

# Investment Strategy

Weekly guidance from our Investment Strategy Committee April 24, 2023

## Currency Spotlight: Reports of U.S. dollar’s death are greatly exaggerated

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- Recent moves to denominate some oil transactions in Chinese yuan have led to a surge in reports about “de-dollarization” and the loss of the U.S. currency’s dominant role in global finance.
- For many reasons, we believe this is unlikely to be imminent. The U.S. dollar’s leading share in global banking and trade, backed by the rule of law and robust institutions, cannot be replaced easily.

## Equities: Bear market check-in

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- After reaching a bear market low of 3,577 on October 12, 2022, the S&P 500 Index has experienced an impressive rally.
- We believe it is unlikely equity markets will continue unscathed leading up to and during a recession. Therefore, we suggest maintaining a defensive stance in portfolios and leaning toward high-quality assets over low-quality assets.

## Real Assets: A sugar-sweet rally

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- Expectations for tighter global supplies are pushing raw sugar prices to 10-year highs.
- We suspect that the recent rally could lose steam as returns moderate later in the year because of a strong Brazilian harvest.

## Alternatives: Systematic Macro demonstrates ability to adapt

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- Systematic Macro managers potentially can profit in up- as well as down-trending markets and can adapt their positioning quickly if trends move against them.
- March 2023 provided an example of this ability to rapidly change positioning, as fixed-income markets reversed a yearlong downtrend.

## Current tactical guidance

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# Currency Spotlight

**Peter Wilson**

Global Fixed Income Strategist

## Reports of U.S. dollar’s death are greatly exaggerated

Since the start of the year, financial newswires and social media have been buzzing with stories about the decline of the U.S. dollar as the dominant global currency in terms of global foreign exchange reserves and its use as a means of exchange in global trade. While there are good reasons why the market is talking about this now, the dollar is highly unlikely to lose its global status overnight. In this report, we list a few of the factors that support the dollar’s preeminence, which we believe will erode only very slowly. In next week’s report, we delve deeper into the implications, including the advantages (and disadvantages) of the greenback’s key-currency role.

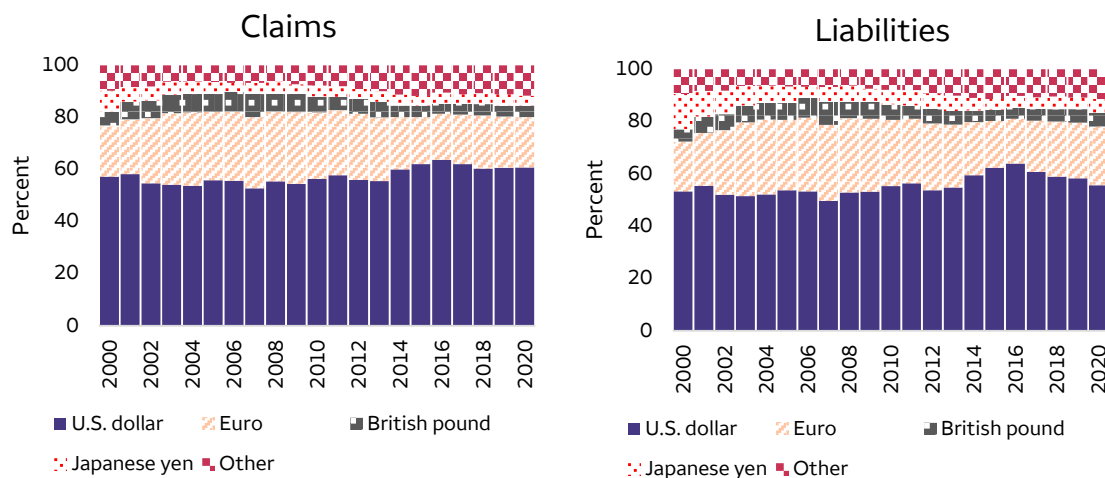
### Why now?

