighted average dollar exchange rate index against six major currencies, base year 1973, calculated by ICE Futures U.S. An index is unmanaged and not available for direct investment.

Improving growth should support equities

Key takeaways

- We expect corporate earnings to rebound in 2021, with U.S. and emerging market benchmarks surpassing pre-recession levels.
- Higher-quality U.S. equity asset classes and sectors still should produce positive returns. Emerging markets and select U.S. cyclical sectors could outperform the S&P 500 Index as the recovery takes hold.

What it means for investors

- We believe investors should continue to lean into U.S. large- and mid-cap equities while bringing allocations to U.S. small-cap equities and emerging market equities up to strategic target weights.

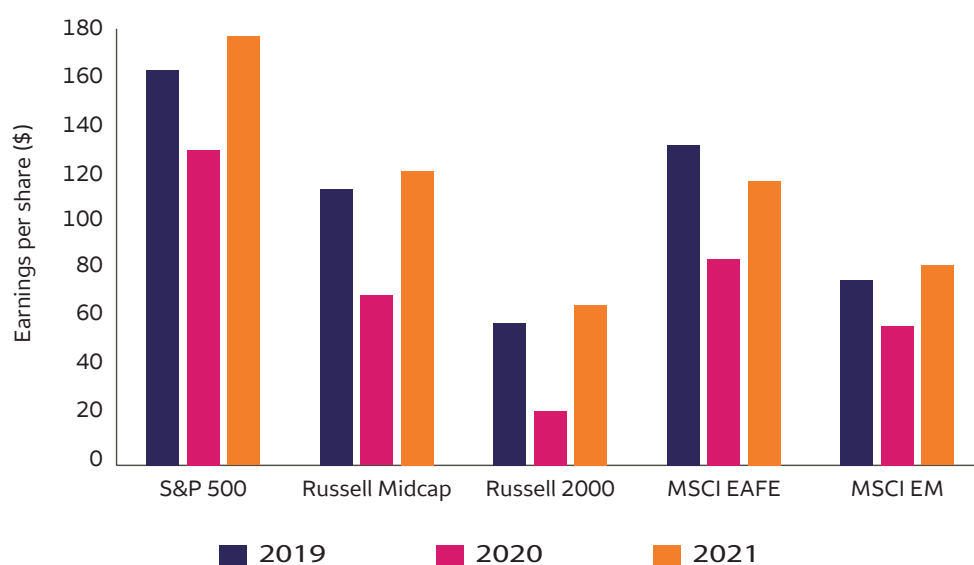
Our forecast continues to favor U.S. over international equities

Improving economic conditions likely will lead to greater business and consumer confidence, which should drive significant corporate earnings growth in 2021. This, coupled with the potential for increased fiscal spending and a moderation of tariffs, also may provide a tailwind to profits. Meanwhile, we expect monetary policy to remain accommodative, providing a backstop to the economy and fostering further equity market gains. We believe the bull market that started in March 2020 will continue in 2021, with the S&P 500 Index reaching record highs.

For 2021, we believe investors should focus on the potential for both earnings improvement and higher equity prices. We estimate that earnings per share (EPS) in the S&P 500 Index will surge by more than 30% — from \$130 in 2020 to \$175 in 2021. Our earnings forecast for year-end 2021 should take the index above previous peak levels seen prior to the recession (see the table below). Our 2021 year-end median price target for the S&P 500 Index is 3,900. Price/earnings ratios are expected to fall in 2021 as earnings climb faster than prices. Strong profit growth and the continued relative advantage of equity earnings yields (earnings/price) to U.S. Treasury yields should be a tailwind for equities.

We expect earnings per share to surpass pre-recession highs

We expect global earnings improvement, as the recovery from the 2020 lockdowns becomes more steady.



Source: Bloomberg and Wells Fargo Investment Institute, as of November 23, 2020. 2019 EPS actual. 2020 and 2021 EPS based on WFII forecasts. EPS = earnings per share. EM = Emerging Markets. Forecasts and targets are based on certain assumptions and on our current views of market and economic conditions, which are subject to change. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

We favor U.S. mid caps; neutral on small caps

We expect the Russell Midcap Index to post a sizable earnings-per-share increase, which should support our 2021 year-end median price target for the index of 2,700. We believe earnings per share for the small-cap equities in the Russell 2000 Index should rebound, with modest upside to price levels. We are neutral on small caps, which may benefit from improving investor sentiment and an overall cyclical recovery. However, fundamentals remain challenged for this group.

Quality remains a key theme, but cyclicalality could play a bigger role

Throughout 2020, we guided investors to move up in quality within their equity exposure. We believe the higher-quality theme will remain important in 2021. The tilt toward high quality — as represented by companies with stable profitability and low financial leverage — is expressed by our preference for U.S. equities over international equities and large- and mid-cap stocks over small-cap stocks. We also see high-quality characteristics in the Communication Services, Consumer Discretionary, Health Care, and Information Technology sectors, which we favor.

