WELLS FARGO
Investment Institute

June 2021

2021 Midyear Outlook

Fuel for growth

A letter to investors from Darrell L. Cronk

June 2021

One year after the global economy emerged from lockdowns, the economy is running faster than many of us have seen in our lifetimes. The U.S. and China have led the way, thanks to the various COVID-19 vaccines, whose accelerating distribution is speeding the recovery and driving faster spending. This, plus a rise in private savings, low interest rates, and the "visible hand" of multiple government support programs are providing fuel for growth that should intensify the 2021–2022 U.S. economic recovery to its fastest two-year pace since 1965–1966.

For the first four months of 2021, corporate bond issuance grew faster than it did during the prior four months. Elsewhere, S&P 500 Index value stocks handily outperformed growth, base metals and agricultural products posted decades-high prices, and many global benchmark equity indexes set new record highs while earnings ran to catch up with valuations.

The main concerns are the rates issues — inflation rates, tax rates, and interest rates. We expect all three to rise over the next 18 months. Demand is outstripping supply in many industries, and the friction is leading inflation and interest rates to recover to pre-pandemic levels, or higher. We expect some dampening effect from all three. Even so, at this early juncture of the recovery, and considering the proposed tax changes, these issues seem very unlikely to douse the economic recovery or the opportunities we describe in this report.

There is a powerful macro mosaic at work with a steadily weakening U.S. dollar, rising commodity prices, strong global equity returns, falling equity and bond volatility, low interest rates, and a robust fiscal stimulus push. Strong market trends also can make for wide market divergences, and so diversification and a disciplined plan to allocate cash are valuable allies. The following pages detail the many potential opportunities and highlight some practices that will help investors keep a forward focus.

On behalf of my Wells Fargo Investment Institute colleagues, I am pleased to offer timely and actionable investment advice. We trust that this guidance will help you achieve your investment plan and goals. We value most highly the trust of our clients and wish you health and continued investment success in 2021.

"As sure as the spring will follow the winter, prosperity and economic growth will follow recession."

—Robert Foster Bennett

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Chief Investment Officer, Wealth and Investment Management

*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.

Selected year-end 2021 forecasts

See pages 14–15 for our complete 2021 and 2022 economic and market forecasts

7.0%
U.S. GDP growth

3.8%
U.S. inflation
Consumer Price Index

4,400–4,600
S&P 500 Index

0.00%–0.25%
Federal funds rate

2.00%–2.50%
10-year U.S. Treasury note yield

$70–$80
West Texas Intermediate crude oil per barrel

Sources: Wells Fargo Investment Institute and Wells Fargo Securities Economics Group, June 14, 2021

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

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

Toward a post-pandemic economy

Key takeaways

- We believe that the global economy is on track for its strongest growth since 1973, paced by the U.S. Global inflation should track higher but avoid disruptive 1970s-era levels.
- We expect the dollar's depreciation trend versus developed market currencies to become more apparent by early in 2022. Dollar weakness here should enable a recovery in emerging market currencies, despite slower vaccine deployment and a delayed reopening in many countries.

What it means for investors

- We view economically sensitive sectors of the stock market, Municipal Securities, and other yield-enhanced sectors of the bond market as best positioned for solid global economic growth and firm — if not excessive — interest rates and inflation.

Strong economic growth on track through 2022

We expect the global economy to chalk up 2021 growth above 6.0%, its best pace since 1973. The pace in 2022 may moderate somewhat but should remain robust. Vaccinations will likely shape the pattern of economic growth worldwide. The U.S. is among those furthest along with vaccine deployment and is returning to its role as the global economy's main growth locomotive. Added support from China comes from leading-edge strength in manufacturing. Gathering momentum in global consumer spending should underpin economic growth, despite the prospect for less 2022 fiscal and monetary stimulus.

Our view is that global economic momentum will broaden later this year following a delayed reopening in Europe and Japan (please see the chart on the next page). Advanced economies should propel further gains in world trade, especially in the exports of technology and manufacturers that drive the Asian economies. Exposure to international trade will likely drive the emerging market recovery.

After the boom in the U.S.

We believe that the U.S. economy already is enjoying a boom that will carry this year's growth to 7%. Our forecast is based on rapid vaccine deployment supporting a fairly smooth reopening of the economy. Cumulative fiscal stimulus as a share of gross domestic product (GDP) is at its highest since the 1930s Great Depression.

The 2022 pace also should remain strong, even as several factors moderate the pace slightly. Fiscal stimulus should diminish. Pent-up demand should largely dissipate, as will excess savings used to finance the spending surge. That said, we think a continued housing recovery and gains in employment and wages will likely provide steady fuel for growth.

