WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee

October 17, 2022

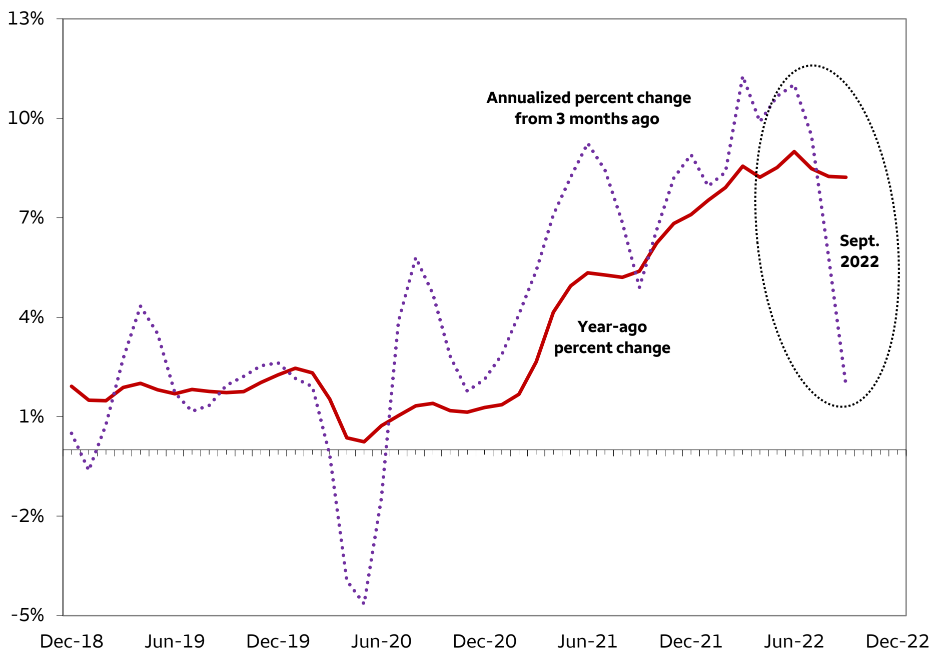
Global Macro spotlight

Gary Schlossberg
Global Strategist

Inflation after the September CPI report

September's Consumer Price Index (CPI)report created understandable anxiety on Wall Street and Main Street over the outlook for inflation through 2023. Inflation is central to the outlook for interest rates; housing and other credit-sensitive sectors of the economy; and economic growth, through its effect on inflation-adjusted incomes (or purchasing power). Inflation is also central to the dollar's ongoing rally in the currency markets. The CPI's rise last month slowed less than expected, to a 12-month rate of 8.2%, propelled by an accelerated rise in the CPI's core rate (excluding food and energy) to a new 40-year high of 6.6%. The good news is that top-line CPI inflation continued to slow over the last 12- and 3-month periods, despite larger-than-expected increases in September.

Inflation still on the downswing despite September's worrisome CPI



Sources: Bureau of Labor Statistics and Wells Fargo Investment Institute. Data as of October 13, 2022.

Weighing the bad news against the good in the inflation outlook

Still, the immediate concern is that fuel costs are rising again, after declining for three straight months, pressuring inflation directly and indirectly through its effect on transportation services and food costs (since energy is needed for fertilizers, transportation, and other expenses). More fundamental is the recent pressure on the CPI's bedrock components, including rents and medical-care costs, both less economically sensitive than other parts of the CPI and historically more difficult to move lower. These components serve as a barometer of the extent to which higher inflation has become embedded in key price indexes.

The good news is that market-based measures of rental inflation, which tend to lead changes in the CPI's slower-moving housing component — 30% of the CPI — already are beginning to cool and, in some cases to post outright declines. More fundamentally, we believe the bulk of the CPI consists of economically sensitive goods and services, whose increases will slow with demand should the economy go through the worst of what we believe will be a recession during the first half of 2023.

