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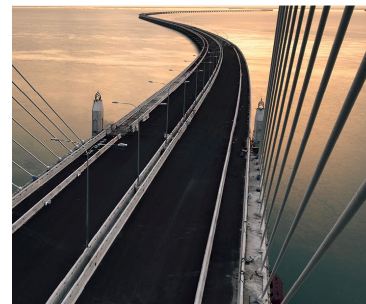

Investment Strategy

Weekly guidance from our Investment Strategy Committee **June 20, 2023**

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- As investors reallocate holdings toward cash and short-term fixed income, we believe it is prudent to align portfolio allocations with the designated investment objective, as large deviations from strategic and tactical weightings could lead to lost opportunities.
- We continue to favor a barbell approach to fixed-income positions. We believe maintaining exposure to high-quality equities could also help investors navigate through today's complex macroeconomic environment.

Equities: Stay defensive until recovery is in sight 4

- After earnings contract in 2023, we expect them to expand modestly in 2024 as the economy emerges from recession. We expect valuations likely will rebound in 2024 to anticipate an earnings recovery.
- Our defensive positioning favors quality ahead of a recession. However, once risk and reward turn more favorable for economic and earnings recoveries, we expect our preferences to lean more cyclically.

Fixed Income: Better times ahead for emerging market debt 5

- With U.S. Treasury yields close to their peaks, we may have seen the end of the longest period of negative returns for emerging market (EM) sovereign debt in two decades.
- The prospect of a moderate recession in the U.S. in coming quarters may widen spreads and keep returns capped for now, before a return to stronger performance more in line with historical norms in 2024.

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- We expect modest commodity performance throughout the remainder of 2023, before a resumption of the bull super-cycle[1] and higher prices in 2024.
- We recently lowered our West Texas Intermediate (WTI) and Brent crude oil, and Bloomberg Commodity Index targets for 2023 and 2024 as recession fears remain a potent headwind.

Alternatives: An update on technology private deal activity 7

- Technology private deal activity remains robust, and general partners are pursuing opportunities to take companies private while valuations are still depressed.
- Technology-focused sponsors continue to be able to fundraise.

Current tactical guidance 8

Investment and Insurance Products: ➤ NOT FDIC Insured ➤ NO Bank Guarantee ➤ MAY Lose Value

1. Bull super cycles are an extended period of time, historically 15-20 years, where commodity prices move upward together.