Inflation: Higher than during the previous decade

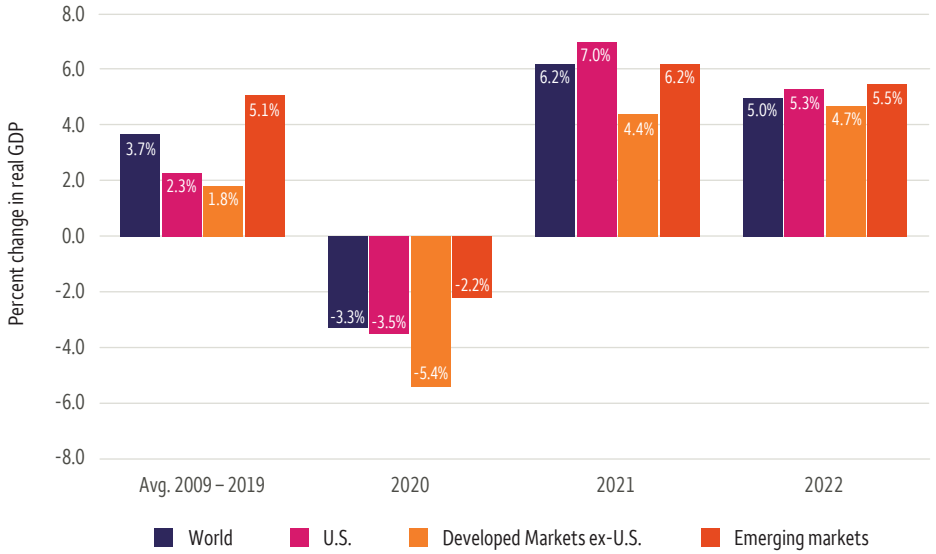
We project that the U.S. Consumer Price Index (CPI) will average 3.8% this year, after a pandemic-depressed 1.3% rate in 2020. Supply shortages and healthy demand should briefly send goods, or merchandise, inflation to a multi-decade high this year. We expect added pressure from accelerated services price increases from a 10-year low in February, responding to a strong rebound in frontline industries hit hardest by the pandemic.

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

We believe inflation will decelerate in 2022, but the degree depends on how quickly supply shortages ease and how well household and business spending persist in 2022. Especially if the pace of spending remains robust, upward pressure on prices could linger.

From a U.S.-led boom this year to more moderate, uniform growth in 2022

We expect fairly uneven, U.S.-led global growth to converge at a still-healthy, but more moderate, rate in 2022.



Sources: International Monetary Fund and Wells Fargo Investment Institute, May 18, 2021. 2021 data = estimates; 2022 data = WFII forecasts. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

Clearer dollar downtrend likely to come

We expect the dollar's depreciation trend to become more apparent later in the year or early in 2022 as we anticipate eurozone growth to converge with the U.S. rate and a more synchronized post-pandemic recovery gets underway. An environment of more balanced global growth and recovering trade, with U.S. twin deficits large and growing, is historically one where the dollar falls rather than rises. U.S. policymakers typically favor a market-determined exchange rate, and likely won't stand in the way of future declines. We see the dollar trading around $1.21 versus the euro by year-end, and a $1.25 to $1.33 range by the end of 2022.

Eventual global recovery to support emerging market currencies

We remain constructive on emerging market currencies. The strong global trade recovery in manufactured goods should more than compensate for a slower return in local spending due to vaccine rollout delays and more prolonged COVID-19 disruption. We expect emerging market currencies to benefit from a recovery in global growth and world trade as well as a robust Chinese economy and Asian technology exports.

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Global economy

Tailwinds

- Monetary and fiscal stimulus
- Relatively low interest rates
- Pent-up demand created by lockdowns

Headwinds

- Geopolitical risks, including U.S. relations with China and other global tensions
- Lingering consumer caution amid pandemic concerns
- Rising interest rates and especially inflation

Year two of the bull market recovery

Key takeaways

- We expect strong U.S. corporate earnings in 2021 (surpassing prerecession levels), but higher corporate tax rates may restrain the increase in 2022 earnings.
- Cyclical equity classes and sectors should continue to outperform as economic growth surges and monetary policy remains accommodative.

What it means for investors

- Investors should continue to lean into U.S. Large Cap Equities, U.S. Small Cap Equities, and Emerging Market Equities while maintaining allocations to U.S. Mid Cap Equities at strategic target weights.

Record earnings this year as the country reopens

Over the next 18 months, we project U.S. economic growth will remain robust as the country reopens. This is likely to boost corporate sales, sending S&P 500 Index profits to record levels. Companies made significant progress cutting expenses during the 2020 recession, creating large operating leverage despite rising input costs. We also expect operating margins to climb as labor productivity improves and corporate pricing power firms. Even as corporate taxes are projected to rise in 2022, we expect supportive monetary policy, along with public and private spending, to push equity markets higher through the year.

We recently increased our year-end 2021 earnings and price targets for the S&P 500 Index, the Russell Midcap Index, and the MSCI EAFE Index due to first-quarter earnings that were much better than expected. For 2022, we see the pace of earnings growth slowing for all equity classes. We also assume that prospective higher corporate tax rates in the U.S. will reduce earnings growth modestly. Even moderately rising interest rates could add some downward pressure on price/earnings ratios in 2022. These factors may restrain 2022 gains somewhat, but on balance we still expect higher equity markets.

We favor U.S. Large Cap Equities and U.S. Small Cap Equities

While the Russell 2000 Index had a very strong first year of recovery, we believe the robust U.S. economic rebound will support continued outperformance. Earnings recovery also will be key for small caps. To counter small-cap volatility, we continue to favor large caps, as they tend to be higher quality, are less volatile, and have more stable earnings power.

We expect cyclicals to outperform defensives

In the first year of this new equity bull market, our sector guidance shifted to include favorable ratings on economically sensitive sectors, such as Financials, Industrials, and Materials, and we have upgraded the Energy sector to favorable and the Real Estate sector to neutral. We maintain our unfavorable view on defensive sectors, such as Consumer Staples and Utilities. Cyclical sectors historically have maintained leadership in the second year of bull markets, and we expect similar relative outperformance early in this cycle.