Core goods inflation — excluding food and energy and representing over 20% of the CPI — already is doing just that. Goods inflation slowed in September for the sixth straight month on lower used-car prices (responsible for much of the early spike in goods prices in the past year), lower freight costs, and the rotation of spending from goods to services. Further declines in goods inflation are likely, as weakening demand for these items leads the economy's slowdown. Our view is that wage inflation also will moderate during the economic slowdown, as spending moderates on labor-intensive travel, entertainment, and other services sensitive to changes in economic activity. We also expect a boost in labor supply, as workers pressured by low saving rates, weakening finances, and higher prices return to the workforce.

Even more fundamental to the inflation outlook is that there are fewer institutional impediments present in the economy to sustain inflation now compared to the high inflation of the 1970s and early 1980s. Three examples:

- Reduced union representation today has driven reduced cost-of-living adjustments protecting workers' incomes, a stark difference compared to 40 years ago.

- Globalization today is a far more important source of competition and cost containment than it was several decades ago, despite recent erosion.

- Lastly, in today's less capital-intensive, more services-oriented economy, financing costs and entry barriers are lower than in a more manufacturing-oriented economy decades ago.

The latest run-up of inflation has been the result of supply shocks — first from the pandemic, then from the war in Ukraine, and also from the delayed response by central banks to contain surging prices. For that reason, we believe that inflation will be more sensitive to a reversal of supply disruptions and to a winding down of demand as the recession here and abroad takes hold.

Equities

Chao Ma, PhD, CFA, FRM
Global Portfolio and Investment Strategist

Inflation is still a market risk

Inflation remains hot and sticky. As of September, the CPI rose 8.2% over 12 months. Excluding the more volatile food and energy prices, core CPI increased 6.6% in the same period, representing a fresh cycle high. These inflation readings are likely to keep the Fed on its hawkish monetary policy path, including further interest rate hikes and balance sheet reductions. The more sticky services and housing price inflation, driven by a tight labor market, are among the major targets of these policies.

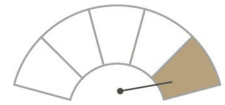
Although earnings have held up well so far this year, we have seen more downward revisions lately. Further earnings deterioration is likely, especially in 2023, given that the cooling effects from tightening monetary policies may take months to show up. Our view is that earnings could decline by 15% peak to trough, which is close to the historical median decline of 13%.

Given the slowing economic and fundamental backdrop, we believe the recent market trends could remain in place over the short term. As shown in the chart below, the equity markets have continued a downward trajectory with U.S. outperformance and elevated volatility over the past year. Bear markets often take time to resolve themselves. Since 1946, bear markets on average have lasted 16 months, resulting in a 35% drawdown.

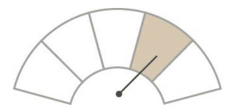
Companies with a greater sensitivity to high interest rates, economic downturns, a strong U.S. dollar, as well as high inflation can be more significantly impacted. We prefer to hedge these influences by staying in domestic-oriented, high-quality, and defensive segments of the market. This includes favoring U.S. large- and mid-cap stocks, as well as the Health Care, Energy, and Information Technology sectors.

Recent equity asset class returns (%)

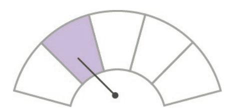
Sources: Wells Fargo Investment Institute and Morningstar. Asset class definition and indexes are provided at the end of the report. Data as of September 30, 2022. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**



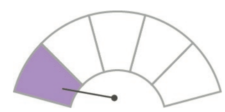
Most favorable
U.S. Large Cap Equities



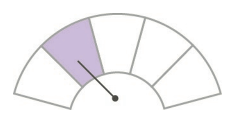
Favorable
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities



Unfavorable
Emerging Market Equities

Fixed Income

Luis Alvarado
Investment Strategy Analyst

TIPS — Use caution as inflation expectations flatten

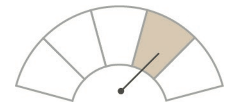
Although year-over-year inflation readings are still elevated in the U.S., we believe that realized inflation will continue to decline toward the Fed's 2% target as we roll into 2023. Rising inflation expectations during 2020 and 2021 allowed Treasury Inflation-Protected Securities (TIPS) to outperform nominal Treasuries. However, so far in 2022 and moving forward, we believe it will be more difficult for TIPS to continue to display better performance versus nominal Treasuries given that inflation expectations already peaked in March and have started to decline, converging around 2.4%.[1] We currently have a neutral guidance recommendation on TIPS but caution is warranted, especially as the Fed continues with its tightening cycle to tame inflation.

The supply and demand dynamic for TIPS is also likely to be less supportive moving forward relative to what it has been over the past two years. In the most recent quarterly refunding statement from the Treasury, it was announced that TIPS issuance would increase by $1 billion on the September and October TIPS auctions. The Treasury expects demand for TIPS to remain robust, as it continues to stabilize the share of TIPS as a percentage of total marketable debt outstanding.[2] Investors should keep in mind that the Fed has been a large purchaser of TIPS, with a current share of above 25% of total market outstanding. Hence, the balance sheet runoff could continue to be a potential headwind for TIPS.

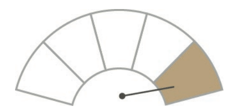
Yearly total return of TIPS compared to other fixed-income asset classes

Year	Intermediate-term fixed income	Long-term fixed income	U.S. Treasuries	U.S. TIPS
2012	4.80	8.78	1.99	6.98
2013	-1.64	-8.62	-2.75	-8.61
2014	4.97	17.71	5.05	3.64
2015	1.25	-3.26	0.84	-1.44
2016	1.94	6.67	1.04	4.68
2017	2.60	10.47	2.31	3.01
2018	0.90	-4.55	0.86	-1.26
2019	7.32	19.57	6.86	8.43
2020	7.92	16.11	8.00	10.99
2021	-2.29	-2.51	-2.32	5.96
YTD 2022	-12.86	-29.89	-13.46	-13.08

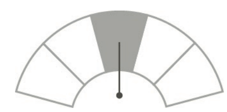
Sources: Bloomberg and Wells Fargo Investment Institute. October 12, 2022. Yearly data from 2012 until October 12, 2022. Intermediate-term taxable fixed income = Bloomberg U.S. Aggregate 5-7 Year Bond Index. Long-term taxable fixed income = Bloomberg U.S. Aggregate 10+ Year Bond Index. U.S Treasuries = Bloomberg U.S. Treasury Index. U.S TIPS = Bloomberg U.S. TIPS Index. YTD = year to date. See definitions on indexes at the end of the report. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**



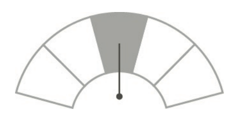
Favorable
U.S. Taxable Investment Grade Fixed Income



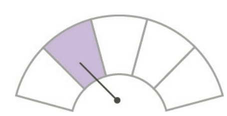
Most favorable
U.S. Short Term Taxable Fixed Income



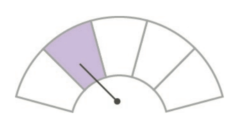
Neutral
U.S. Intermediate Term Taxable Fixed Income



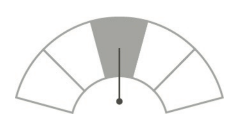
Neutral
U.S. Long Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



Unfavorable
Developed Market Ex.-U.S. Fixed Income



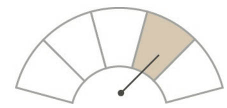
Neutral
Emerging Market Fixed Income

1. Average 2-year and 5-year breakeven inflation rate as of October 12, 2022.
2. U.S. Department of Treasury, Quarterly Refunding, Financing Estimates 3rd Quarter, August 3, 2022.