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Asset Allocation Spotlight

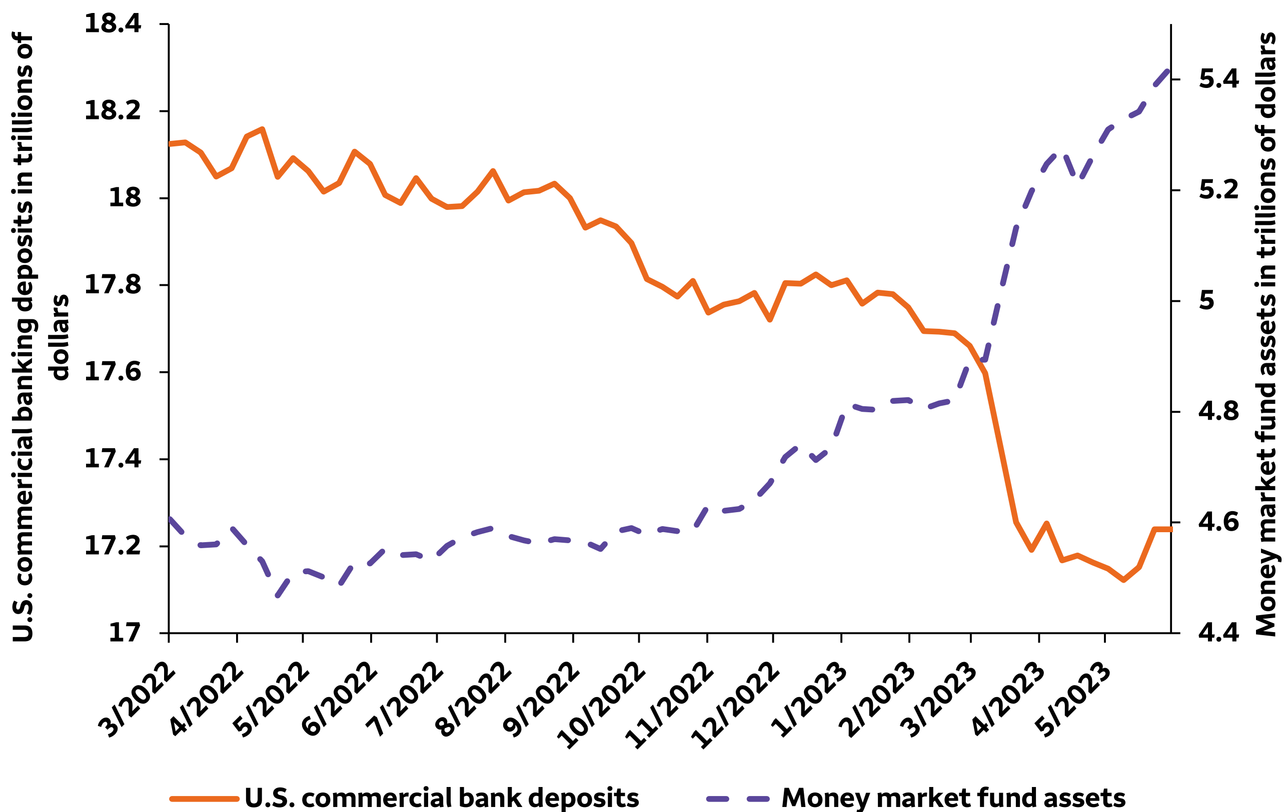
Michelle Wan, CFA
Investment Strategy Analyst

Michael Taylor, CFA
Investment Strategy Analyst

Beware of cash concentration

Short-term U.S. Treasury bills in the 3- to-12-month maturity range currently offer yields above 5%.[2] Since the Federal Reserve (Fed) began raising interest rates last year, higher-yielding money market funds have gradually attracted investors, and then experienced a surge of inflows after bank failures earlier this spring roused a perceived flight to deposit safety. We are currently most favorable on U.S. Short Term Taxable Fixed Income and agree with a "getting paid to wait" approach.[3] Yet, we caution investors to recognize the potential risks of waiting and not to ignore other asset classes.

Chart 1. Money market fund investment has surged in 2023



Sources: Bloomberg and Wells Fargo Investment Institute. Money market fund data is reported by Investment Company Institute (ICI), including retail and institutional money market funds. Commercial bank deposits are reported by the U.S. Federal Reserve under Asset and Liabilities of Commercial Banks in the United States H. 8 Table 1. Data as of June 7, 2023.

2. Bloomberg data, June 9, 2023.
3. "Getting paid to wait," *Market Commentary*, June 1, 2023.

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Potential risks in the market

Since January, the Treasury General Account (TGA) has declined notably. Now that the U.S. debt ceiling is suspended, we expect new issuance from the Treasury could exceed $1 trillion. To date, the Fed has contained balance-sheet growth, and foreign investors have reduced their holdings of U.S. debt. U.S. investors with sidelined dry powder will likely be the main purchasers of the new debt issuance.[4] We see three potential effects to consider as these new issuances increase Treasury supply and investors procure them through direct purchases or through money market funds:

