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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **October 16, 2023**

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- The correlation between equities and fixed income has increased significantly over the past two years, but equities are still much less correlated with fixed income than with other asset classes.
- While the recent uptick in correlations has led to an increase in the longer-term correlation, bonds still play an important role in the portfolio from a diversification and a yield standpoint.

Equities: With 5% bond yields, why bother with stocks? 4

- Those who argue for the value proposition of bonds over stocks often correctly point out that U.S. Treasury interest rates currently exceed the two more visible stock yields: dividend and buyback yields.
- While we agree that bonds look compelling today, we believe that this simplistic comparison misses a major component of the stock value proposition: earnings.

Fixed Income: Five reasons to hold bonds — even when rates are rising . 5

- The Federal Reserve is likely to keep interest rates elevated well into next year. Despite high yields, there are many benefits to owning bonds.
- Higher yields have led to negative market price performance for many fixed-income securities. However, the higher yields also now provide the potential for positive real returns (the return over inflation) going forward.

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- Rising global real interest rates, comparatively high and rising U.S. Treasury yields, and a strengthening U.S. dollar have hit the price of gold in recent months.
- We suspect, however, that these headwinds will fade in 2024, opening up gold to have a strong 2024.

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- We continue to believe the investment opportunity set within the distressed credit category should continue to grow as the elevated interest rate environment continues to weigh on overly indebted small and mid-sized businesses.
- We continue to maintain favorable guidance on the distressed credit hedge fund category and distressed credit/special situations private capital strategies, as we expect stress and distress levels to rise further in the coming quarters.

Current tactical guidance 8

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Asset Allocation Spotlight

Veronica Willis
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Jeremy Folsom
Investment Strategy Analyst

Fixed income still a strong counterbalance for equities

Over the past two years, an increase in the correlations (percentage of time when assets move in the same direction) between equities and fixed-income asset classes has raised concerns about the value of holding bonds in a diversified portfolio. The value of diversification is driven in large part by the correlations among assets held in that portfolio. If all the assets held were perfectly positively correlated, there would be no diversification benefit because the assets would move in the same direction 100% of the time. Because bonds have tended to have low to no correlation with equities over the past two decades, the inclusion of fixed income in a diversified allocation has helped to stabilize portfolio performance by rising and acting as buffer during equity market downturns.

This basic tenet of diversification theory did not hold up well in 2022, as an equity bear market commenced and bond prices also sharply declined, courtesy of the Federal Reserve's (Fed's) aggressive tightening campaign. In fact, in 2022, equities and fixed income (as measured by the S&P 500 Index and Bloomberg U.S. Aggregate Bond Index) declined for three consecutive quarters for the first time in decades. Since then, correlations have remained high as interest rates have generally moved higher (bond prices have dropped) during periods when the stock market has corrected. That's because bond investors are betting that the Fed will keep interest rates higher for longer and equity investors are concerned about the impact of higher rates on the economy.

Table 1: Average 20-year and 1-year correlations between equities and fixed income

Correlation as of	20-year equities vs. bonds	1-year equities vs. bonds
December 2019	**-0.36**	**-0.09**
December 2020	**-0.32**	**-0.40**
December 2021	**-0.26**	**0.16**
December 2022	**0.02**	**0.77**
September 2023	**0.03**	**0.76**

Sources: © 2023 – Morningstar Direct, All Rights Reserved*, and Wells Fargo Investment Institute as of September 30, 2023. YTD = year to date. Equities represented by S&P 500 Index. Fixed income represented by the Bloomberg U.S. Aggregate Bond Index. Correlations shown are the 20-year or 1-year correlations calculated using quarterly total returns as of the end of the month specified. **Past performance is no guarantee of future results**. An index is unmanaged and not available for direct investment.

The sharp short-term rise in correlations in 2022 led to a rise in the long-term correlation from negative to just above zero.

Fixed income vs. equity correlation not that high, both historically and comparatively

The rapid increase in correlation between equities and fixed income has come in stark contrast to the period of extremely low — and even negative at times — correlation over most of the past two decades. While the correlation between equities and fixed income climbed higher in 2022 and has remained elevated, it is still relatively low compared to the market environment from the 1980s to 2000s. Additionally, when compared to other diversifiers like commodities and hedge funds, fixed income remains less correlated with equities.

