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FROM THE DESK OF DARRELL L. CRONK

State of the Markets

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Darrell L. Cronk is the president of Wells Fargo Investment Institute, which is focused on delivering the highest quality investment expertise and advice to help investors manage risk and succeed financially. Mr. Cronk leads global investment strategy and research including equity, fixed income, real assets, and alternative investments. He also serves as chief investment officer for Wealth & Investment Management, a division of Wells Fargo & Company that includes Wells Fargo Private Bank, Wells Fargo Advisors, and Abbot Downing.

Confident or Complacent?

"A wise person will make more opportunities than he finds."
— Sir Francis Bacon.

Global markets are closing out the first month of 2021 with the same enthusiasm for global reflation with which they closed 2020. Investors are seeing record highs across the S&P 500, Nasdaq 100, Russell 2000, and MSCI Emerging Markets indexes. The value rotation within equities is about to enter its fifth month, the longest consecutive streak in five years, and approximately 85% of S&P 500 stocks remain in an uptrend, one of the best readings in eight years.

The recent strong performance is not confined to equities. Base metal prices are at or close to decade highs, and Brent crude oil and 10-year U.S. Treasury yields are also at 10-month highs, with developed and emerging market credit spreads at 10-month lows. Bond yields and inflation expectations have stabilized — with the current U.S. 10-year Treasury settling between 1.0% and 1.1% and the 10-year breakeven inflation rate (expected inflation rate over the next 10 years) hovering just over 2%. This is happening despite President Biden's proposal for a $1.9 trillion stimulus package — perhaps reflecting skepticism that Congress will approve that level of spending.

Sentiment has been running hot — after record inflows into money market funds in 2020, investors find themselves with very large amounts of liquidity and dry powder that they potentially may reallocate into risk markets in 2021. Fourth-quarter earnings are tracking to substantial consensus beats, and market breadth has widened considerably, a good confirmation signal. History has shown that market tops have rarely formed when breadth was this strong.

After two straight years of S&P 500 equity multiple expansion driving returns, earnings are expected to mount a sizable recovery this year, consistent with what we've seen historically in the early stages of a recovery. The good news is that normal economic risks associated with large imbalances generating credit stress appear limited at present, thanks to monetary policy accommodation and supportive financial conditions.

There remain challenges, however, as we further parse the underlying data. High valuations, regulatory tightening, higher tax rates, and inflation risks remain active concerns for investors. The second wave of the pandemic is also proving to be far worse than the first wave from a public health perspective, and vaccine distribution programs have rolled out with various fits and starts. Early virus containment and mass vaccinations are by no means a sure thing and will require effective policy responses. These developments point to a weaker and more divergent start to the year for the economy. The gap between strong manufacturing data and depressed service sectors is widening and bears watching as the year progresses.

Despite these near-term disappointments, we maintain that even if the Biden-proposed American Rescue Plan stimulus is reduced through negotiations from $1.9 trillion to around $1.0 trillion, the aggregate fiscal stimulus during the past 12 months still would be an eye-popping $4.4 trillion, or roughly 20% of U.S. gross domestic product (GDP). A second element, likely proposed in coming months, will target longer-term growth initiatives — it generally is believed to be another $1 trillion to $2 trillion of fiscal support passed through either normal Congressional measures or the budget reconciliation process. In our opinion, this stimulus, along with the fading of the pandemic's second wave, has the potential to jump start a second-half global acceleration, which we think could lead to U.S. and global GDP growth clocking in at a boomy 4.7% and 5.5%, respectively, for calendar-year 2021.

So, what should investors do with this vexing set of unknowns and conditions?

Those who focus on long-term measures, such as forward equity valuations, interest rate levels, and credit spreads, should recognize that over tactical time horizons (6 to 18 months), markets often have been dominated by business-cycle and policy momentum trends. While it is difficult to argue that many of these indicators look cheap by historical standards, they often have been mean reverting early in a cycle, as trends like earnings growth catch up or interest rates work to climb back to pre-pandemic levels.

We have a uniquely bullish macro environment today — early recovery cycle dynamics, rising commodity prices, a falling U.S. dollar, low interest rates with deeply negative real yields, markets flush with liquidity, fiscal stimulus kicking in at levels never before witnessed, and better vaccine news likely on the way. These conditions can create a powerful backdrop for capital markets. We believe current circumstances favor confidence over complacency.

Risk Considerations

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

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NASDAQ 100 Index consists of the 100 biggest companies listed on the NASDAQ Composite Index. The list is updated quarterly and companies on this Index are typically representative of technology-related industries, such as computer hardware and software products, telecommunications, biotechnology and retail/wholesale trade.

NASDAQ Composite Index measures the market value of all domestic and foreign common stocks, representing a wide array of more than 5,000 companies, listed on the NASDAQ Stock Market.

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.

Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

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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