We acknowledge that high-growth sectors may experience periods of underperformance when economic growth is stout and interest rates are rising. Another potential headwind is the proposed increase in corporate tax rates, which matters to the Information Technology and Consumer Discretionary sectors because they have some of the highest marginal tax rates among the sectors. Therefore, we have downgraded the Consumer Discretionary and Information Technology sectors to neutral. We recommend a full allocation to both sectors, anticipating performance to be in line with the S&P 500 Index over our tactical time horizon.

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

Leaning into cyclical sectors

We expect strong economic and earnings growth to benefit cyclical sectors more than defensive sectors.

Sector	S&P 500 weight (%)	WFII weight guidance	Guidance
Communication Services	11.1%	+2% to +4%	Favorable
Consumer Discretionary	12.1%	-2% to +2%	Neutral
Consumer Staples	6.0%	-4% to -6%	Most unfavorable
Energy	2.8%	+2% to +4%	Favorable
Financials	11.9%	+2% to +4%	Favorable
Health Care	13.0%	-2% to +2%	Neutral
Industrials	8.9%	+2% to +4%	Favorable
Information Technology	26.3%	-2% to +2%	Neutral
Materials	2.8%	+2% to +4%	Favorable
Real Estate	2.5%	-2% to +2%	Neutral
Utilities	2.6%	-2% to -3%	Most unfavorable

Sources: FactSet and Wells Fargo Investment Institute, as of May 28, 2021. S&P 500 sector weightings may not add to 100% due to rounding. Please see the end of the report for guidance definitions.

Emerging markets favored over developed ex-U.S. markets

We believe Developed Market ex-U.S. Equities will be restrained by a moderate recovery in Japan and ongoing struggles with vaccine distribution and reopenings in Europe. While some emerging countries have had their share of virus challenges, most Asian countries (which we favor from a regional perspective) are well on their way to recovery. The global economic boom expected over the next 12 months should drive strong emerging country earnings growth. This linkage between the global economy and Emerging Market Equities should support outperformance relative to Developed Market ex-U.S. Equities in the early innings of the recovery. We recommend taking advantage of recent weakness in Emerging Market Equities to add exposure.

Favored asset classes

- U.S. Large Cap Equities
- U.S. Small Cap Equities
- Emerging Market Equities

Favored equity sectors

- Communication Services
- Energy
- Financials
- Industrials
- Materials

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

Rising rates and defensive positioning

Key takeaways

- We expect strong corporate bond issuance to continue, along with positive inflows into sectors supported by the strong economic recovery
- Tax-exempt income is likely to be in high demand given the expectations for higher tax rates.

What it means for investors

- With U.S. Treasury yields expected to rise further, we believe investors should take a more defensive stance within fixed income, favoring the intermediate sector and maintaining exposure to credit risk.

Yield-curve steepening likely to continue

Rising U.S. Treasury yields along with continued government spending, Federal Reserve (Fed) bond purchases, and low short-term interest rates are likely to persist through at least the first half of 2022. The combined impact should reverberate in fixed-income markets through 2022. While periods of volatility could occur, we anticipate that policymakers will remain committed to ensuring that ample liquidity and benign financial conditions remain in place to support the recovery. Ultimately, we see overall fixed-income returns struggling but believe exposure in intermediate maturities may provide some cushion for returns against a backdrop of rising yields.

The Fed likely will keep financial conditions easy until it achieves its goals or at least until significant progress is made toward them. To this end, the Fed will not hike its target federal funds rate through 2022, in our view. Although we believe short-term rates will remain anchored, we do expect the recent increases in economic growth and inflation (compared with pre-pandemic rates) to push longer-term rates meaningfully higher than today's levels.

Eventually, we believe strong economic growth is likely to give policymakers enough assurance to begin reducing policy stimulus. As long as inflation doesn't continue to rise, we look for the Fed to follow a sequence: first, a change in language (or a signal of tapering), likely later this year, and then implementing tapering sometime in 2022 followed by a potential rate hike in 2023.

The economic recovery supports credit

Generating income continues to be one of the top priorities for many fixed-income investors. The strong economic recovery should support credit-oriented asset classes and sectors. We expect strong issuance of corporate bonds to continue along with positive inflows into credit-oriented investments. However, valuations for both investment-grade and high-yield corporate bonds are relatively expensive given the current level of credit spreads compared with the levels we have seen over the past decade (see chart on next page). Therefore, while a neutral allocation is appropriate, investors should take care not to over-allocate to these asset classes despite the favorable environment. Preferred Securities are another yield-oriented fixed-income sector that could continue to benefit from the sentiment for risk appetite. We favor using active managers in these asset classes, as they are better positioned to provide due diligence and assess credit risks.

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

Narrowing high-yield corporate spreads highlight valuation concerns

High-yield corporate spreads have been tightening and approaching all-time lows as investors' appetite for credit risk has increased.

Sources: Wells Fargo Investment Institute and Bloomberg, as of May 27, 2021. Monthly data: January 31, 1994, to July 31, 2000; daily data: August 15, 2000, to April 26, 2021. Option-adjusted spread (OAS) is the spread relative to a risk-free interest rate. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.** Please see the end of the report for index definitions.

