WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **March 13, 2023**

- At current levels, stocks are not as attractive versus bonds, especially considering the deteriorating macro and earnings environment we forecast.
- We prefer quality asset classes (U.S. Large and Mid Cap) and sectors (Information Technology, Health Care, and Energy) once their risk-reward balance becomes more attractive, at or near the lower end of their trading ranges.

- The volatile start for global bonds in 2023 is explained by the turnaround in the market's expectations for year-ahead inflation and the renewed rise in the market-implied peak federal funds rate.
- In this environment, the U.S. Federal Reserve (Fed) will likely not signal a pause anytime soon. Short- and long-term bond yields and the U.S. dollar are supported, risk assets look vulnerable.

- Our year-end 2023 oil target range for West Texas Intermediate Crude is \$100 – \$120, and slightly higher for Brent crude at \$105 – \$125.
- During bull super-cycles, historically oil prices tended to rise leading into recessions, and continued rising months after the start of recessions.

- New home sales remain in line with pre-pandemic levels, yet future interest rate increases may cause the downward trend to resume as the Fed renews its commitment to fight inflation.
- We remain cautious on the single-family residential market as higher rates add further pressure to an increasingly stressed consumer.

Equities Spotlight

"Nothing in life is to be feared. It is only to be understood." — Marie Curie

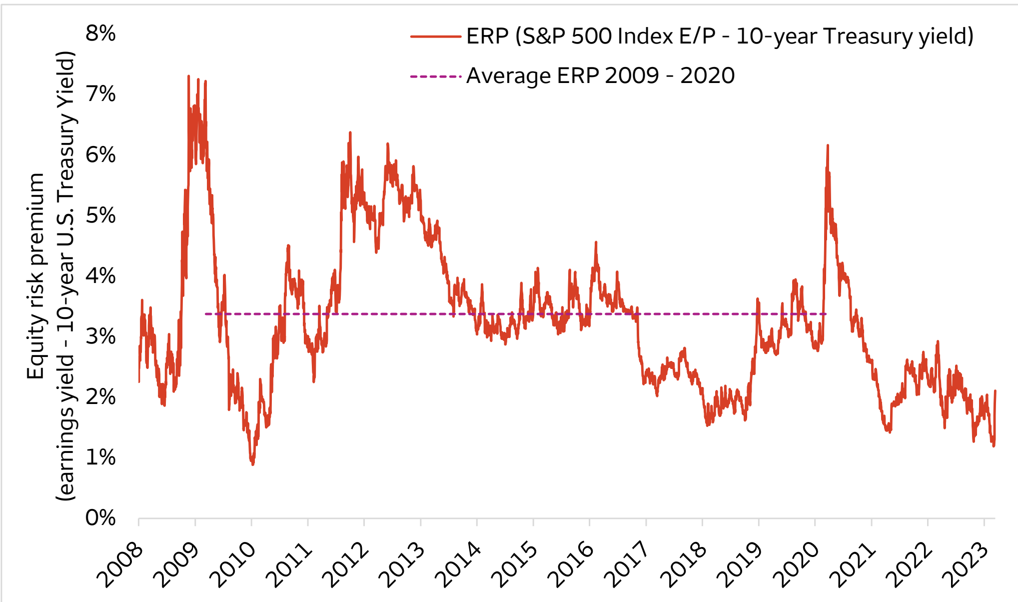
Austin Pickle, CFA
Investment Strategy Analyst

Equity risk premia at multi-decade lows

Recently, the U.S. equity risk premium hit lows last seen 13 years ago. What does this mean and what are the implications?

For those unfamiliar, the equity risk premium (ERP) measures the equity earnings yield minus a bond yield. The earnings yield is the inverse of the price to earnings ratio, or earnings divided by price. The chart below shows the ERP as calculated by the S&P 500 Index earnings yield minus the 10-year U.S. Treasury yield.

Chart 1. Equity risk premium at multi-decade lows



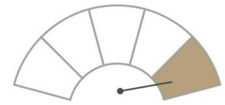
Sources: Bloomberg and Wells Fargo Investment Institute. Daily data: January 1, 2008 – March 13, 2023. Earnings yield is calculated as the trailing 12-month earnings per share divided by the current price. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.**

Investors have not had to contend with such a low ERP in quite some time. The average ERP between the 2009 financial crisis and 2020 pandemic lows was 3.4% (March 12, 2009-March 23, 2020). With bond yields suppressed by central-bank policies, equities looked perpetually attractive relative to bonds. This was the era of "there is no alternative" to equities, or TINA. Today, with the S&P 500 Index earnings yield only in the mid-5% range, the yield on 10-year U.S. Treasuries at roughly 3.5%, and the yield on 2-year Treasuries north of 4%, there are now attractive options relative to equities.