- Liquidity: Investors with sizable cash holdings could continue seeking to take advantage of attractive short-term yields. These transactions have the potential of reducing liquidity in the market — one of the key factors supporting market resilience and subdued volatility thus far this year. Liquidity reduction along with bank-lending tightening could propel downside risks, such as a credit crunch, to develop faster, increasing the risk of a Fed policy misstep as policymakers aim to reduce inflation while tightening at a level that avoids a deep recession. A mitigating factor could be that bank reserves at the Fed could be used to purchase new issuance and offset the potential liquidity drain in the market.
- Crowding-out effect: As investors allocate into fixed-income assets with short-term maturities, they might overly reduce investments in long-term fixed income and other asset classes, such as equities and commodities, to fund purchases. This crowding-out effect could lead to underexposure to asset classes that may potentially offer return opportunities and a lower downside participation as the macroeconomic landscape changes. We are in a complex economic and market environment with a variety of risk factors. A singular focus on short-term yield may lead investors to be blindsided by unanticipated risks that could lead to investment results deviating far from a disciplined strategy.
- Reinvestment risk: If a sizeable portion of a portfolio is held in money market or short-term bond funds, investors should consider the possibility of reinvestment risk. Short-term fixed-income yields may decline as the Fed shifts interest rate policy in the second half of the year. After a few months, short-term fixed-income assets may mature at a time when long-maturity bonds are more expensive. We favor a barbell approach for fixed-income holdings in today's milieu to help potentially mitigate reinvestment risk.

Implications for investors

Our investment outlook is that a moderate recession will likely occur as economic conditions continue to weaken. Therefore, we believe that maintaining a defensive strategy focusing on high-quality assets is an effective strategy to ride out a potential economic downturn.

While investors wait for equity market opportunities to appear, we believe that short-term fixed income and money market funds may offer attractive yields. Yet, we do not favor drifting too far from our tactical equity underweight guidance by reallocating disproportionally into money market funds or short-duration Treasury bills. Should the risks mentioned above materialize, we believe market volatility could resurge as Fed policy responds to unfolding economic data over the next few months. This could lead to market turmoil in various asset classes.

Our research shows that it is extremely difficult to time the market and that missing the best days in the market could create drag on return for long-term investors. For these reasons, we believe investors should continue to diversify their allocations by maintaining exposure to a mix of asset classes while adopting an underweight to equities and an overweight to fixed income based on our most recent guidance.[5]

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4. "The coming Treasury issuance deluge," Piper Sandler, June 12, 2023.
5. "Announcing 2024 targets, and updated guidance," *Institute Alert*, April 21, 2023.

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Equities

Chris Haverland, CFA
Global Equity Strategist

Stay defensive until recovery is in sight

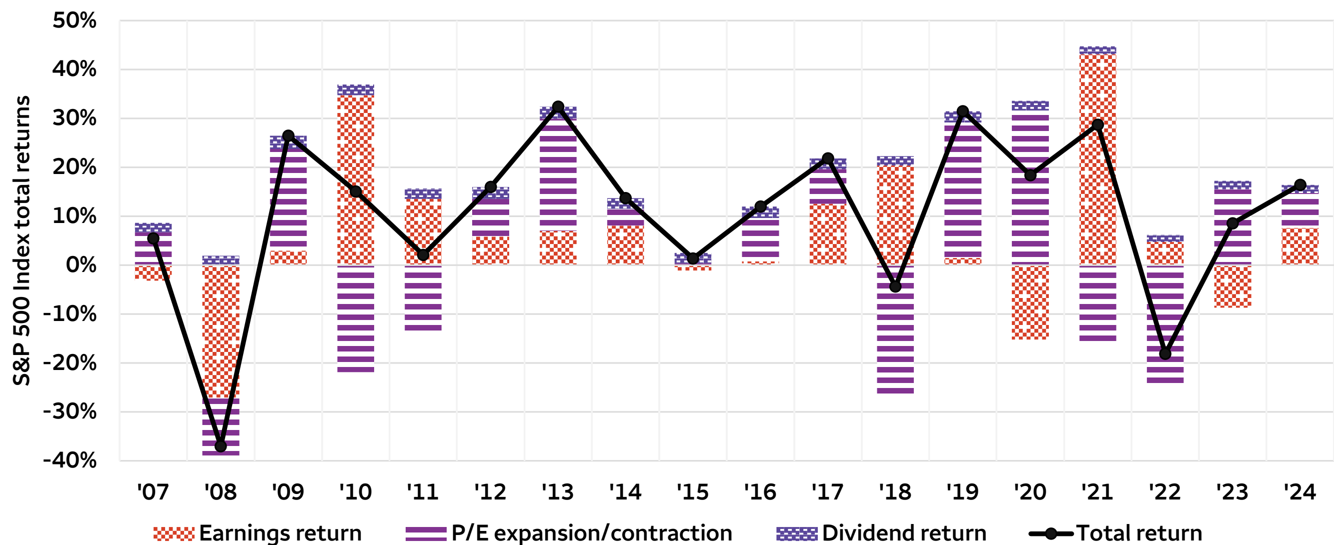
While equity markets are positive year-to-date, the economic and earnings weakness we anticipate should drive prices lower later this year. As the economy weakens, our preference for quality and more defensive positioning in portfolios remains in effect. We continue to favor U.S. Large Cap Equities over U.S. Mid Cap Equities and U.S. Small Cap Equities.