As the economic and earnings recovery strengthens in 2021, we foresee potential opportunities in some traditional cyclical sectors, especially those with higher-quality characteristics. One reason that the Consumer Discretionary sector remains a favorite is its inclusion of industries that should benefit from an improving economy. We also upgraded Materials to favorable and Industrials to neutral, reflecting a weaker U.S. dollar, improving fundamentals, and the possibility of increased infrastructure spending.

We expect emerging markets to outperform developed (ex-U.S.) markets

We believe the performance of developed market (ex-U.S.) equities will be restrained by Brexit unknowns and a continuation of trade concerns. Furthermore, the MSCI EAFE Index sector composition presents a disadvantage relative to the S&P 500 Index, with a greater emphasis on Financials and a smaller weight to the Information Technology sector. Although earnings should rebound in 2021 from depressed levels, we expect developed market (ex-U.S.) equity gains to lag those of the U.S. and emerging market equities.

We expect emerging market companies, especially in Asia, to continue their earnings recovery in 2021. In particular, China should be supported by our expectations for robust business spending, better consumer spending, and improved trade relations. The top two sector weightings in the MSCI Emerging Markets Index are Consumer Discretionary and Information Technology, both of which could benefit from rising business and consumer sentiment. Asia's positives are partly offset by the expectation for continued weakness in Latin America, leaving our overall guidance for emerging markets at neutral.

Favored asset classes

- U.S. Large Cap Equities
- U.S. Mid Cap Equities

Favored equity sectors

- Communication Services
- Consumer Discretionary
- Health Care
- Information Technology
- Materials

Low yields persist on road to recovery

Key takeaways

- An extended low-rate environment likely will add to already high demand for yield-oriented product.
- Tax-exempt income is likely to be in high demand. We believe investors should look for opportunities to add municipal bond allocations in taxable accounts.

What it means for investors

- As uncertainties fade, we believe investors should look for opportunities in higher-yielding fixed income investments while taking care to avoid being overly conservative in fixed income positioning.

Fiscal and monetary policy should remain accommodative

Record fixed income supply, historic monetary policies, and additional government deficit spending are likely to continue through at least the first half of 2021. The impact of these unprecedented actions will reverberate in fixed income markets throughout the year and beyond. While we expect volatility to remain elevated, we anticipate that policymakers will ensure that ample liquidity remains accessible to help markets weather this unique environment. Ultimately, we see rates in longer maturities rising modestly but expect interest rates to remain at low levels for the foreseeable future.

The Fed has revamped its inflation target framework — it is now targeting an average inflation level rather than a specific target level. While the change may appear nuanced and of little consequence, we believe this new path implies that the Fed will remain accommodative for longer than previously indicated. As a result, we see no Fed rate hikes through year-end 2021; our federal funds rate target is unchanged from the current level of 0.00% – 0.25%. Despite significant new Treasury issuance, we see only modestly higher rates in longer maturities as Fed buying and global demand help keep longer-term rates contained. Our year-end 2021 target for the 10-year Treasury is 1.00% to 1.50% while our 30-year target is 1.75% to 2.25%, modest increases from today's levels.

The federal debt and deficit exploded as lawmakers responded to the pandemic. Signs point to new Washington executive and congressional leadership continuing on an expansive fiscal path for 2021. The added Treasury supply that will be required to fund this spending should be well absorbed by markets. A quicker-than-expected recovery could put added pressure on longer-term rates at times, but even under that scenario we expect rate increases will be muted as global demand for Treasury securities remains strong.

Consider yield-oriented investments

With a low-yield environment expected to persist well into the economic recovery, we believe that investors should favor higher-yielding fixed income asset classes and sectors. Corporate bonds should continue to pay a premium over Treasury securities. We also believe that investors should consider moving down the credit spectrum into the high-yield asset class for the benefit of added yield, but such a move must be made with caution. Accordingly, we prefer active management in lower-quality investments. Preferred securities are another yield-oriented fixed income sector that we currently view favorably. Investors purchasing preferred securities may want to do so with a buy-and-hold mentality, as these securities can become highly volatile during times of market stress.