Consider municipal bonds

Improving economic conditions and an increase in vaccination rates are likely to benefit revenues at the state and local levels. Additionally, the anticipation of higher tax rates and several of the fiscal stimulus measures passed should help alleviate budget burdens suffered by state and local governments. We remain favorable on Municipal Securities, and for investors in higher effective tax brackets, Municipal Securities remain attractive and an important part of fixed-income positioning. Investors should undertake careful credit research or professional management in the current muni market environment, which has seen uneven impacts across the market and even within sectors.

Rising rates may affect global investors

We are neutral on emerging market sovereign debt denominated in U.S. dollars. A global recovery should be a tailwind for emerging market credit, and higher yields are attractive to investors. However, given the longer duration of the emerging market bond index, we believe that (for investors comfortable with the credit) a partial allocation to shorter-duration emerging market corporates may be a useful potential portfolio stabilizer.

Currency gains against a weaker dollar may support developed market debt returns. But government bond yields in the eurozone and Japan remain near or below zero and provide virtually no cushion against rising rates/falling prices in a more reflationary environment.

Favored sectors

- Preferred Securities
- Municipal Securities

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

Commodities trend up; REITs waking up

Key takeaways

- We expect robust commodity demand for the remainder of 2021 and 2022 while supplies play catch-up.
- After having trailed the improvement in the economy for most of this past year, REITs now look poised to keep pace with the upturn. We have upgraded REITs to neutral.

What it means for investors

- We expect Commodities to continue to perform well in 2021 and 2022. We also look for REIT relative performance to finally pick up.

Expect current trends to continue across real assets

Above-trend U.S. and global economic growth should support robust commodity demand and a sustained rally in prices. After having trailed the improvement in the economy, REITs now looked poised to keep pace with the upturn. We remain favorable toward Commodities and have upgraded REITs to neutral. Increased oil production volumes and prices should benefit midstream and integrated energy companies.

Commodities — a continued bounce

We expect the commodity bounce to continue through 2022. A world economy that is growing across regions is the main macroeconomic tailwind. Potentially large and multiyear infrastructure spending and the accelerating green energy transition are commodity-intensive and likely to be supportive as well. We expect demand growth to outpace supply growth through 2022. Additionally, our forecast for the recent U.S. dollar strength to fade later this year or in early 2022 should benefit Commodities.

All major commodity sectors are likely to participate in the rally. The Energy and Industrial Metals sectors are cyclical and typically benefit more directly from a surging world economy. A weaker U.S. dollar and widespread accommodative fiscal and monetary policies should be tailwinds to the Precious Metals sector. We expect Agriculture to benefit from declining inventories and increasing demand.

Gold grinding higher

We anticipate that sizable amounts of monetary and fiscal stimulus as well as investor concerns over possible inflation should lend their support most fervently in 2021 before our expectations for a weaker U.S. dollar and fading reopening trade potentially help drive gold spot prices to all-time highs in 2022. Modestly higher real interest rates may be a headwind, but we think they're unlikely to prevent the price of gold from reaching a range between $2,000 and $2,100 by year-end 2021 and between $2,100 and $2,200 by year-end 2022.

Oil targets increased

OPEC+[1] has shown surprising resolve this past year by withholding a historical amount of production (see chart on page 11). Even now, with oil prices significantly higher than year-ago levels, OPEC+ has been disciplined in its supply response. Additionally, U.S. producers seemingly have decided on capital discipline and have not brought back production as quickly as in past cycles. We anticipate that this supply restraint, combined with the economic rebound, booming global trade, and ramping consumer demand, should sustain the oil price rally. The sizable spare capacity available could be a headwind, but we expect producers to remain disciplined in bringing this available supply back online.

1. OPEC+ is the 14 members of the Organization of the Petroleum Exporting Countries plus 10 non-OPEC countries, including Russia.

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

Welcome to the party, REITs

The more significant pandemic-induced real estate concerns continue to fade. We upgraded both private and public real estate from unfavorable to neutral. Although we believe oversupply remains a concern for areas such as office and select retail, we expect stronger demand and improving business conditions to counterbalance and help REITs overall. We believe the sector boasts an attractive dividend yield, fair valuations, and relative performance that is finally showing signs of life.

Drilling down, the economic acceleration should continue to propel some of the cheaper REIT subsectors versus some more expensive subsectors that have enjoyed long-term demand drivers. As a result, we have downgraded Data Centers from favorable to neutral and Health Care from neutral to unfavorable, and we have upgraded Retail and Lodging from unfavorable to neutral. Our favored sectors are Industrial and Single Family Home REITs.

Midstream and integrated energy companies should benefit

Traditional energy infrastructure is overbuilt, which puts pressure on volumes and tariffs on existing pipelines. Yet, midstream-focused companies have made tremendous strides in improving business models and balance sheets and embracing capital discipline. We believe midstream energy companies should benefit from these improvements as well as cheap valuations and the economic reopening. Midstream and integrated oil companies both should benefit from the continued oil price rally, and from investor rotation into previously beaten-down market areas. We prefer midstream C corporations over master limited partnerships based on a variety of factors.