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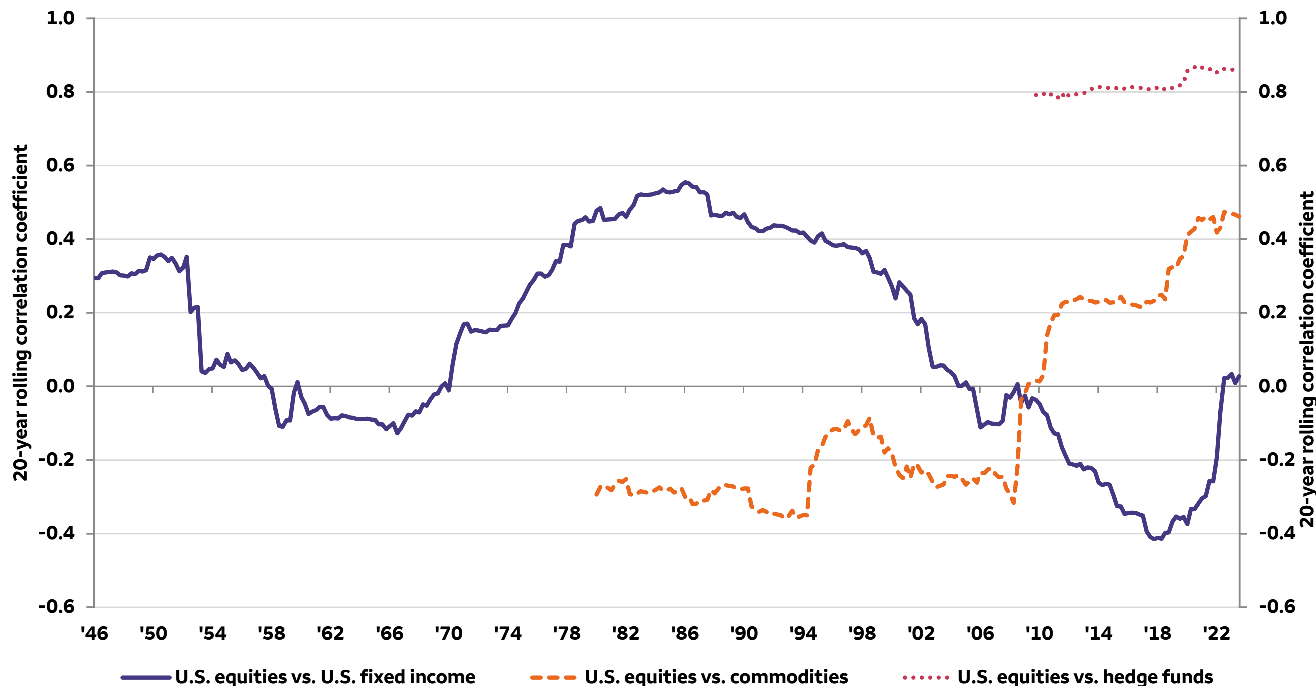
Chart 1. Long-term equity correlation with fixed income remains relatively lower than with other asset classes



Sources: Bloomberg, © 2023 – Morningstar Direct, All Rights Reserved*, and Wells Fargo Investment Institute. Quarterly data from January 1, 1946 to September 30, 2023. U.S. equities represented by S&P 500 Index. U.S. equities vs. commodities from 1980 to 2023. U.S. equities vs. hedge funds from 2010 to 2023. U.S. fixed income represented by a blend of IA SBBI U.S. Long-Term Government Bond Index and IA SBBI U.S. Long-Term Corporate Bond Index until 1976, and then the Bloomberg U.S. Aggregate Bond Index. Commodities represented by Bloomberg Commodity Index. Hedge funds represented by the HFRI Fund Weighted Composite Index. Correlations are calculated using monthly total returns. **Past performance is no guarantee of future results**. An index is unmanaged and not available for direct investment.

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Year to date, we've seen signs of stabilization in the correlation between equities and fixed income, and in our view, we do not expect a continued, extended period of extremely high short-term correlations. Correlations should normalize from current elevated levels if markets return to more normal conditions as we expected. As such, we do not expect long-term correlations to move much higher, and we anticipate that fixed income will continue to provide an attractive counterbalance to equity market volatility.

Long-term, income-focused investors may consider adding fixed income exposure to potentially aid risk mitigation efforts and take advantage of today's elevated yields. In July 2023, we published updated long-term strategic allocations that included a small increase to U.S. Taxable Investment Grade Fixed Income for investors with an Income objective. Long-term investors with an Income objective should consider locking in higher U.S. Long Term Fixed Income yields. Meanwhile, U.S. Short Term Fixed Income remains a solid investment to take advantage of the higher yield environment and as a liquid place to park cash intended for future trading opportunities.