Consider municipal bonds

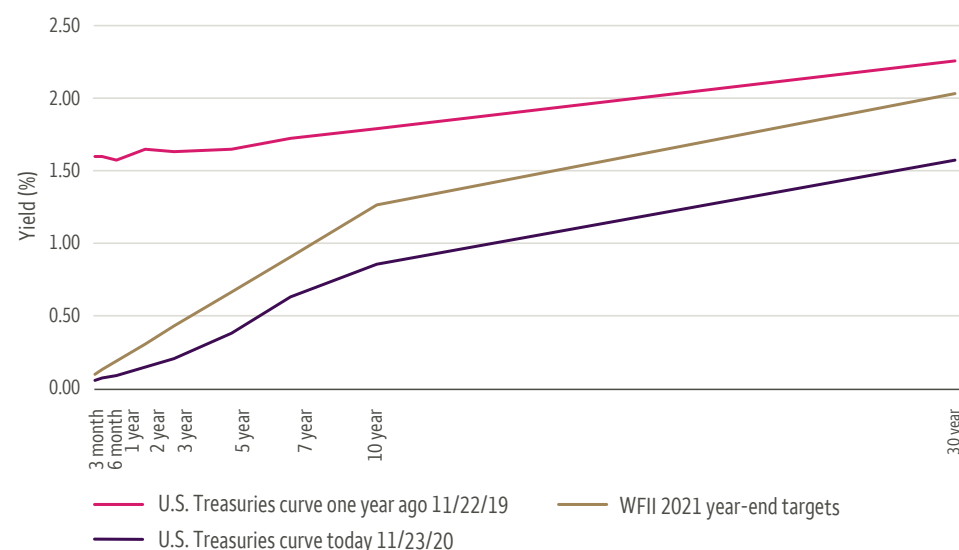
States and municipalities face economic headwinds as revenue declines force difficult decisions that could impair services and government employment levels. More stimulus for states is likely needed, and we believe more will be forthcoming in 2021, which should help alleviate some credit concerns. We do not think municipal bankruptcies at the state level are likely. We remain favorable on municipals; for investors in higher effective tax brackets, municipal securities remain attractive and can be an important part of fixed income positioning. We would take care to diversify positions, and we favor A-rated or better general obligation and essential-service revenue issues.²

Think globally

We believe investors should consider an allocation to emerging market bonds. These securities carry an attractive higher yield, and dollar-denominated sovereigns should be insulated from currency fluctuations and domestic fiscal concerns. Dollar depreciation should aid returns for developed market debt. However, outside of foreign exchange movements, we do not expect meaningful returns from government bonds in the eurozone and Japan, with yields likely to remain near zero or in negative territory.

We expect yields across the curve to stay low

We believe the Fed will keep the federal funds rate — and therefore short-term interest rates — at the current level. However, we expect longer-term yields to rise modestly as the economic recovery takes hold.



Sources: Bloomberg and Wells Fargo Investment Institute. Weekly data as of November 23, 2020. Forecasts and targets are based on certain assumptions and on our current views of market and economic conditions, which are subject to change. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. **Past performance is no guarantee of future results.**

² Ratings based on S&P/Moody's.

Favored asset classes

- High Yield

Favored sectors

- Corporate Securities
- Preferred Securities
- U.S. Municipal Bonds

Commodity bounce likely to continue

Key takeaways

- A rebound in economic growth and likely COVID-19 vaccines and therapeutics should support commodity demand in 2021.
- Lingering real estate impacts should weigh on REITs overall, while the divergence between the REIT “haves” and “have nots” continues to widen.

What it means for investors

- We expect commodities to perform well in 2021. REIT investors should be selective.

Commodities look favorable; REITs unfavorable

We expect the rebound in U.S. and global economic growth in 2021, along with positive developments toward COVID-19 vaccines and therapeutics, to lay the groundwork for increased confidence and improved commodity demand. Next year looks less rosy for REITs, where we expect lingering real estate impacts to weigh on performance. We enter 2021 favorable on Commodities and unfavorable on REITs. Large, well-capitalized, broadly diverse midstream energy companies — both master limited partnerships (MLPs) and C-corporations — may fare better than some of their energy peers in a difficult 2021 environment.

Commodities should benefit from healthy demand

Our forecast for continued economic improvement should support robust commodity demand. Yet, supply may be slow to come back online. The 2020 price drop wiped out the weaker marginal suppliers, which handicaps the supply response. Additionally, of the suppliers that remain, it may take consistently higher prices to convince them to reopen that mine, or hire more oil rigs, or plant more acreage. We believe this lag effect should support higher commodity prices in 2021, therefore we remain favorable.

In 2021, we expect tailwinds supporting each of the major commodity subsectors. We anticipate Industrial Metals will likely benefit from the economic rebound — especially in China — as well as potential U.S. stimulus and from any infrastructure spending that Congress may approve. Precious Metals should benefit from low real (inflation-adjusted) long-term interest rates, a weaker dollar, and widespread accommodative monetary policies, in our opinion. The global thirst for energy commodities should return as the pandemic fades in the back half of 2021. We look for agriculture to benefit from declining inventories, increasing demand, and a price trend that finally is showing signs of life.

Fundamentals continue to favor gold

We believe the fundamental backdrop continues to be attractive for gold. Sizable monetary and fiscal support and a weaker U.S. dollar should be supportive. Yet, modestly higher real interest rates may be a headwind (see the chart on the next page). We expect the price of gold to end 2021 between \$2,100 and \$2,200.

Oil's picture might brighten in the second half of 2021

Next year might be a tale of two halves for oil. We expect the first half to be characterized by excessive inventories and substantial spare capacity, which should keep price moves in check and range-bound. This environment could be painful for producers, and we will likely see the recent spike in bankruptcies continue.