Our view is that 2023 corporate revenue growth should stall as a recession begins. Throw in sticky input and wage costs, and we expect operating margins to continue declining toward pre-COVID-19 levels. We anticipate that profits should rebound through 2024, as we expect the economic recovery to gradually take hold, but corporate earnings may not recapture their 2022 peak until early 2025.

As is typical, equity prices likely will increase at a much more rapid pace than earnings can recover, leading to price/earnings (P/E) multiple spikes and above-average valuations in 2024. However, once the earnings recovery catches up to the price recovery during the back half of next year, we expect multiples to revert to average levels.

Once the recession appears to be fully priced in to market valuations, we expect an opportunity to position for an emerging 2024 recovery. Based on prior cycles, we believe that time will likely come while the economy is still within the grips of the recession. In 2024, we foresee the end of the recession, the Fed cutting interest rates, an economic rebound in the U.S. and abroad, and easing credit conditions — in short, a favorable environment for risk assets.

Earnings growth and P/E expansion may potentially drive total return for the S&P 500 Index in 2024



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of June 13, 2023. 2023 and 2024 are Wells Fargo Investment Institute forecasts. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.**

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Fixed Income

Peter Wilson
Global Fixed Income Strategist

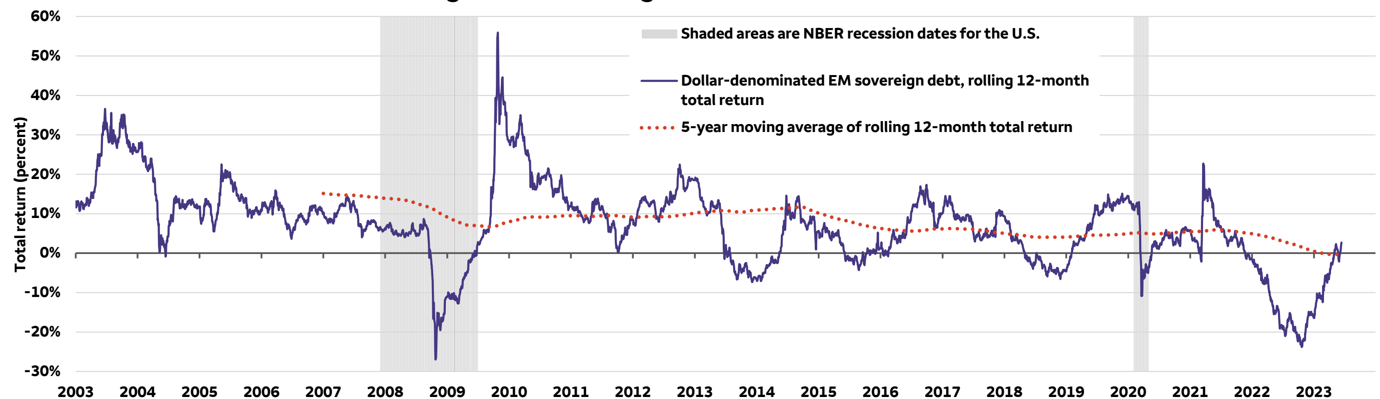
Better times ahead for emerging market debt

The past two years have been a testing time for EM bonds. The chart shows that rolling year-over-year returns reached a low point of -24% in 2022 before rebounding. The duration (a measure of a bond's interest rate sensitivity) of this period of negative returns was such that the 5-year moving average of annual returns has fallen below zero, performance not seen since the EM crises of the late 1990s.