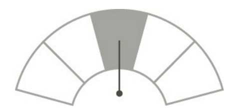
Real Assets

"The first principle is that you must not fool yourself, and you are the easiest person to fool."
— Richard Feynman

John LaForge
Head of Real Asset Strategy



Favorable
Commodities



Neutral
Private Real Estate

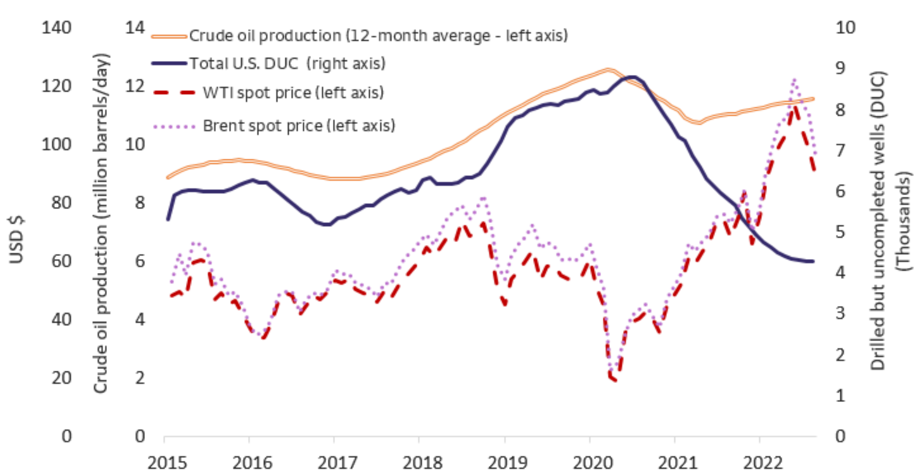
Oil markets could remain tight for years

The third quarter of 2022 was rough on most assets as the calls for a global recession intensified. So far in the fourth quarter, though, oil has started to rise again, up 18% on the year while most other assets continue to decline. Why oil is faring better than the rest has to do with tight global supply — a trend that began in 2020, continues today, and we believe will likely support oil prices for years to come.

The trend of tight global oil supplies started in early 2020, sparked by the U.S. Prior to this, the rise of shale oil allowed U.S. producers to increasingly build reserves of "drilled but uncompleted wells" (DUCs), which could quickly be turned into extra production. What changed, though, was the reaction by U.S. producers to negative sentiment toward fossil fuels. Investors began to prefer capital discipline and returns of shareholder equity over more oil production. In response, U.S. producers began depleting their DUCs to meet demand instead of drilling new holes. This trend has continued into 2022, with the number of U.S. DUCs now sitting at eight-year lows. Another source of oil tightness emerged when the Organization of Petroleum Exporting Countries+ (OPEC+), announced hefty plans to cut production by 2 million barrels per day (2% of daily global demand), citing an impending recession.

The bottom line is we believe global oil supplies should remain tight and oil prices should remain high for years to come. Demand remains high, but government climate policies have Western oil producers hesitant to produce too much. Other groups, such as OPEC+, could step in to fill the supply gap, but they will likely hold out for higher prices. There is little incentive for OPEC+ to swamp the market with oil, which would ultimately lead to lower oil prices and less revenue for OPEC+.

U.S. DUC wells and total production



Sources: Bloomberg, Energy Information Administration, and Wells Fargo Investment Institute. Monthly data from January 31, 2015 – August 31, 2022.