Two trends coincide to explain why everyone is seemingly concerned for the dollar’s global role right now. The first is that geopolitical volatility is much increased after the onset of the war in Ukraine, and some countries worry about vulnerabilities in trade and finance given the increasing use of sanctions and other enforcement methods (the so-called “weaponization” of the dollar). Agreements among Saudi Arabia, China, and Russia to price some oil transactions in Chinese yuan exemplify this trend. Another factor in the “Why now?” analysis is the U.S. financial tremor after the failure of a California bank in early March, which is really the first serious bout of financial concern to happen in the era of ubiquitous social media and of cryptocurrency. Social media and the promotion of alternative currencies may amplify perennial concerns about the dollar’s declining role, but this does not make those concerns any more valid than they were previously.

### Hard to rip out the plumbing

Overall, the facts are reassuring. Global currency status does not disappear overnight. The reason is because the U.S. dollar remains massively dominant in the “plumbing” of the global financial system (by which we mean its role in international trade and payments, and its dominance of borrowing by international financial institutions).

**Chart 1. Share of international and foreign currency banking claims and liabilities**



Sources: Federal Reserve and Bank for International Settlements. Annual data from 2000 – 2020. Share of banking claims and liabilities across national borders or denominated in a foreign currency. Excludes intra-euro area international liabilities and claims. At current exchange rates.

The chart, from a Federal Reserve (Fed) article on the international role of the dollar<sup>1</sup>, shows that the dollar's share of international financing is stable at around 50% – 60% of claims and liabilities, with only the euro as a serious competitor. Such dominance means powerful “network effects<sup>2</sup>” and serious barriers to entry for any contender to world currency status. And we notice that all the main alternatives to the U.S. dollar here are developed market currencies — even the Chinese yuan, most often cited as the main threat to the dollar, is nowhere.

And why? The simple fact is that U.S. financial markets are unparalleled globally in terms of depth, liquidity, and governance, which makes the dollar the most desirable medium of exchange for efficient — and, importantly, transparent — transactions. The euro is the most obvious challenger in this regard, as noted, but it has the major drawback of being a supranational currency, with no single national authority underwriting its viability or ensuring its stability. This weakness became painfully apparent during the Greek and Italian financial crises a decade ago, when a euro breakup for a time seemed a real possibility to many.

The same considerations apply to global trade as well as to global funding. The Fed report cited earlier shows the dollar's share of export financing at virtually 100% within the Americas, and even in the Asia-Pacific region at more than 70%. Most of the world's trade is between U.S.-aligned developed markets and will continue to be denominated in dollars. In this context, recent reports of yuan-denominated oil sales, while significant as evidence of growing geopolitical realignment, are little more than symbolic in terms of overall trade volumes.

The dollar's dominance in international financing and as an international medium of account is backed by its role as a store of value. Trust in the dollar as a store of value is in turn backed by the rule of law and robust institutions, of which the Fed — able to respond quickly and efficiently as a “global firefighter” — is a prime example. The fact that the Fed now regularly opens U.S. dollar swap lines with major developed central banks in times of financial stress should be seen as a sign of U.S. institutional strength as well as of persistent global demand for dollars. This is not the case for the Chinese yuan, for example, whose international role remains, at best, nascent.

Our conclusion is that reports of the imminent demise of the dollar are greatly exaggerated (to paraphrase Mark Twain). We would not dismiss such stories out of hand, because given current geopolitical realignments, *realpolitik* considerations make it understandable that global actors (China, Russia, Saudi Arabia, and some aligned countries) will take steps to try and reduce dependence on the U.S. dollar. That is happening as a global trend, but it is destined to be a very slow-moving one. There should be no danger to U.S. dollar dominance in the short term, given barriers to entry and the difficulties of establishing alternative payments and financing systems. It is fair to say this may be a somewhat negative long-run backdrop for the dollar, but it is unlikely to find expression in any kind of crash. The dollar may drift lower over the long term, but we believe the possible eventual loss of U.S. financial dominance is too broad and slow-moving a trend to be cited as a factor behind an abrupt decline in its exchange rate or the cause of any future turmoil in the global financial market.

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1. Federal Reserve, “The International Role of the U.S. Dollar,” October 6, 2021.