As we progress to the second half of the year, the pandemic-induced oil market issues will likely start to fade. Demand, inventories, and spare capacity should return to more “normal” levels, while the supply response may be impaired. This environment may support higher oil prices than the consensus expects by year-end. Our 2021 year-end oil targets for West Texas Intermediate (WTI) and Brent are \$45 to \$55 and \$50 to \$60, respectively.

Mixed picture for REITs

Even as the economy recovers, the lingering COVID-19 impact on real estate leads us to an unfavorable outlook on REITs as a whole, but we see divergent paths among the subsectors. From retailers struggling to pay rent to shrinking office space to would-be travelers staying home, the future for some real estate subsectors does not look so rosy, even post-pandemic. We do see positive trends for the technology-related subsectors (Data Center REITs, Infrastructure REITs, and Industrial REITs) as well as niche subsectors (Single Family Home REITs and Manufactured Home REITs).

Midstream energy (MLPs and C-Corporations)

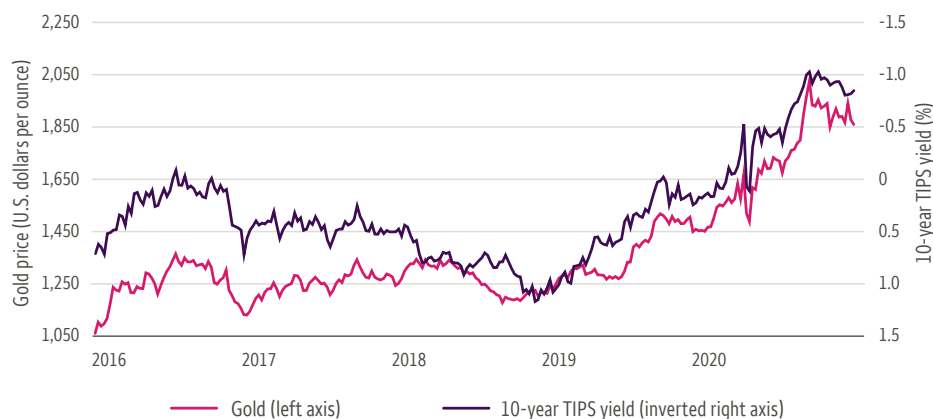
Despite our outlook for a more constructive oil market environment in the second half of the year, prices and volumes are unlikely to return to early 2020 peaks. Continued pressure from environmental, social, and governance (ESG) investors and resulting investor outflows, stressed balance sheets, and overbuilt energy infrastructure are additional headwinds. We see potential for better opportunities outside of the energy complex. Yet, we expect large, well-capitalized, broadly diversified Midstream companies to hold up well relative to some of their energy company peers. In addition, we prefer Midstream C-Corporations over MLPs, as the C-Corporation structure is more likely to attract outside capital.

Favored real assets

- Commodities
- Technology- and niche-related REIT subsectors:
 - Data Center REITs
 - Infrastructure REITs
 - Industrial REITs
 - Single Family Home REITs
 - Manufactured Home REITs

Gold versus 10-year Treasury Inflation Protected Securities (TIPS)

Because gold and TIPS are both used as potential inflation hedges, gold prices have generally risen as inflation-adjusted Treasury yields have fallen. Increasing real interest rates could be a headwind to gold prices in 2021.



Sources: Bloomberg and Wells Fargo Investment Institute, November 23, 2020. Weekly data: January 1, 2016 – November 23, 2020. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. **Past performance is no guarantee of future results.**

Please see pages 18 and 19 for important definitions and risk considerations.

Post-pandemic may provide opportunities

Key takeaways

- We look for micro cycles in sectors such as retail, commercial real estate, travel and leisure, and transportation to drive opportunities for both relative value and event driven hedge fund strategies next year.
- Though core strategies dominate private real estate assets, we view value-add and opportunistic (particularly in industrial and multifamily assets) as the private real estate strategies best positioned for 2021.

What it means for investors

We believe investors should gravitate toward hedge fund and private capital portfolios that are more focused on themes arising out of the COVID-19 crisis. Often, sectors and industries facing the biggest challenges also elicit the best long-term investment opportunities.

A mixed environment demands a focused approach

In our midyear report, “Alternative Investments and the COVID-19 Crash,” we highlighted four phases that we felt would drive the opportunity set for global alternative investments in the coming months and years — lending and liquidity, dislocation, distress and restructuring, and recovery. While we anticipated that these phases would occur broadly and in a linear fashion as in previous credit cycles, we actually find that they are existing simultaneously within a subset of sectors and industries. In other words, the expansive default cycle that we expected has been replaced with multiple “micro cycles” that are highly sensitive to fiscal and monetary stimulus. This does not necessarily diminish the opportunity set for global alternative investments in 2021, but it does elicit a more focused approach.

Credit and stock market volatility should benefit several hedge fund strategies

Though credit market volatility has declined meaningfully, we expect 2021 to be another strong year for relative value hedge fund strategies focused on either structured credit or long/short credit, as well as event driven managers focused on distressed debt. In particular, we believe strategies with exposure to residential mortgage-backed securities should benefit from further strength in the housing market next year as well as increased demand from yield-hungry investors.