Alternatives

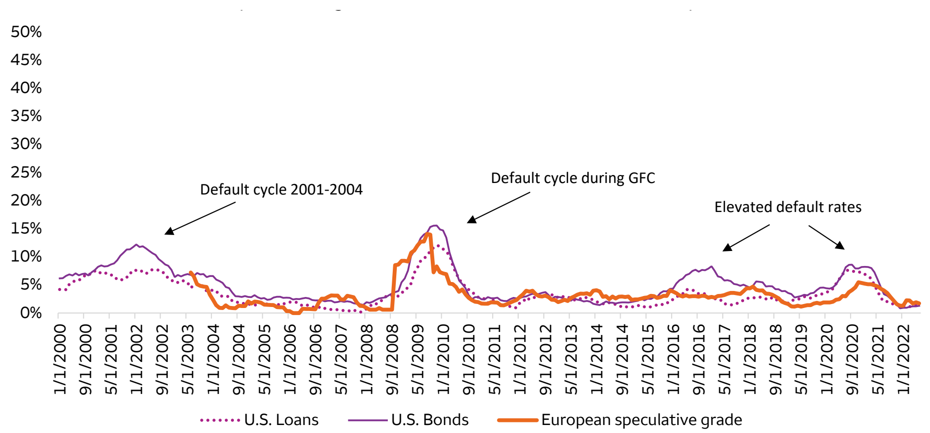
Brian Lane
Lead Analyst, Private Credit
Global Manager Research

The opportunity in Distressed Debt

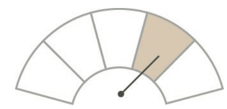
Distressed Debt is often an Event Driven strategy where the event is a corporate restructuring. The investor usually purchases discounted debt to own restructured equity. Discounted entry prices typically afford investors significant downside protection.

Many investors are currently trying to determine where default rates will be in 2023. Monetary policy may play a role as interest rates rise around the world to combat inflation. Also, slowing global gross domestic product growth and a possible recession may create opportunities in speculative-grade credit markets. Many allocators try to tactically commit capital to Distressed Debt strategies when defaults are low and persistent. However, these investments can generate positive returns in both benign credit environments as well as distressed cycles. When defaults are high, the opportunity set is plentiful and managers can deploy capital aggressively. When defaults do not rise significantly, the opportunity set is thin, but managers can be more discerning and steer toward deep value investing.

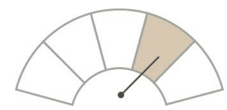
Speculative grade credit default rates - U.S. and Europe



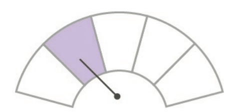
Sources: Moody's. Data as of July 2022. GFC = global financial crisis.



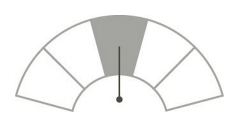
Favorable
Hedge Funds – Relative Value



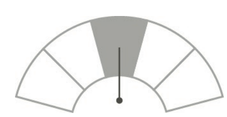
Favorable
Hedge Funds – Macro



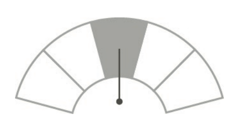
Unfavorable
Hedge Funds – Event Driven



Neutral
Hedge Funds – Equity Hedge



Neutral
Private Equity



Neutral
Private Debt

Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not appropriate for all investors and are only open to "accredited" or "qualified" investors within the meaning of U.S. securities laws.

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. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. **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. 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.

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. The **Energy** sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. 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. Risks associated with the **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.

Investing in distressed companies is speculative and subject to greater levels of credit, issuer and liquidity risk. In addition, the repayment of default obligations contains significant uncertainties.

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.

Definitions

Bloomberg U.S. Aggregate 5-7 Year Bond Index is composed of the Bloomberg U.S. Government/Credit Index and the Bloomberg U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 5-7 years.

Bloomberg U.S. Aggregate 10+ Year Bond Index is composed of the Bloomberg U.S. Government/Credit Index and the Bloomberg U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 10 years or more.

Bloomberg U.S. Treasury Index measures the total return US dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. The largest weightings in the index are Treasury notes with maturities of 8-10 years.

Bloomberg U.S. TIPS Index is an unmanaged market index comprised of all U.S. Treasury Inflation-Protected Securities rated investment grade, have at least one year to final maturity, and at least $500 million par amount outstanding.

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

An index is unmanaged and not available for direct investment.

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