Favored asset class

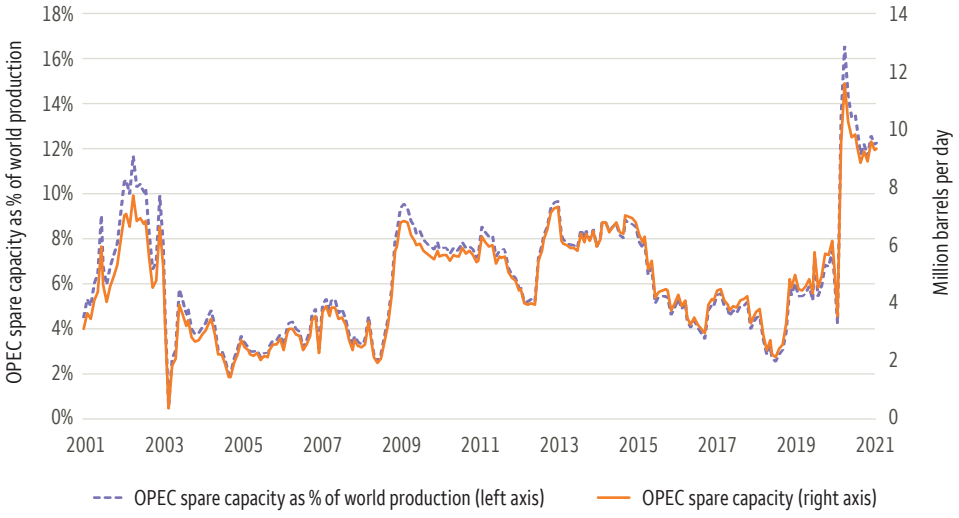
- Commodities

Favored commodity sectors and REIT subsectors

- Agricultural commodities
- Precious Metals commodities
- Single Familiy Home REITs
- Industrial REITs

OPEC spare capacity supports oil price ceiling

OPEC's spare capacity reached unprecedented extremes in 2020. We expect the group to continue to take a disciplined approach to bringing those barrels back online.



Sources: Bloomberg, Department of Energy, and Wells Fargo Investment Institute, as of April 30, 2021. Monthly data: January 31, 2001, to April 30, 2021.

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

Economic recovery supports opportunities

Key takeaways

- We believe the environment for equity and credit selection remains attractive, as the economic recovery allows investment managers to differentiate more effectively between profitable and unprofitable firms.
- With yields likely to remain low, investors can look to Relative Value strategies focused on Structured Credit with little to no duration risk and Direct Lending strategies as a nontraditional source of income.

What it means for investors

- If 2020 follows past financial crises, now may be an opportune time for qualified investors to consider private capital Distressed Debt strategies that can patiently deploy assets over the next three to five years.

Conditions favorable for alternative investments

We continue to believe that favorable conditions for hedge funds are likely to remain in place.[2] While the exceptionally strong returns since the nadir of the COVID-19 dislocation are likely to normalize over the ensuing quarters, we still expect to see a supportive environment for equity and credit selection strategies. Moreover, as interest rates rise, we may eventually see an accelerated credit cycle leading to higher defaults and wider spreads, especially considering the increased leverage among corporate borrowers. Over the next 12 to 36 months, we favor the Equity Hedge strategy but maintain a neutral view for the Relative Value, Macro, and Event Driven strategies.

At the substrategy level, robust debt issuance trends, coupled with our expectation that credit fundamentals will again take center stage as the economy reopens and stimulus fades, lead us to maintain a favorable view for Long/Short Credit strategies. Regarding Structured Credit we believe that current market pricing accounts for positives such as the improving economy and slightly wide yield spreads compared with corporate credit. Under current pricing, our outlook is neutral.

The opportunity set for liquid Distressed Debt investing has likely been postponed until the next credit cycle, although historically high corporate cash balances coupled with the proliferation of special purpose acquisition companies (SPACs)[3] should benefit Merger Arbitrage strategies, where we hold a neutral rating. We favor Discretionary Macro but are starting to see signs that the environment for Systematic Macro eventually may benefit from trends within Commodities and interest rates as well as higher volatility. Until then, we maintain our neutral view on Systematic Macro.

We continue to expect conditions to support Equity Hedge not only from steadily falling correlations between and rising dispersion among equity prices (please see the chart on page 13) but also from several thematic opportunities. For example, a rotation from growth to value, coupled with the impact of higher input prices on fundamentals, should lead to broader dispersion among sectors and industries.

With historically elevated levels of cash or "dry powder," robust credit markets, and recovering economies, 2021 deal markets (led by the SPAC market's continued surge) have been very active. Financial sponsor-related M&A ended the quarter at an all-time high.

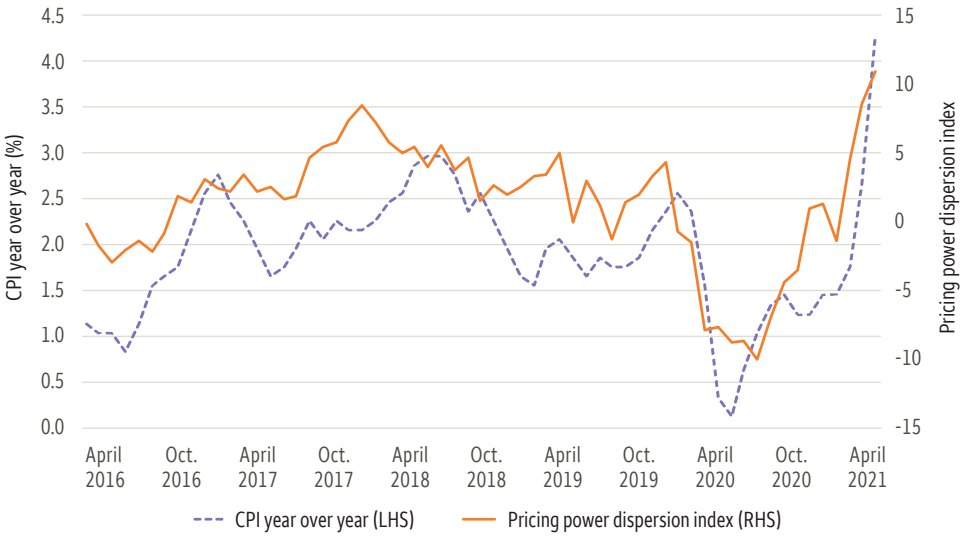
2. Wells Fargo Investment Institute, "An Aging Cycle — but Early Innings for Alternatives," November 2018