2. “A phenomenon whereby a product or service gains additional value as more people use it,” according to *Oxford Languages*.

# Equities

Chris Haverland, CFA

Global Equity Strategist

## Bear market check-in

After reaching a bear market low of 3,577 on October 12, 2022, the S&P 500 Index has experienced an impressive rally. Still high, but improving inflation readings, lower long-term yields, and anticipation of a pause in rate hikes have supported equity prices. While some are calling this a new bull market, we would caution investors that bear markets have rarely ended prior to economic recessions or while the Fed is still tightening monetary policy.

Investor optimism has been building as we likely approach the end of the current rate-hike cycle. However, we believe the Fed will maintain its restrictive policy stance at least through year-end 2023. And as Wells Fargo Investment Institute President Darrell Cronk pointed out in his latest *State of the Markets* report: When things fall apart, equity markets often do not bottom until after the first rate cut. In addition, we forecast a recession beginning later this year, which likely will weigh on corporate earnings and cap near-term upside to equity prices.

The table below shows that the current bear market is below average in length and maximum drawdown. While we are likely closer to the end than the beginning of this bear market, it is unlikely that equity markets will continue unscathed leading up to and during a recession. Equity markets will eventually bottom and look toward a 2024 recovery, but we believe that happens in the recession, not before. Until then, we suggest maintaining a defensive stance in portfolios and leaning toward high-quality assets over low-quality assets.

### S&P 500 Index bear markets

Bear market start	Bear market length (years)	Overlapping recession?	Bear market drawdowns	6-month returns after bear end	12-month returns after bear end	Time to recover previous peak from bear bottom (years)
1946	3.04	Yes	-29.6%	22.8%	42.1%	0.99
1956	1.22	Yes	-21.6%	9.8%	31.0%	0.92
1961	0.54	No	-28.0%	20.5%	32.7%	1.19
1966	0.66	No	-22.2%	22.1%	32.9%	0.57
1968	1.49	Yes	-36.1%	22.8%	43.7%	1.78
1973	1.73	Yes	-48.2%	30.9%	38.0%	5.79
1980	1.70	Yes	-27.1%	44.1%	58.3%	0.23
1987	0.28	No	-33.5%	19.0%	21.4%	1.64
2000	2.55	Yes	-49.1%	11.5%	33.7%	4.64
2007	1.42	Yes	-56.8%	52.7%	68.6%	4.05
2020	0.09	Yes	-33.9%	44.7%	74.8%	0.41
2022*	1.28	-	-25.4%	-	-	-
<b>Average overall</b>	<b>1.34</b>	-	<b>-35.1%</b>	<b>27.4%</b>	<b>43.4%</b>	<b>2.02</b>
<b>Average w/o recession</b>	<b>0.49</b>	-	<b>-27.9%</b>	<b>20.5%</b>	<b>29.0%</b>	<b>1.14</b>
<b>Average w/ recession</b>	<b>1.65</b>	-	<b>-37.8%</b>	<b>29.9%</b>	<b>48.8%</b>	<b>2.35</b>

Sources: Bloomberg and Wells Fargo Investment Institute. Data include 20%+ bear markets. Averages do not include 2022\* data.

2022\* bear market length is from January 3, 2022 – April 17, 2023.

2022\* bear market return is measured from January 3, 2022, to October 12, 2022. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

# Real Assets

*"If agriculture goes wrong, nothing else will have a chance to go right." — M.S. Swaminathan*