Within corporate credit, we expect both long/short credit and collateralized loan obligation investors to benefit from increased credit dispersion, especially among sectors directly affected by COVID-19, where a large valuation gap exists. The distressed debt playbook for event driven hedge funds is changing to account for the speed of the aforementioned micro cycles and the Fed’s actions to avoid widespread defaults by purchasing corporate bonds. Nonetheless, we think the ramifications of the spike in defaults and bankruptcies in 2020 will last into 2021 and provide ample trading opportunities for both relative value and event driven managers.

In a similar vein, we think 2021 will be another year conducive to fundamental, bottom-up stock selection. We maintain our favorable view on equity hedge. While corporate earnings growth should improve next year, we do not believe that a rising tide will lift all boats, and we envision ample opportunities for skilled managers to short overvalued equities.

Alternative investments are not suitable for all investors and are only open to “accredited investors” or “qualified investors” within the meaning of the U.S. securities laws. They are speculative, highly illiquid, and designed for long-term investment and not as trading vehicles.

Private real estate should benefit from acquisitions at depressed prices

The pandemic has exacerbated the headwinds faced by retail properties and also caused stress in hotel and office sectors. In contrast, the pandemic has boosted the industrial property sector as e-commerce continues its secular growth, while many multifamily rental properties continue enjoying strong demand. For 2021, we are focusing on the private real estate sub-strategies of "value-add" and "opportunistic," with an emphasis on industrial and multifamily properties. We believe that vintage year 2021 funds can potentially post strong returns as property owners seek liquidity or dispose of struggling properties. Both sub-strategies have tended to perform strongly after economic downturns, as seen in the chart below. We expect most value-add and opportunistic funds to make meaningful acquisitions (at discounted valuations) starting in mid-2021 or later.

Performance of value-add and opportunistic North American Private Real Estate funds

Value-add and opportunistic North American Private Real Estate funds that started investing in the 2001 and 2007-2009 recessions delivered higher returns compared to other vintages.



Sources: Burgiss, National Bureau of Economic Research, and Wells Fargo Investment Institute. Data as of second quarter 2020. IRR is internal rate of return, which is the average annual return that investors realized over time from an investment of a particular vintage. Funds are pooled IRRs calculated with 457 funds categorized as value-add or opportunistic private real estate focusing on North America. **Past performance is not a guarantee of future results.**

Private debt and private equity may offer focused but attractive opportunities

We anticipate localized opportunities for private debt, especially in those funds employing distressed and special situation strategies. These funds may extend opportunistic credit (including rescue financings) to stressed firms, and may employ 'distress for control' or similar strategies to acquire equity of restructured companies on favorable terms. Private equity may face challenges next year, with buyout valuations and dry powder remaining at elevated levels. We continue to favor secondary funds. We also see considerable opportunities in growth equity and buyout funds able to invest in health care and information technology companies.

Favored hedge fund sub-strategies

- Relative Value: Long/Short Credit
- Relative Value: Structured Credit
- Event Driven: Distressed
- Equity Hedge: Directional

Favored private capital sub-strategies

- Private Real Estate: Value-Add and Opportunistic
- Private Debt: Distressed and Special Situations
- Private Equity: Secondaries and Health Care/Information Technology

Economic and market forecasts

U.S. GDP (gross domestic product) growth

A global growth recovery from a slowdown through early 2021 should be supported by another economic reopening following the introduction of an effective COVID-19 vaccine.

Economic forecasts	2020 year-end target	2021 year-end target
U.S. GDP growth	-3.7%	3.8%
U.S. inflation	1.0%	1.7%
U.S. unemployment rate	8.2%**	6.5%
Global GDP growth	-3.1%	5.2%
Developed market GDP growth	-5.3%	3.4%
Developed market inflation	0.6%	1.5%
Emerging market GDP growth	-1.7%	5.9%
Emerging market inflation	4.0%	4.0%
Eurozone GDP growth	-7.8%	1.5%
Eurozone inflation	-0.1%	1.2%
Dollar/euro exchange rate	\$1.19*	\$1.21–\$1.29
Yen/dollar exchange rate	¥104.31*	¥99–¥109

Federal funds rate

We expect the Fed to keep short-term rates near zero throughout 2021, limiting returns on cash and short-term fixed income allocations.

Fixed Income targets	2020 YTD (actual)*	2021 year-end target
Federal funds rate	0.25%	0.00%–0.25%
10-year U.S. Treasury yield	0.84%	1.00%–1.50%
30-year U.S. Treasury yield	1.57%	1.75%–2.25%

West Texas Intermediate crude

Constrained supply and firming demand should drive oil prices higher by year-end.

Source: Wells Fargo Investment Institute, December 7, 2020.

*Actual as of November 30, 2020. Forecasts, targets and estimates are based on certain assumptions and on our current views of market and economic conditions, which are subject to change. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. **Fourth quarter average.

Past performance is no guarantee of future results.