3. SPAC = Special Purpose Acquisition Company, a financial entity that utilizes funds raised in an Initial Public Offering (IPO) to merge with a target company

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

Inflation could be the next driver for active equity selection

As inflation has picked up, the dispersion between companies with pricing power and those without has grown. We believe this is a catalyst for security selection for the remainder of this year and into 2022.



Sources: Bloomberg, Goldman Sachs, and Wells Fargo Investment Institute, as of April 30, 2021. An index is unmanaged and not available for investment. Please see the end of the report for index definitions.

The sectors that have proven most resilient to the pandemic are familiar: technology (especially enterprise software), industrial goods (including building products and packaging), financial services (especially fintech[4] and payments), and health care (especially services). These four broad sectors accounted for over 65% of all transactions last year and are set to host most of the deal activity in 2021. We believe the effects of the pandemic have created nuanced opportunities for managers focused on small to midsize companies and strategies such as Venture Capital or Growth Equity that invest in the earlier stages of a company's life. We also continue to believe that secondary funds may help build well-balanced private equity portfolios diversified across vintage, style, and asset class.

If 2020 is similar to past financial crises, now may be an opportune time for qualified investors to consider Distressed Debt strategies that can patiently deploy assets over the next three to five years, especially in capital structures that are under pressure or where secular challenges are likely to exist.

Investors' search for income is robust as yields trend to historical 40-year lows. We believe that Direct Lending strategies have the potential to provide qualified investors with an additional source of stable, diversified, and uncorrelated returns. We are more constructive on Direct Lending funds raised post-COVID-19 and are more constructive on funds that have an expertise in recession-resistant sectors, particularly those in software and health care.

4. Fintech, or financial technology, is a term for the technology and computer programs used to support or enable banking and financial services.

Most favored strategies

- Equity Hedge
- Long/Short Credit
- Discretionary Macro
- Growth Equity
- Distressed Debt
- Direct Lending

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

2021 & 2022 economic and market forecasts

U.S. GDP (gross domestic product) growth and inflation

Economic growth and inflation should run well above their 10-year averages through 2022 but should moderate somewhat next year.

Economic forecasts	Year-end 2020 actual	Year-end 2021 forecast	Year-end 2022 forecast
U.S. GDP growth	-3.5%	7.0%	5.3%
U.S. CPI inflation	1.3%	3.8%	2.8%
U.S. unemployment rate	6.8%	4.7%	4.1%
Global GDP growth	-3.5%	6.3%	5.1%
Developed market GDP growth	-4.5%	4.9%	4.6%
Developed market inflation	1.0%	2.2%	2.0%
Eurozone GDP growth	-4.9%	3.7%	3.9%
Eurozone inflation	-0.3%	1.3%	1.5%
Emerging market GDP growth	-0.8%	6.2%	5.5%
Emerging market inflation	3.4%	4.2%	4.4%

S&P 500 Index

We expect record earnings to support higher price levels in 2022.

Equity targets	Year-end 2020 actual	Year-end 2021 forecast	Year-end 2022 forecast
S&P 500 Index	3,756	4,400–4,600	4,800–5,000
S&P 500 EPS	$139	$200	$220
Russell Midcap Index	2,743	3,200–3,400	3,500–3,700
Mid-cap EPS	$82	$130	$155
Russell 2000 Index	1,975	2,450–2,650	2,650–2,850
Russell 2000 EPS	$23	$72	$95
EAFE Index	2,148	2,300–2,500	2,400–2,600
EAFE EPS	$95	$130	$145
MSCI Emerging Markets Index	1,291	1,400–1,600	1,500–1,700
MSCI Emerging Markets EPS	$65	$88	$105

Sources: Wells Fargo Securities Economics Group, Bloomberg, and Wells Fargo Investment Institute, June 14, 2021. GDP = gross domestic product. Wells Fargo Investment Institute forecast and targets. Forecast and targets are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.

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

Fixed-income targets	Year-end 2020 actual	Year-end 2021 forecast	Year-end 2022 forecast
10-year U.S. Treasury yield	0.91%	2.00–2.50%	2.25–2.75%
30-year U.S. Treasury yield	1.64%	2.75–3.25%	2.75–3.25%
Federal funds rate	0.09%	0.00–0.25%	0.00–0.25%

Federal funds rate

We do not expect the Fed to hike its target federal funds rate through 2022.