Although sovereign credit spreads were volatile and generally wider in 2022, the main driver of these negative returns was the rise in underlying U.S. Treasury yields. The 10-year Treasury note yield rose from near 1.5% at the end of 2021 to a peak of 4.25% in October 2022, and this October peak exactly coincides with the nadir of EM sovereign debt returns — which is unsurprising since the dollar-denominated sovereign debt had a relatively long duration of eight years at the end of 2021.

The good news is that, given current levels[6] for 10-year yields just below 3.75%, and our year-end 2024 target range of 3.75% – 4.25%, we do not expect notably higher Treasury yields this cycle. We believe that this means that the higher yields of EM sovereign debt (around 7.75% at the index level[7]) should not be undercut by capital losses as they were in 2022. The less good news is that before the end of 2024, we expect the U.S. to pass through a recession, albeit a moderate one. This development would likely be accompanied by wider EM sovereign spreads and somewhat higher EM yields, even if this should be partially offset by temporarily lower longer-term Treasury yields during any recession. Such an outlook may keep prospective returns capped for now, but we anticipate these will return closer to historical levels (in the mid- to high-single digits) if recession turns to recovery in 2024, as we expect.

U.S. dollar-denominated EM sovereign debt — rolling annual returns



Sources: JP Morgan Indexes, Wells Fargo Investment Institute, and National Bureau of Economic Research (NBER). Dollar denominated sovereign debt measured by JP Morgan Emerging Markets Bond Index Global (EMBIG). An index is unmanaged and not available for direct investment. EM = emerging markets. Latest data as of June 12, 2023. **Past performance is no guarantee of future results.**

6. Here and elsewhere in text, latest data as of close June 12, 2023.
7. The index used is the JP Morgan Emerging Markets Bond Index Global (EMBIG). See disclosures for index definitions.

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Real Assets

"Sometimes you need to press pause to let everything sink in." – Sebastian Vettel

Mason Mendez
Investment Strategy Analyst

John LaForge
Head of Real Asset Strategy

Lower targets, but super-cycle still intact

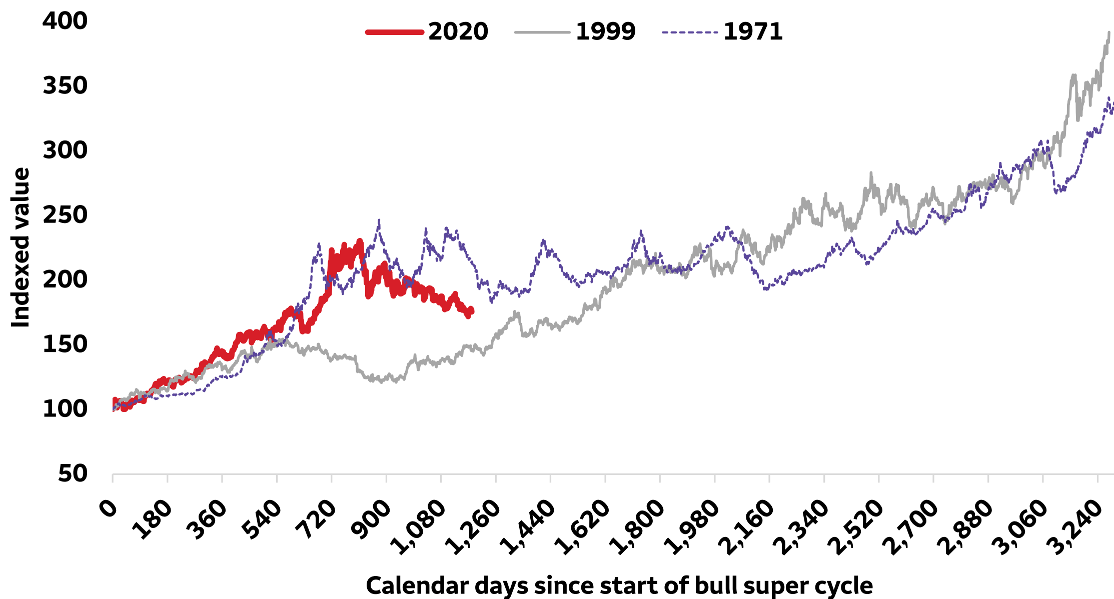
Commodity prices have moderated in 2023, and the Bloomberg Commodity Index (BCOM) is down 9.4% year-to-date, as of June 12. In response to weak performance and a looming recession, we recently lowered our year-end crude oil and BCOM targets. Despite lower targets, though, we stress that we are still favorable on Commodities and believe the bull super-cycle that began in March 2020 is still intact.