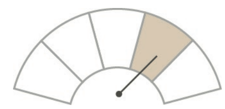
What does this mean?

At these levels, stocks are not as attractive versus bonds, especially considering the deteriorating macro and earnings environment we forecast. This all figures into our rationale to remain underweight stocks in our portfolios.

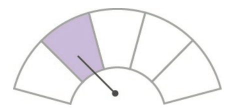
Additionally, with such a low ERP, we would expect equity markets to be especially sensitive to interest rate moves going forward. If interest rates were to spike meaningfully higher, stocks likely would struggle.



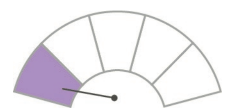
Most favorable
U.S. Large Cap Equities



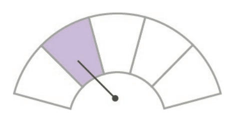
Favorable
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities

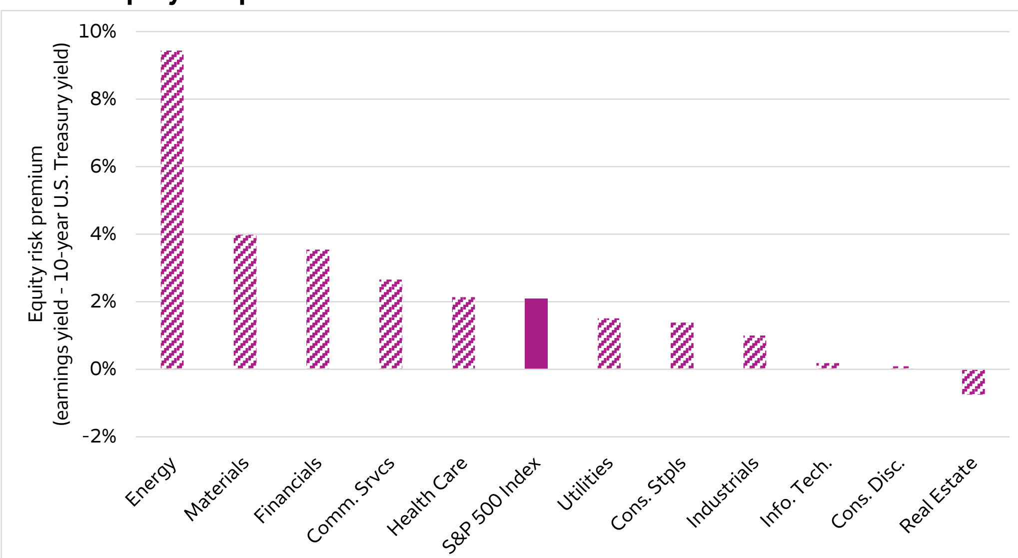


Unfavorable
Emerging Market Equities

That is not to say that all areas of the market exhibit low ERPs. The chart below illustrates this by plotting ERPs of the S&P 500 Index and its sectors. Notice how the Energy sector, for example, enjoys a high ERP. The Energy sector's attractive price relative to earnings is one of the reasons we originally moved to, and remain at, a favorable rating for the sector. Additionally, two of our unfavorable sectors, Real Estate and Consumer Discretionary (as measured by S&P 500 subsectors), land at the bottom of the ERP rankings.

Keep in mind, though, that our outlook and sector rankings consider many technical, fundamental, and macro metrics and are not based on ERPs alone. Take the Information Technology sector as an example. From the chart below we can tell the sector remains expensive (has a low ERP). Yet, we remain favorable as Information Technology enjoys quality characteristics that we believe will serve it well at this stage of the cycle as we approach an anticipated recession. The sector generally enjoys low debt levels, is a cash-generating, and is a historical leader in share repurchases. Additionally, our view that long-term rates likely peaked removes one of the major headwinds that weighed heavily on the sector's 2022 performance.