Real Assets targets	2020 YTD (actual)*	2021 year-end target
West Texas Intermediate crude (barrel)	\$45	\$45–\$55
Brent crude (barrel)	\$48	\$50–\$60
Gold (troy ounce)	\$1,777	\$2,100–\$2,200
Bloomberg Commodity Index (total return)	159	165–175

Equity targets	2020 YTD (actual)*	2021 year- end target
S&P 500 Index	3,622	3,800–4,000
Earnings per share	\$141	\$175
Russell Midcap Index	2,624	2,600–2,800
Earnings per share	\$83	\$120
Russell 2000 Index (small cap)	1,820	1,715–1,935
Earnings per share	\$25	\$65
MSCI EAFE Index	2,054	1,900–2,100
Earnings per share	\$91	\$115
MSCI Emerging Markets Index	1,205	1,150–1,350
Earnings per share	\$65	\$80

S&P 500 Index

We expect a significant rebound in earnings and relatively modest price appreciation in 2021.

Source: Wells Fargo Investment Institute, December 7, 2020. *Actual as of November 30, 2020. Forecasts, targets and estimates are based on certain assumptions and on our current views of market and economic conditions, which are subject to change. An index is not managed and not available for direct investment. **Past performance is no guarantee of future results.**

Risks to our outlook

Economy

- We believe the most visible risks to our 2021 growth outlook are pandemic-containment efforts that are stringent enough to reverse the recovery, leading to a double-dip recession. Other growth hurdles could come from an end to rental forbearance and other credit-quality issues at the same time that government spending pulls back.
- Europe's worsening economic slowdown, increased monetary stimulus by the European Central Bank, and flight-to-quality support for the dollar in more turbulent market conditions could upend forecasts of dollar weakness relative to the euro, in our opinion.

Fixed income

- Although not our base case, we believe a highly effective vaccine would allow a faster-than-expected recovery. Such a robust recovery, coupled with the significant stimulus already in the economy, could produce higher-than-expected interest rates and risk assets could rally.
- Should policymakers have to respond to a continued or new crisis, we have some concern that limited fiscal flexibility and novel policy tools would be less effective in the future given their extensive use over the past year.

Real assets

- Policy missteps or a resurgence in COVID-19 cases could depress economic growth and confidence in 2021.
- A slowdown in Chinese economic growth could lead to reduced demand for commodities.

Equities

- A new surge in COVID-19 infections or disappointment about a vaccine could restrain the recovery and create new uncertainties about earnings-per-share growth.
- Policy uncertainty resulting from a divided U.S. government could lead to a lack of compromise and an inability to pass economic and market-friendly legislation.

Alternative investments

- A faster-than-expected return to "normal" could lead to further core real estate price appreciation and truncate the opportunity set for value-add and opportunistic strategies.
- A double-dip recession could put pricing pressure on 2020- and early 2021-vintage portfolios.

Top 5 portfolio ideas for 2021

Key takeaways

- We believe that improving economic data and bullish investor sentiment should support equities as the recovery continues into 2021.
- With yields relatively low, investors may need to diversify their bond holdings to seek yield in fixed income investments outside of traditional bonds.

What it means for investors:

- In periods of high volatility, we suggest taking action thoughtfully and not reacting emotionally to market conditions.

1 Hold the right amount of cash

In our view, investors should hold enough cash to meet short-term liquidity needs to avoid selling assets at inopportune times. Investors may be over-allocated to cash, as money market balances remain near all-time highs. Investors holding high levels of cash likely are missing out on the market recovery and could be impeding long-term performance. Our research also has found that missing the 10 best days in the market over the past 10 years resulted in a decrease in annualized return by over 50% — from 10.7% to 4.3%.³ For portfolios with high levels of cash, we suggest that investors invest the cash thoughtfully. One potential strategy is dollar-cost averaging — investing cash over time in an effort to take advantage of market fluctuations.⁴

2 Selectively increase risk

As we enter a new bull market, we expect risk assets like equities to outperform. But within the equity asset group, we suggest that investors be selective in how they increase risk. We generally favor U.S. equities over international equities because we believe that growth prospects in the U.S. are stronger than those for international economies. Within U.S. equity asset classes, we prefer large-cap and mid-cap equities over small-cap equities because larger companies typically have higher cash balances, lower leverage, and better earnings growth than their smaller counterparts. We also suggest using gold as part of a tactical commodities allocation (2% to 4% of the portfolio) in an effort to hedge risk and provide a level of diversification. Within fixed income, we favor taking credit risk and keeping duration (interest-rate sensitivity) neutral.

3 Consider exposure to higher-quality, growth-oriented sectors

Quality remains a key theme, but cyclical could play a bigger role. We favor cyclical sectors that should demonstrate more consistent performance as the U.S. economic recovery advances. Our favored sectors include Information Technology, Health Care, Communication Services, and Consumer Discretionary. Also, we favor the Materials sector and upgraded Industrials to neutral, in order to seek opportunities as economic improvement broadens around the globe and on the prospect of increased infrastructure spending.