Real assets targets	Year-end 2020 actual	Year-end 2021 forecast	Year-end 2022 forecast
West Texas Intermediate (WTI) crude oil	$49	$70–$80	$75 –$85
Brent crude oil	$52	$75–$85	$80–$90
Gold	$1,898	$2,000–$2,100	$2,100–$2,200
Bloomberg Commodity Index	167	210–220	225–235

West Texas Intermediate crude

Supply restraint and booming demand should support oil prices.

Exchange rate targets	Year-end 2020 actual	Year-end 2021 forecast	Year-end 2022 forecast
Dollars per euro	$1.22	$1.17–$1.25	$1.25–$1.33
Yen per dollar	¥103	¥105–¥115	¥102–¥112

Sources: Wells Fargo Securities Economics Group, Bloomberg, and Wells Fargo Investment Institute, June 14, 2021. GDP = gross domestic product. Wells Fargo Investment Institute forecast and targets. Forecast and targets are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.

Risks to our forecasts

Our conviction remains that economic growth and inflation will remain elevated, even if they decelerate modestly from their 2021 levels. Yet, we see a symmetry between downside and upside risks to that outlook. The economic environment could return to the regime of 2010–2019, which featured low inflation, slow economic growth, historically low interest rates, and dollar appreciation (the dollar tends to rise when the global economy struggles). Alternatively, inflation and economic growth could rise further — more significantly above their averages over the past 40 years — with commensurately higher interest rates and a weaker dollar.

The risk for a return to the environment of 2010–2019

- A new pandemic flare-up could become serious enough to disrupt the reopening of the U.S. and other economies, undercutting prospects for solid growth worldwide.
- U.S. tax increases could prove to be more of a drag on spending and economic growth than we currently anticipate. In this environment, inflation also should decline, possibly to 2% or lower, closer to its pace during much of the past decade.
- Corporate earnings could weaken and force equity valuations (and prices) to correct lower. By contrast, long-term fixed-income prices might look more attractive and attract funds out of equities and commodities.

The risk for stronger economic growth and inflation

- High levels of M&A activity, CEO optimism about earnings, inventory shortages that encourage production and employment, and robust housing demand could persist. Instead of decelerating, inflation could remain above 3%.
- Improving spending across the global economy could mean a synchronized global recovery, which typically produces dollar depreciation and, thereby, more dollars for every euro, yen, or peso that U.S. companies earn overseas — a support for reported earnings.
- Unprecedented liquidity — record cash on corporate balance sheets and historically high bank deposits — could reinforce uptrends in risk assets, such as equities and commodities.
- We believe it unlikely that inflation and interest rates would rise to levels that disrupt other risk markets (equities and commodities), but stronger growth and inflation than our base case could further reinforce the positive trends in investment returns during the past 12 months.

Five post-pandemic ideas for your portfolio

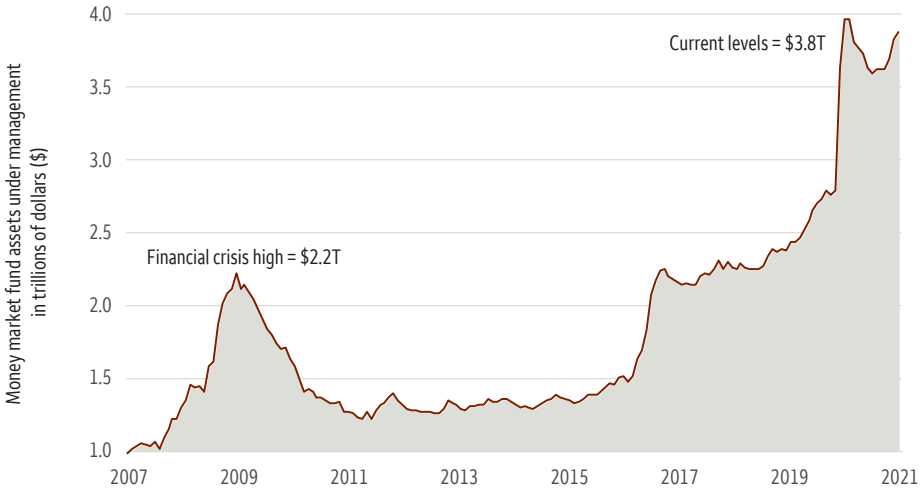
1 Put cash to work selectively

Against the backdrop of a vigorous economic recovery, we favor equities over fixed income. We prefer U.S. Large Cap Equities and U.S. Small Cap Equities and favor Emerging Market Equities over Developed Market ex-U.S. Equities. In implementing these preferences, we favor allocating cash thoughtfully, particularly as investors' cash holdings have increased significantly since 2007 (see the chart below). One potential strategy is to dollar cost average by investing cash incrementally in those asset classes we favor. Dollar cost averaging does not guarantee a profit or protect against losses; it simply focuses on systematic asset accumulation to avoid guesswork. This strategy could be worth considering, particularly if a portfolio's allocations to U.S. Small Cap Equities and Emerging Market Equities are below the levels that we favor over a strategic or long-term horizon.

Another side to this advice is that, while we favor established sectors, some caution around the periphery of equity markets can be especially helpful now. Periods of unusually strong economic growth, abundant liquidity, and historically low long-term interest rates can produce distortions and unsustainable valuations in some of the more speculative segments of the financial markets, as investors saw in January.

The market has been flush with liquidity

Large amounts of cash alternatives on the sidelines may present an opportunity for investors.