For 2023, we lowered our WTI and Brent crude targets to $80-$90 per barrel and $85-$95 per barrel, respectively, as we expect recession fears to be a potent headwind for higher prices in the coming months. Our new 2024 year-end crude targets are much higher for WTI ($90-$110 per barrel) and Brent crude ($95-$115 per barrel), reflecting our expectations for a re-tightening of supply and resumption of the bull super-cycle.

As a result of lower crude oil targets, we also lowered our 2023 and 2024 BCOM targets to 235-255 and 255-275, respectively. Even with lower BCOM targets, we still believe the bull super-cycle is on track. Historically, super-cycle performance has not been a straight shot —there have been periods in most bull super-cycles when strong performance has taken a pause. As seen in the chart below, these pauses have been temporary, and a normal part of the multi-year super-cycle.

In our view, 2023 marks one of those pauses, before a revival of the bull super-cycle and stronger performance in 2024. Our new targets in the 2023 Midyear Outlook reflect this view, and we believe that current price weakness across the commodity complex potentially an opportunity for investors to potentially benefit from the long-term bull super-cycle.

Modern commodity bull super-cycles



Sources: Bloomberg, Prices by G.F. Warren and F.A. Pearson, Bureau of Labor Statistics (BLS), National Bureau of Economic Research (NBER), Reuters, and Wells Fargo Investment Institute. Performance is indexed to 100 as of the start of the bull super-cycle, and measured from October 4, 1971 – November 20, 1980, July 13, 1999 – July 2, 2008. Daily data from March 18, 2020 – June 12, 2023 was used for the current super-cycle. **Past performance is no guarantee of future results.**

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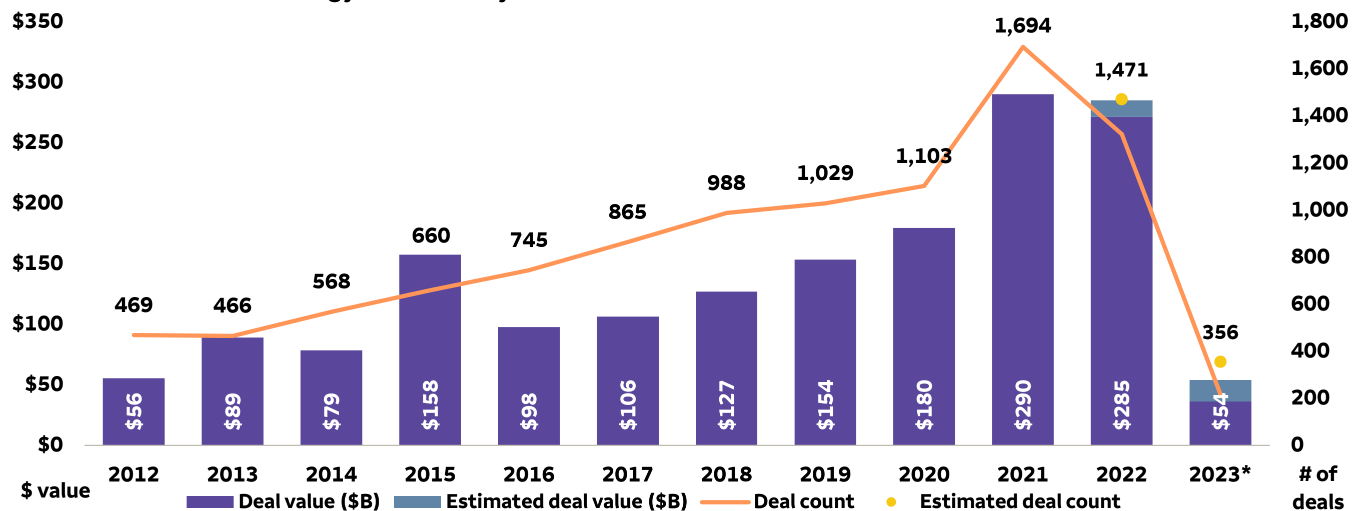
Alternatives

