WELLS FARGO
Investment Institute

*December 2021*

# 2022 Outlook: Which way to the recovery?

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Jobs are plentiful, companies are profitable, businesses have reopened, and we've seen a third straight year of strong price gains in the S&P 500. However, consumers see low inventories on some products as they do their holiday shopping, difficulties finding cars to buy, worker shortages at their favorite restaurants, and increases in prices at the grocery store and the pump. All this is leaving investors wondering if continued elevated inflation and high energy prices will cut into corporate earnings in 2022 — and bring volatility to portfolios.

Our 2022 Outlook strives to help investors separate the noise from the important information and offer a clear direction on what we believe is next for the recovery.

***[On-screen graphic – 2022 Outlook: Which way to the recovery?]***

As the post-COVID-19 economy comes into view, 2022 looks to be an important transition year as we expect the booming growth profile of 2021 to slow to a more sustainable trajectory that is still above-average.

We believe economic growth and inflation — both in the U.S. and around the world — should stay elevated in 2022, but the U.S. is likely to remain the world's main driver of economic activity. That advantage should favor continued strengthening of the dollar — that's an added headwind for export-oriented Asia and Europe. What's more, the strong dollar along with consumer-led growth in the U.S. reinforce our preference for U.S. financial markets — specifically higher-quality, and less cyclical equities.

The main risk comes from the ongoing disruptions to goods inventories, and the risk that the COVID-19 restrictions on personal contact may continue to prevent service industries, such as restaurants, hotels, and travel from getting back on their feet. The inventory shortages also raise prices. Our view is that economic growth will remain strong, but that inventories gradually will catch up and reduce inflation.

***[On-screen graphic – What does this mean for investors?]***

So, with the economy at a crossroads between strong recovery, on the one hand, and disruptions and inflation, on the other, we believe that investors should still follow the road to continued growth. The economy should stay on track.

That's why we believe that equities will again outperform fixed income, and that the U.S. equity markets will outperform international markets.

***[On-screen graphic – U.S. Large-Cap, U.S. Mid-Cap, Balance between growth and cyclical equity sectors]***

In U.S. equities, we favor quality and larger firms, U.S. large-cap and mid-cap, and a balance between growth and cyclical equity sectors.

***[On-screen graphic – Favored sectors: Leveraged loans, Commercial mortgage-backed securities, Preferred securities, Municipal securities]***

In fixed income, the continuing recovery coupled with a modest rise in interest rates should support credit and spread-oriented asset classes and sectors, such as, leveraged loans, commercial mortgage-backed securities, and preferreds. Tax-exempt income is likely to be in high demand given the expectations for higher tax rates.

***[On-screen graphic – Favored real assets: Commodities, Real estate investment trust (REITs) subsectors: Industrials, Residential (including apartments, single-family properties and self-storage), Infrastructure or cell towers]***

Meanwhile, commodity prices are unlikely to repeat their stellar performance of the past year, but we do expect more upside. And in Real Estate Investment Trusts, we favor Industrial, Residential, and Infrastructure.

***[On-screen graphic – Most favored strategies: Relative Value: Arbitrage, Macro: Systematic and Discretionary, Event Driven: Merger Arbitrage, Private Equity: Small/Mid Cap buyouts and Growth Equity/Venture, Private Debt: Direct Lending]***

And for alternatives, we are pivoting our hedge fund guidance in 2022 toward the Relative Value and Macro strategies, which we believe can provide diversification and non-correlated returns to global risky assets.

To learn more about what we believe is next for the recovery, please download our Wells Fargo Investment Institute report: *2022 Outlook: Which way to the recovery?*

**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. **Mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. **Leveraged loans** are generally below investment grade quality ("high-yield" securities or "junk" bonds). Investing in such securities should be viewed as speculative and investors should review their ability to assume the risks associated with investments which utilize such securities. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to 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. **Preferred securities** have special risks associated with investing. Preferred securities are subject to interest rate and credit risks. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. **Commercial Mortgage Backed Securities (CMBS)** are a type of mortgage-backed security backed by commercial mortgages rather than residential real estate. CMBS tend to be more complex and volatile than residential mortgage-backed securities due to the unique nature of the underlying property assets. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions

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

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

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CAR-1121-04345