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Investment Institute

FROM THE DESK OF DARRELL L. CRONK

State of the Markets

December 20, 2021

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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.
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2021 — The year that wasn't

"In investing, what is comfortable is rarely profitable." — Robert Arnott.

Truth be told, in our business, we spend a lot of time waiting. We wait for the next data release. We wait for the next earnings reports. We spend many of our waking hours, far more than we might care to admit, squinting at trends and inflection points, waiting for indexes to breach moving averages, and anticipating subtle directional movements in the multi-colored lines that cross our multiple monitors.

Watch us come together on a conference call and buzz with excitement because the lines on a commodity chart formed a contango.[1] Listen to the clamor in our investment strategy committee when yield curves threaten to invert and equity indexes are on the brink of forming a golden cross. We watch trends, we forecast, we crunch our numbers, and we wait.

As the sand in the 2021 hourglass empties, and I reflect on the year that was, I took a close look at the phenomena that materialized on my charts in 2021 — and the phenomena that didn't. And it strikes me that perhaps 2021 is best characterized as the year that wasn't.

[1] Contango refers to a situation where the future spot price is below the current price, and people are willing to pay more for a commodity at some point in the future than the actual expected price of the commodity. This may be due to people's desire to pay a premium to have the commodity in the future rather than paying the costs of storage and carry costs of buying the commodity today.

Rather than discuss what did happen in 2021, let's discuss what *didn't* happen.

- Not once on our 2021 monitors did we see the S&P 500 and Bloomberg Commodity indexes trade below their 200-day moving averages — not even one time. Commodities came close recently; the S&P 500 Index never did. This rarely, if ever, happens. The S&P 500 Index is now 38% above pre-pandemic highs and 109% above post-pandemic lows (as of December 16, 2021). Based upon forward earnings estimates, earnings are 44% above pre-pandemic highs, keeping multiples in check.
- Not once in the data did we see leadership from any of the defensive equity sectors. Either cyclicals or growth stocks led the way — even as we witnessed some quite violent rotations in sector leadership as markets reacted to reflation trades, the emergence of vaccines, then the COVID-19 Delta variant, and late-year Federal Reserve (Fed) pivots as inflation persisted.
- In no quarter over the past year did we have anything less than blowout earnings. In fact, following third-quarter earnings, we are now up to six straight quarters of actual earnings beating consensus expectations by double digits. That has never happened.
- Not once this year in our U.S. dollar (USD) charts did we see the USD meaningfully break a sustained and strong uptrend, notwithstanding that most predicted the USD would decline in 2021 against most other global currencies. The only period in which the USD temporarily weakened was through the summer "growth scare," but then it quickly resumed its upward trajectory.
- At no point this past year did we see volatility (as measured by the Chicago Board Options Exchange Volatility Index (VIX)) drop below 15 for any sustained period of time. Consider this: Before the pandemic, 15 represented a ceiling; in 2021, 15 better resembled a floor.
- And at no point this year did our charts register a decline in year-over-year headline inflation, as measured by the consumer price index (CPI). In fact, at this time last year, CPI was 1.4%, and in the last print of 2021, CPI grew 6.8% — and equity markets rallied.

There was plenty to worry about in 2021, but we saw a robust economic recovery, and we stayed optimistic about risk assets.

As we prepare for 2022, with the release of our *2022 Outlook*, we find ourselves optimistic once more, in fact significantly more optimistic than many on the street. Some have S&P 500 Index targets as low as 4,400; our target range is 5,100-5,300. Some are actually pricing in a Fed policy mistake as their base case, forecasting ever-increasing numbers of Fed rate hikes in 2022.

As in 2021, many investors have constructed a sturdy wall of worry — built on very real concerns about new COVID-19 variants, doubts that inflation will ease, uncertainty about the new signals the Fed is sending, unprecedented supply-chain distortions, and troublingly high energy prices. We titled our *2022 Outlook* "Which way to the recovery?" because we believe many investors stand at a crossroads, wondering whether to add risk exposure to portfolios, or to remove risk exposure.

- Where others may see uncertainty, we see a U.S. economy that is clearly stronger than many realize as we move from early-cycle dynamics to mid-cycle drivers, and the economic recovery becomes self-sustaining. We see the U.S. and global economy growing at a robust 4.5%. To support our optimism, we would point to the most recent Atlanta Federal Reserve GDP (gross domestic product) tracker estimating fourth quarter (Q4) 2021 growth of 8.7% (as of December 9), the latest Institute of Supply Management manufacturing purchasing managers index (PMI) coming in at a strong November 61.1, and the service PMI at a record at 69.1.

- Where others may see inflation running hot, we would agree for the first half of the year in 2022 but see inflation fading during the second half, as we expect supply chain disruptions to abate and year-over-year comparisons to become more favorable. One data point that we will watch closely and wait for is labor inflation. During past rising inflationary cycles, inflation progressed from goods inflation to services-based inflation to labor inflation. We have seen the goods inflation, and we are right in the thralls of services-driven inflation. We believe wage and labor inflation will be an important story for 2022.
- We see the USD having a little less exciting year in 2022. If our forecast is correct that the U.S. economy and markets will outperform international markets, the U.S. dollar is likely to hold its levels and even strengthen a bit more in 2022.

The holidays are a good time for reflection, and at least for me, perspective and a renewed focus on what's important. For our part, the first principles of our mission are always to make a humble attempt to guide you on the forward direction of travel and the potential magnitude of asset-price movements, informed by a deep understanding of the most salient themes shaping the investment landscape. I can attest, it is not always easy work, but we appreciate your support, we benefit from your perspective, and we wish you the best and most restful of holiday seasons.

Risk Considerations

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

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. 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.

Definitions

Bloomberg Commodity Index is comprised of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity.

Chicago Board Options Exchange Volatility Index (VIX) reflects a market estimate of future volatility, based on the weighted average of the implied volatilities for a wide range of strikes.

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

Purchasing Managers Index (PMI) surveys track sentiment among purchasing managers at manufacturing, construction and/or services firms. An overall sentiment index is generally calculated from the results of queries on production, orders, inventories, employment, prices, etc.

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

An index is unmanaged and not available for direct investment.

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