Karin Geldfeld
Senior Research Investment Analyst

An update on technology private deal activity

As public markets continued their volatility in 2022 and into 2023, the Information Technology sector still garnered a lot of interest and capital from the private equity sector. While the dollar value of technology private equity deals dropped from a record $290.3 billion in 2021 to $285.3 billion in 2022, according to Pitchbook, this was still the second-best year for technology deal volume on record, dating back to 2012 (see chart).

U.S. Information Technology deal activity



Sources: Pitchbook and Wells Fargo Investment Institute, annual data, 2012 – 2022. Data for 2023 is for January – March, the latest available. *Estimate through March 31, 2023.

As one might expect, private equity sponsors have turned to "take-privates" — in other words, taking public companies off the exchanges and turning them back into private companies — as public technology company valuations have declined, and growth has been hampered by interest rate increases over the past year. According to Pitchbook, over half of the take-private deals in 2022 were technology-oriented — a trend that has carried into this year as well, with software take-private deals making up half of the 10 take-private deals in the first quarter of 2023.

Finally, on the fundraising front, the private equity landscape is divided into the "haves" and "have-nots," and not surprisingly, technology sponsors have mostly performed well in the past decade. As such, technology-focused general partners (both generalists with technology focus and technology specialists) continue to fundraise with more ease, given the stellar track records they have garnered.

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.

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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, June 20, 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.

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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. There are no guarantees that **value stocks** will increase in value or that their intrinsic values will eventually be recognized by the overall market. **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.

Sovereign debt is generally a riskier investment when it comes from a developing country and tends to be a less risky investment when it comes from a developed country. The stability of the issuing government is an important factor to consider, when assessing the risk of investing in sovereign debt, and sovereign credit ratings help investors weigh this risk.

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.

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 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.

JPMorgan Emerging Markets Bond Index Global (EMBI Global), which currently covers 27 emerging market countries. Included in the EMBI Global are U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

Commodity Composite: Measures a basket of commodity prices as well as inflation. It blends the historical commodity index introduced by George F. Warren & Frank A. Pearson, former academics at Cornell, collected and published commodity price data in their book, Prices, and the producer price index for commodities (PPI-Commodities), and the National Bureau of Economic Research (NBER) Index of Spot Market Prices of 22 Commodities and the Reuters Continuous Commodity Index. The index components and weightings, from Warren and Pearson's Prices, change over time but the 11 commodity groups used from 1786-1932 are: Farm Products, Foods, Hides and Leather products, Textile Products, Fuel and Lighting, Metals and Metal Products, Building Materials, Chemicals and drugs, Spirits (stopped tracking 1890), House furnishing Goods, and Miscellaneous. The PPI-Commodities is compiled by the Bureau of Labor Statistics and shows the average price change from the previous month for commodities such as energy, coal, crude oil and the steel scrap. The NBER Index of Spot Market Prices of 22 Commodities is a measure of price movements of 22 sensitive basic commodities whose markets are presumed to be among the first to be influenced by changes in economic conditions. The Reuters Continuous Commodity Index comprises 17 commodity futures that are continuously rebalanced: cocoa, coffee, copper, corn, cotton, crude oil, gold, heating oil, live cattle, Live hogs, natural gas, orange juice, platinum, silver, soybeans, sugar no. 11, and wheat.

An index is unmanaged and not available for direct investment.

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