Chart 2. Equity risk premia: S&P 500 Index and sectors



Sources: Bloomberg and Wells Fargo Investment Institute. As of March 13, 2023. Earnings yield is calculated as the trailing 12-month earnings per share divided by the current price. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.**

Investment implications

The ERP could reset higher by some combination of earnings accelerating, bond yields resetting lower, or stock prices falling. With a recession looming, we suspect that in the near term, the probability leans toward the latter, which brings us to our outlook. We expect that macro and earnings pressures will remain, which could cap equity rallies. In other words, be prepared for range bound markets. That is, until year-end when investors likely will begin to anticipate the early-cycle recovery we expect in 2024.

In the meantime, we still prefer to buy quality asset classes (U.S. Large and Mid Cap) and sectors (Information Technology, Health Care, and Energy) when their risk-reward balance becomes more attractive, at or near the lower end of their trading ranges.

Fixed Income

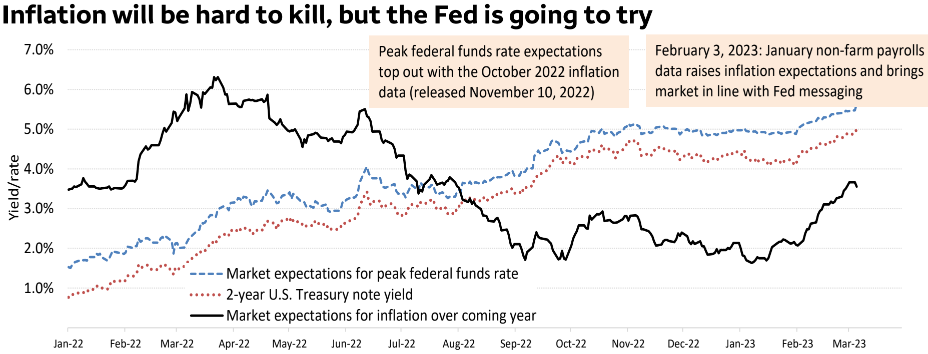
Stubborn inflation, feisty Fed

As measured by the total return on the Bloomberg Global Aggregate Index,[1] +3.3%, January 2023 was the best first month for global bonds since 1990. The worst February on record exactly reversed this performance, -3.3%. Two words explain this historical whipsaw — inflation and the Fed. The chart below shows that January's strong start was in fact a continuation of the benign environment for bonds that began with the lower-than-expected October inflation report released on November 10; this was the point that market participants stopped revising higher their expectations for peak federal funds rates, and — following from this — 2-year yields marked their high.

The most important catalyst for February's reversal was the strong January labor market report released on February 3, which, alongside disappointing price reports suggesting that further slowing in inflation would be harder won, and continued hawkish Fed rhetoric, led to a two-percentage-point jump in market expectations for year-ahead inflation. In turn, this information finally convinced participants that the Fed's own indications of how high they might raise rates were not a bluff: the market's call on peak federal funds rates leapt from around 4.90% to above 5.50%, and 2-year yields reached 5%.[2]

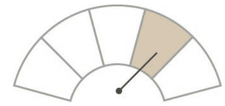
This means that market expectations for the peak in the Fed rate cycle should remain the key drivers for both long- and short-term yields, and there may be further to go here. The March 22 Federal Open Market Committee meeting will release new Fed expectations for rates in 2023 – 2025, which may be very influential. It means that while peak federal funds rate expectations are rising, the U.S. dollar may not resume its October – January decline. With very low-risk returns of over 5% available in Treasury bills and short-term bonds, riskier assets such as equities and credit may not be able to ignore stubborn inflation and a feisty Fed for much longer.

Inflation will be hard to kill, but the Fed is going to try

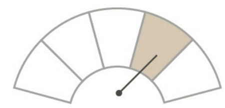


Sources: Bloomberg and Wells Fargo Investment Institute. Latest data as of March 7, 2023. Market expectations for peak federal funds rate are calculated as the highest implied rate seen in the federal funds futures contract curve over two years following data date. Market expectations for inflation over the coming year are derived from the breakeven inflation rate, the difference between the yield on the nominal (regular) 1-year U.S. Treasury note and the inflation-adjusted security of the same maturity.