³Bloomberg and Wells Fargo Investment Institute, as of October 31, 2020. The market is represented by the S&P 500 Index. Analysis based on price return for the S&P 500 Index. An index is unmanaged and not available for direct investment.

Past performance is no guarantee of future results.

⁴A periodic investment plan such as dollar cost averaging does not assure a profit or protect against a loss in declining markets. Since such a strategy involves continuous investment, the investor should consider his or her ability to continue purchases through periods of low price levels.

4 Diversify income sources

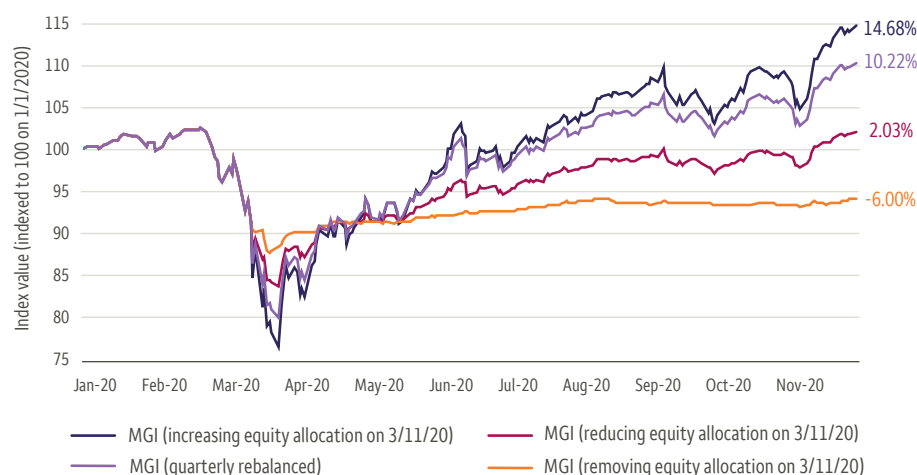
Low rates may rise only slightly in 2021, but we suggest diversifying to seek yield in fixed income investments beyond traditional bond holdings. We favor adding to credit exposure, but selectivity remains key as the risk of pandemic-related bankruptcies rises. We favor U.S. investments over developed international investments due to the greater uncertainties in economic growth prospects overseas. Within fixed income sectors, we favor municipal bonds and investment-grade and high-yield corporates, as we believe those sectors are well positioned to offer yield. Emerging market bonds, dividend-paying stocks, and preferred securities also may offer attractive streams of portfolio income.

5 Be proactive not reactive

Investors tend to exhibit certain cognitive and emotional behavioral biases that can lead to unwise decisions. In periods of high volatility, we suggest taking action thoughtfully and not reacting emotionally. The chart below compares four hypothetical investor reactions after the bear market was officially announced on March 11, 2020. The first investor increased equity exposure (added 30% more to equities, taken from investment-grade fixed income), the second one maintained strategic allocations through rebalancing, the third one decreased equities (half of the equity exposure redistributed to cash and investment-grade fixed income), while the fourth investor completely exited equities. In this example, the portfolios with increased equity exposure outperformed, while those that decreased equity holdings underperformed.

The wrong reaction to negative news can be costly

Investors who increased their allocation to equities or rebalanced quarterly outperformed investors who removed or reduced their allocation to equities.



Sources: ©2020 - Morningstar Direct¹ and Wells Fargo Investment Institute, as of November 23, 2020. MGI = Moderate Growth & Income. Performance results for the portfolios are hypothetical and are presented for illustrative purposes only. Hypothetical results do not represent actual trading. An index is unmanaged and not available for direct investment. **Hypothetical and past performance do not guarantee future results.** Please see end of report for the portfolio compositions, risks associated with the representative asset classes and index definitions.

Please see pages 18 and 19 for important definitions and risk considerations.

Hypothetical Portfolio Compositions (page 17)

Moderate Growth and Income: 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.

Moderate Growth and Income (increasing equity allocation): 2% Bloomberg Barclays U.S. Treasury Bill (1–3 Month) Index, 16.8% Bloomberg Barclays U.S. Aggregate Bond Index, 6% Bloomberg Barclays U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index, 27.3% S&P 500 Index, 15.6% Russell Midcap Index, 10.4% Russell 2000 Index, 7.8% MSCI EAFE Index, 9.1% MSCI Emerging Markets Index.

Moderate Growth and Income (reducing equity allocation): 16.5% Bloomberg Barclays U.S. Treasury Bill (1–3 Month) Index, 45.5% Bloomberg Barclays U.S. Aggregate Bond Index, 6% Bloomberg Barclays U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index, 10.5% S&P 500 Index, 6% Russell Midcap Index, 4% Russell 2000 Index, 3% MSCI EAFE Index, 3.5% MSCI Emerging Markets Index.

Moderate Growth and Income (removing equity allocation): 30% Bloomberg Barclays U.S. Treasury Bill (1–3 Month) Index, 59% Bloomberg Barclays U.S. Aggregate Bond Index, 6% Bloomberg Barclays U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index.