**Mason Mendez**

Investment Strategy Analyst

## A sugar-sweet rally

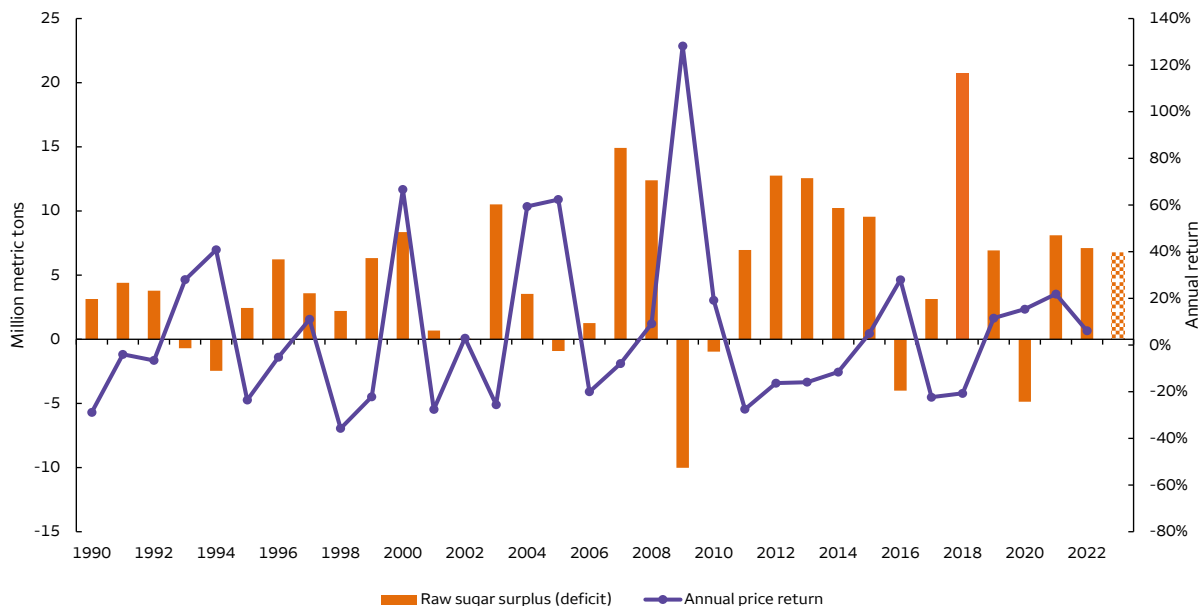
2023 has been a sweet year for sugar, and prices are up 23% as of April 21, 2023. In fact, it may be surprising to learn that sugar is the best-performing commodity in 2023. Strong performance is being fueled by near-term expectations for reduced supply among key growers in Asia. Tread carefully, though, as there are indications that Brazil could reap a record harvest later in 2023, which could stall the price rally.

Brazil and India are the two largest raw sugar producers in the world, accounting for 19.7% and 20.4% of global production, respectively, as of December 31, 2022. In 2022 India held the #1 spot as the largest producer, but that could change in 2023, as poor growing conditions are expected to reduce India's harvest by 3% (1 million metric tons). Brazil, on the other hand, is expected to experience more favorable conditions, which could translate into a production jump of 7% (2.6 million tons).

Why the extra potential supply from Brazil could matter to future sugar prices is because it has in the past. This can be seen in the chart below, where positive orange bars indicate surplus sugar and the indigo line shows annual returns. Notice the lower-than-average returns during periods of extra sugar supplies. Of course, past performance is no guarantee of future results.

The bottom line is that while sugar surpluses have been shrinking recently, investors should be aware that Brazil is expected to reap a record harvest later in 2023, which could sink future sugar prices as it often has in the past.

### Raw sugar prices vs. supply and demand balance



Sources: Bloomberg and Wells Fargo Investment Institute. Annual data are from December 31, 1990 – December 31, 2023. U.S. Department of Agriculture estimates for 2023 are shown by the orange dotted bar. **Past performance is no guarantee of future results.**