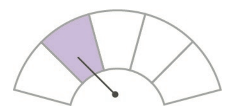
Peter Wilson
Global Fixed Income Strategist



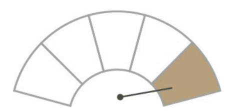
Favorable
U.S. Taxable Investment Grade Fixed Income



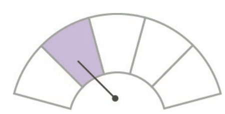
Favorable
U.S. Short Term Taxable Fixed Income



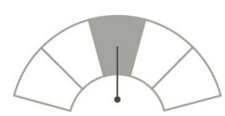
Unfavorable
U.S. Intermediate Term Taxable Fixed Income



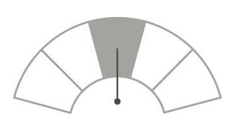
Most favorable
U.S. Long Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



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



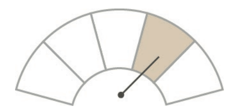
Neutral
Emerging Market Fixed Income

1. See disclosures for index definitions.
2. Latest data as of March 7, 2023.

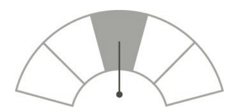
Real Assets

John LaForge
Head of Real Asset Strategy

Mason Mendez
Investment Strategy Analyst



Favorable
Commodities



Neutral
Private Real Estate

Can oil prices rise during a recession?

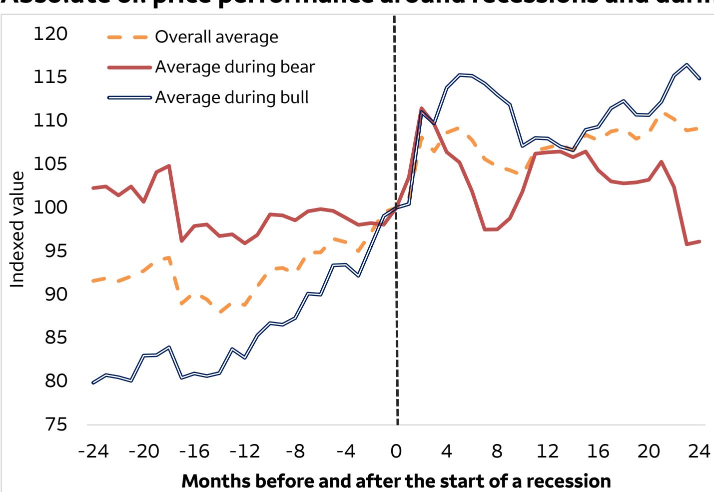
With a looming recession around the corner in 2023 and oil prices between $70 – $85 per barrel, one might wonder why we expect higher oil prices. It seems a bit counterintuitive, right? History shows us, though, that has often been the case, that oil tends to rise into recessions, especially when commodities are in a bull super-cycle[3] (see chart). Of course past performance is not a guarantee of future results.

The chart below plots oil's average price performance around recessions. During past bear super-cycles, oil prices rose heading into recessions, but quickly fell once recessions hit (red line). During bull super-cycles, though, oil prices often rose into recessions and continued higher during the thick of the recessions (blue line). The most recent example of this occurred during the 2008 recession, when commodities were in a bull super-cycle and continued to rise 63% seven months after the start of the recession.

Looking into 2023, our view is the bull super-cycle that began in 2020 is still young and strong. We continue to see the same tight supply conditions that initially sparked the super-cycle in March 2020. In the case of oil, large oil-producing groups such as OPEC+[4] are strategically limiting production. While in the U.S., producers remain disciplined because of anti-fossil-fuel rhetoric coming from Washington D.C. On the demand side, emerging markets now dominate global demand and account for over 50% of consumption. Therefore, we suspect that China's reopening will be a strong driver of oil demand in 2023, offsetting much of the demand lost from the West.

Overall, despite the expected recession, we believe that tight supply, China's reopening, and the effects of the commodity bull super-cycle will be supportive of higher oil prices, most likely to be seen in the latter half of 2023.

Absolute oil price performance around recessions and during super-cycles



Sources: Bloomberg, Kitco, Bureau of Labor Statistics, National Bureau of Economic Research, and Wells Fargo Investment Institute. Monthly data from September 1900 – January 2022. Indexed to 100 at the start of recessions. Overall average is the average of the periods around every U.S. recession since 1902.

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3. Super-cycle: Individual commodity prices tend to move together, over very long bull and bear cycles, often lasting a decade or more.
4. The Organization of the Petroleum Exporting Countries Plus (OPEC+) is a loosely affiliated entity consisting of the 13 OPEC members and 10 of the world's major non-OPEC oil-exporting nations.

Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

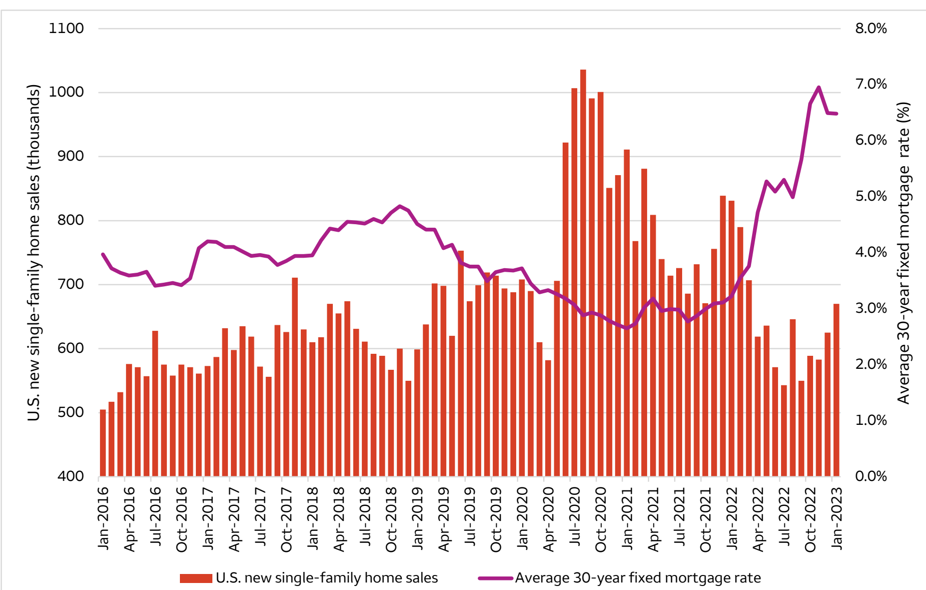
Housing remains casualty of the fight against inflation

New home sales have retreated from their late 2020 peak yet remain in line with pre-pandemic levels. During the same period, mortgage rates rose from a low of 2.7% to around 7.0% in late 2022, significantly raising the interest expense for home purchases and pressuring valuations on new and existing homes alike. While a modest pullback in mortgage rates since November 2022 has spurred an accompanying rise in sales, the longer-term trend of higher rates may continue well into 2023.

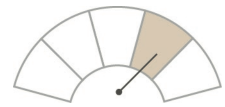
Recent indications suggest that elevated inflation levels may be more stubborn than initially thought. In response, Fed Chair Jerome Powell has embarked on a renewed campaign to signal that short-term rates may go higher and remain elevated for longer. Although longer-term mortgage rates may not rise in lockstep with the federal funds rate, the recent correlation has been quite strong, suggesting mortgage loans may continue to become more expensive in the coming quarters.

While rate increases tend to have a lagged effect on the general economy, mortgage rate increases tend to have a more immediate impact on new home sales as the increased debt costs flow directly to consumers at the time of purchase. While the resilient labor market has functioned as a counterbalance of sorts, the rate of wage growth has not kept pace with rising mortgage payments. Although the tug-of-war between wages and interest rates remains in limbo, we remain cautious on the single-family residential market given the outlook for an elevated interest rate regime adding further pressure to an increasingly stressed consumer.

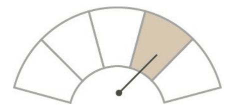
U.S. new single-family home sales and average 30-year fixed mortgage



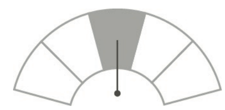
Sources: Federal Reserve Economic Data and Wells Fargo Investment Institute. Data as of January 31, 2023.



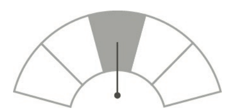
Favorable
Hedge Funds – Relative Value



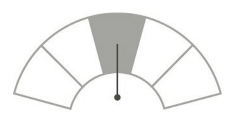
Favorable
Hedge Funds – Macro



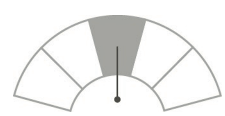
Neutral
Hedge Funds – Event Driven



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

Forecasts are not guaranteed and 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. **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. 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. This can result in greater price volatility. Risks associated with the **Consumer Discretionary** sector include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players; reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. 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. 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.

Technical analysis is based on the study of historical price movements and past trend patterns. There is no assurance that these movements or trends can or will be duplicated in the future.

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

An index is unmanaged and not available for direct investment.

Bloomberg Global Aggregate Bond ex U.S. Index is considered representative of bonds of foreign countries.

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.

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