Sources: Wells Fargo Investment Institute and Morningstar Direct, as of April 30, 2021

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

2 Overweight cyclical sectors

Accommodative monetary policy, fiscal stimulus, and strengthening corporate investments in plant and equipment should support U.S. large-cap equity sectors that tend to outperform early in an economic expansion. Among the sectors in the S&P 500 Index, we believe Industrials, Materials, Financials, and Energy fit this bill.

3 Play defense in fixed income

While we have increased our long-term interest rate targets, we continue to favor the intermediate part of the yield curve. This preference seeks to take advantage of higher yield potential without overly exposing portfolios to longer-duration securities, which are more rate sensitive and may struggle as interest rates rise. At the same time, valuations for investment-grade and high-yield corporate bonds are expensive, and we prefer full benchmark allocations to these asset classes but without over-allocating to them. To support yield needs, we favor Preferred Securities. We favor Municipal Securities because tax rates are likely to rise.

4 Stay with commodity price uptrends

The pandemic may have created the catalyst needed to sustain gains in commodity prices. Oil price volatility around midyear has dominated the news cycle, but resurgent commodity prices also have included agricultural commodities and industrial metals. We believe that prices will continue moving higher due to strengthening global economic growth and demand. We recommend increasing allocations for investors over the tactical 12- to 18-month time frame.

5 Favor equity and credit selection strategies in alternative investments

We expect significant dispersion in performance among sectors, industries, and geographies. This environment should favor stock and credit picking, as well as strategies that capitalize on the economic recovery, increased corporate deal activity, and asset reflation. Since last year, M&A activity has reverted to pre-pandemic levels. If M&A volume continues to increase over the next year, Merger Arbitrage and activist managers should benefit. We expect strong performance from Relative Value strategies focused on Structured Credit and Long/Short Credit and Event Driven managers focused on Distressed Debt.

Key takeaways

- We suggest an approach to U.S. equities that includes larger allocations to cyclically oriented large-cap stocks and fast-growing small caps.
- We favor a focus on intermediate fixed-income maturities, and less exposure to long maturities, while long-term interest rates are rising.
- Commodities can act as a useful way to benefit from the global economic expansion and may help hedge against inflation.

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

Definitions

The **Bloomberg Barclays U.S. Corporate High Yield Bond OAS Index** measure the Option adjusted spreads of USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

The **Bloomberg U.S. Investment Grade Corporate Bond Index** OAS is the difference in yield between the U.S. IG Corporate Bond Index and 10-year Treasury yield.

The **Bloomberg Commodity Index** is comprised of 23 exchange-traded futures on physical commodities weighted to account for economic significance and market liquidity.

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

The **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.

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 **Pricing Power Dispersion Index** is a custom index created in Bloomberg using the difference between the Goldman Sachs Inflation Outperform equity basket and the Goldman Sachs Inflation Underperform equity basket. Each basket consists of S&P 500 equities that have demonstrated low/high earnings and sales correlation to CPI and low/high price correlation to 10-year breakevens and have seen gross margins increase/decrease over the most recent inflation up cycle.

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 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.

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

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. There are no guarantees that growth or value stocks will increase in value or that their intrinsic values will eventually be recognized by the overall market. The return and principal value of stocks fluctuate with changes in market conditions. The growth and value type of investing tends to shift in and out of favor. **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. 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 and asset-backed 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. **Sovereign debt** is generally a riskier investment when it comes from a developing country and tends to be a less risky investment when it comes from a developed country. The stability of the issuing government is an important factor to consider when assessing the risk of investing in sovereign debt, and sovereign credit ratings help investors weigh this risk.

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. 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 of 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 **Merger Arbitrage, Event Driven, Equity Hedge, Relative Value, Structured Credit, Long/Short Credit, Systematic, and Discretionary Macro**, 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

Investing in **distressed companies** is speculative and involves a high degree of risk. Distressed companies most likely will declare bankruptcy shortly, could currently be in bankruptcy proceedings, or are just emerging from bankruptcy. Because of their distressed situation, these securities may be illiquid, have low trading volumes, and be subject to substantial interest rate and credit risks.

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.

Wells Fargo Investment Institute (WFII) guidance definitions

Most favorable: WFII's highest conviction guidance that indicates a strong desire to overweight an asset class (or sector) within a portfolio. It also communicates that, over a tactical time frame, WFII views the asset class (or sector) as offering investors a very attractive risk/reward opportunity.

Favorable: Guidance that indicates a desire to overweight an asset class within a portfolio. It also communicates that, over a tactical time frame, WFII views the asset class (or sector) as providing investors with an attractive risk/reward opportunity.

Neutral: Guidance that indicates a desire to maintain an asset class near the long-term (strategic) allocation guidance within a portfolio. It also communicates that, over a tactical time frame, WFII views the asset class (or sector) as providing investors with an acceptable risk/reward opportunity.

Unfavorable: This WFII guidance level indicates a desire to underweight an asset class (or sector) within a portfolio. It also communicates that, over a tactical time frame, WFII does not view the asset class (or sector) as providing investors with an attractive risk/reward opportunity.

Most unfavorable: WFII's highest conviction guidance indicating a strong belief in underweighting an asset class within a portfolio. This also communicates that, over a tactical time frame, WFII views the asset class (or sector) as offering investors a very unattractive risk/reward opportunity.

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