# Alternatives

**Arun Kumar, CFA**

Lead Retail Research Analyst

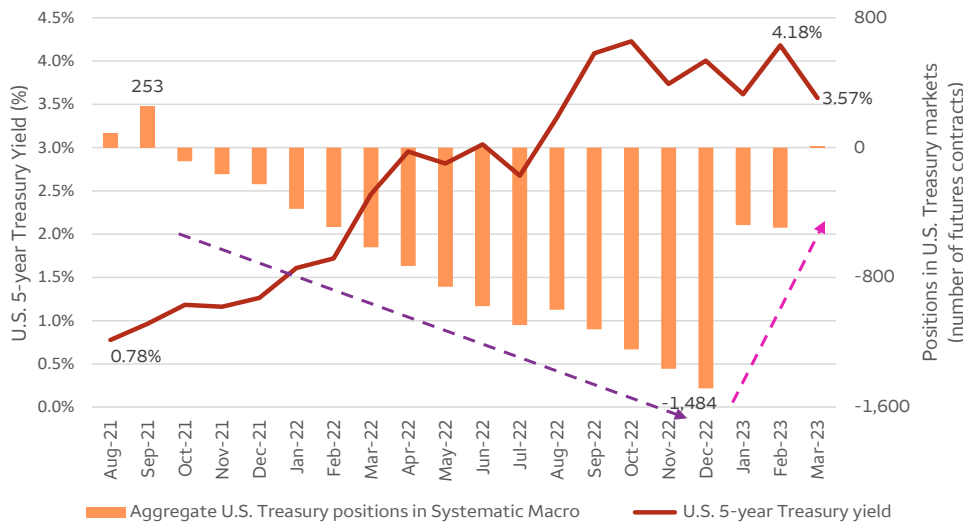
## Systematic Macro demonstrates ability to adapt

One of the attractive attributes of the Systematic Macro strategy is that managers generally build their positions slowly, based on market price trends in fixed income, equity, currency, and commodity markets. The system generally works by gradually building positions as these price trends extend themselves over time, but the system also can adapt quickly if the trend has a sudden reversal.

The chart below illustrates a recent example. The bars in the chart depict the total number of short positions in some U.S. Treasury note markets. (A short position is one that allows the manager to benefit when the price of an asset declines. The negative numbers indicate short contracts.) The line in the chart shows 5-year U.S. Treasury yields since August 2021. Bond prices generally fell last year and led managers to take more short positions as the year progressed. Essentially, managers were well positioned for profiting from the price declines. However, March 2023 was a reversal month: Yields dropped and bond prices rose as several U.S. banks and a European bank came under financial pressure. The rise in prices undercut Systematic Macro strategy performance somewhat, but we want to illustrate how quickly the number of short Treasury futures positions declined during the month.

Although March was a difficult month for the category, Systematic Macro strategies have shown gains since the beginning of 2022. We maintain our favorable guidance on such strategies, in large part because their trading systems potentially can profit in up- as well as down-trending markets, and because these systems can adapt their positioning very quickly.

### U.S. 5-year Treasury yields and illustrative positioning\* in Systematic Macro



Sources: Societe Generale and Wells Fargo Investment Institute. Monthly data, August 2021 – March 2023. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. **Past performance is no guarantee of future results.**

\*The bars represent aggregate Treasury futures contracts (number of contracts for \$2 billion constant portfolio size in U.S. 2-Year, 5-Year, 10-Year, and 30-Year Treasury futures markets) at the respective month ends. Positioning is based on Societe Generale’s 20/120 day moving average cross-over strategy. All four U.S. Treasury markets used in Societe Generale’s methodology are included in the above illustration.

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.

## Current tactical guidance

### Cash Alternatives and Fixed Income

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
	U.S. Intermediate Term Taxable Fixed Income High Yield Taxable Fixed Income	Cash Alternatives Developed Market Ex-U.S. Fixed Income Emerging Market Fixed Income	U.S. Taxable Investment Grade Fixed Income	U.S. Long Term Taxable Fixed Income U.S. Short Term Taxable Fixed Income

### Equities

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
U.S. Small Cap Equities	Emerging Market Equities	U.S. Mid Cap Equities Developed Market Ex-U.S. Equities	U.S. Large Cap Equities	

### Real Assets

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
		Private Real Estate	Commodities	

### Alternative Investments\*

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
		Hedge Funds—Event Driven Hedge Funds—Equity Hedge Private Equity Private Debt	Hedge Funds—Relative Value Hedge Funds—Macro	

Source: Wells Fargo Investment Institute, April 24, 2023.

\*Alternative investments are not appropriate for all investors. They 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. Please see end of report for important definitions and disclosures.

### 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. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate. 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.

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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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