Definitions

A/A2 rating (S&P/Moody's): Upper-medium grade and subject to low credit risk.

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

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

Bloomberg Barclays U.S. Corporate High Yield Bond Index covers the universe of fixed-rate, noninvestment-grade debt.

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

JPM EMBI Global Index covers 27 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.

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

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

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The **Russell Midcap Index** measures the performance of the 800 smallest companies in the Russell 1000 Index.

The **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.

The **S&P 500 Index** is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market.

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Risk considerations

Forecasts and targets are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.

All investing involves risks, including the possible loss of principal. There can be no assurance that any investment strategy will be successful and meet its investment objectives. Investments fluctuate with changes in market and economic conditions and in different environments due to numerous factors, some of which may be unpredictable. Asset allocation and diversification do not guarantee investment returns or eliminate risk of loss. Each asset class has its own risk and return characteristics, which should be evaluated carefully before making any investment decision. 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. Some of the risks associated with the representative asset classes include:

General market risks

Stock markets, especially foreign markets, are volatile. A stock's value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **International investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets. Investing in **small- and mid-cap companies** involves additional risks, such as limited liquidity and greater volatility.

Investments in **fixed-income securities**, including **municipal securities**, are subject to market, interest rate, credit, liquidity, inflation, prepayment, extension, and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in a decline in the bond's price. **High-yield fixed-income securities** are considered speculative, involve greater risk of default, and tend to be more volatile than investment-grade fixed-income securities. **Municipal securities** may also be subject to the alternative minimum tax and legislative and regulatory risk, which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. **Treasury Inflation-Protected Securities (TIPS)** are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond to fluctuate more than other fixed income securities. TIPS have special tax consequences, generating phantom income on the "inflation compensation" component of the principal. A holder of TIPS may be required to report this income annually although no income related to "inflation compensation" is received until maturity. If sold prior to maturity, fixed-income securities are subject to market risk. All fixed-income investments may be worth less than their original cost upon redemption or maturity.

Similar to bonds, **preferred securities** are interest rate sensitive. Their dividends are not guaranteed and are subject to change. Some preferred securities include a call provision, which may negatively affect the return of the security. A prerefunded bond is a callable bond collateralized by high-quality securities, typically Treasury issues. **U.S. government securities** are backed by the full faith and credit of the federal government as to payment of principal and interest if held to maturity. Although free from credit risk, they are subject to interest rate risk. **Mortgage-related securities** are subject to prepayment and call risks in addition to the risks of investing in debt securities. Call risk is the risk that the issuer will redeem the issue prior to maturity. This may result in reinvestment risk, which means the proceeds will generally be reinvested in a less favorable environment. Changes in prepayments may significantly affect yield, average life, and expected maturity.

Sector investing

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. 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. Risks associated with the **Information 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

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, and less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt, and private real estate fund investing involve 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.

Private debt strategies seek to actively improve the capital structure of a company, often through debt restructuring and deleveraging measures. Such investments are subject to potential default, limited liquidity, the creditworthiness of the private company, and the infrequent availability of independent credit ratings for private companies. Investing in distressed companies is speculative and involves a high degree of risk. Because of their distressed situation, these securities may be illiquid, have low trading volumes, and be subject to substantial interest rate and credit risks. Private capital investments are complex, speculative investment vehicles not suitable for all investors. They are not subject to the same regulatory requirements as registered investment products and engage in leverage and other aggressive investment practices. There is often limited (or even nonexistent) liquidity and a lack of transparency regarding the underlying assets.

Hedge fund strategies, such as **Event Driven**, **Equity Hedge**, **Relative Value**, **Structured Credit**, and **Long/Short Credit**, 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 because 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. Private capital investments are complex, speculative investment vehicles not suitable for all investors. They are not subject to the same regulatory requirements as registered investment products and engage in leverage and other aggressive investment practices. There is often limited (or even nonexistent) liquidity and a lack of transparency regarding the underlying assets.

Real assets

Real assets are subject to the risks associated with **real estate**, **commodities**, **MLPs**, and other investments and may not be suitable for all investors.

The **commodities markets**, including investments in **gold and other precious metals**, 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. Investments in commodities may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies, which may expose investors to additional risks. Investment in securities of **MLPs** involves certain risks that differ from an investment in the securities of a corporation. MLPs may be sensitive to price changes in oil, natural gas, etc.; regulatory risk; and rising interest rates. A change in the current tax law regarding MLPs could result in the MLP being treated as a corporation for federal income tax purposes, which would reduce the amount of cash flows distributed by the MLP. In addition, there are certain tax risks associated with an investment in MLP units, and conflicts of interest may exist between common unitholders and the general partner, including those arising from incentive distribution payments. Other risks include the volatility associated with the use of leverage, volatility of the commodities markets, market risks, supply and demand, natural and man-made catastrophes, competition, liquidity, market price discount from net asset value, and other material risks. Investment in **real estate securities** includes risks, such as the possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.

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