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Equities

"Chance fights ever on the side of the prudent." — Euripides, Greek playwright

Austin Pickle, CFA
Investment Strategy Analyst

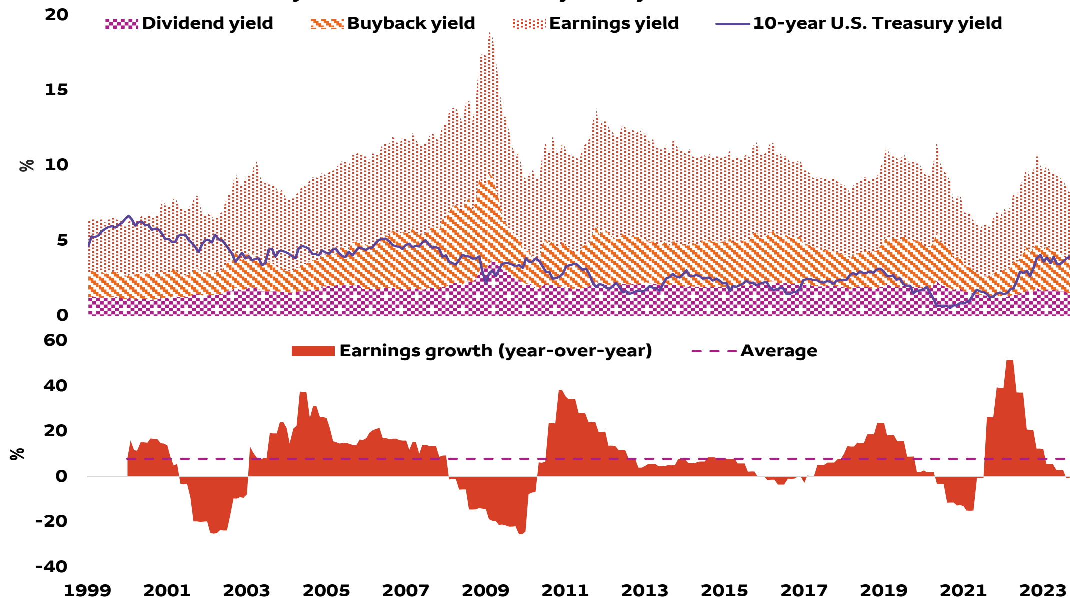
With 5% bond yields, why bother with stocks?

With long-term interest rates having broken out lately, we have increasingly been getting questions as to the value proposition of stocks versus bonds. Essentially the questions boil down to this: "Why should investors bother with stocks with long-term Treasury yields near 5%?" Let's discuss.

Those who argue for the value proposition of bonds over stocks often correctly point out that U.S. Treasury interest rates currently exceed the two more visible stock yields: dividend and buyback yields. While we agree that bonds are compelling today, especially coming out of the ultra-low interest rate environment of the past decade, we believe that this simplistic comparison misses a major component of the stock value proposition: earnings. While earnings are not tangible payouts to investors like dividends, they are the driving force of stock price gains, and how much investors pay for those earnings matters. When this earnings yield[1] is considered, aggregate stock yields handily surpass the 10-year U.S. Treasury yield (see chart below). The propensity of stocks to grow earnings over time has helped power stocks to greater long-term historical total returns than bonds throughout both high- and low-interest rate environments.

This is not to say that investors should ignore bonds and load up on equity exposure. In fact, given our outlook for a recession, we favor leaning toward the relative stability of bonds by overweighting fixed income at the expense of equities. But stocks do offer more than just a dividend and buyback yield, and investors should be aware.

Stocks offer more than just a dividend and buyback yield



Sources: Bloomberg, Wells Fargo Investment Institute. Stock yields and earnings growth represented by the S&P 500 Index. Monthly data: January 31, 1999 – September 30, 2023. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment.

1. Earnings divided by price.

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Fixed Income

Brian Rehling, CFA
Head of Global Fixed Income Strategy

Five reasons to hold bonds — even when rates are rising

Fixed-income investors have faced a difficult environment of rising yields over the past several years. Still, for many investors, bonds should continue to play an important investment role. We highlight several factors to consider when selecting a bond allocation. Those factors include performance, diversification, volatility, yield, and liquidity.

Performance – Investors should focus on total return (income plus price change), not just the movement of bond prices. Investors may also consider that holding a bond to maturity, should the issuer not default, will result in receiving the expected cash flows and principal at maturity — regardless of whether interest rates increase or decrease.

Diversification — The foundation of modern portfolio theory suggests that having a well-diversified mix of major asset classes, primarily stocks, fixed income, and cash alternatives, may help investors take advantage of different market environments and optimally balance risk and return. The next two years are unlikely to look like the past two years from an asset class performance perspective.

Volatility — While investors have experienced that losses are possible in fixed-income positions; the price movements have been less severe than the downside seen in equity markets at times over the past two years. Moving out of fixed income into equities may lead to concentration in an asset class that historically has exhibited greater volatility in the search for return.

Yield — As yield have increased, so has the potential for higher coupon payments. Many bonds now offer investors the potential for a positive real return (the return over inflation).

Liquidity — For predictability, consider holding bonds to maturity. For most fixed-income securities, the price on investors' statement will fluctuate, but this has no impact on cash flow or what the issuer pays at maturity if the security is held to maturity.

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Real Assets

"As good as gold." — Charles Dickens

John LaForge
Head of Real Asset Strategy

Mason Mendez
Investment Strategy Analyst

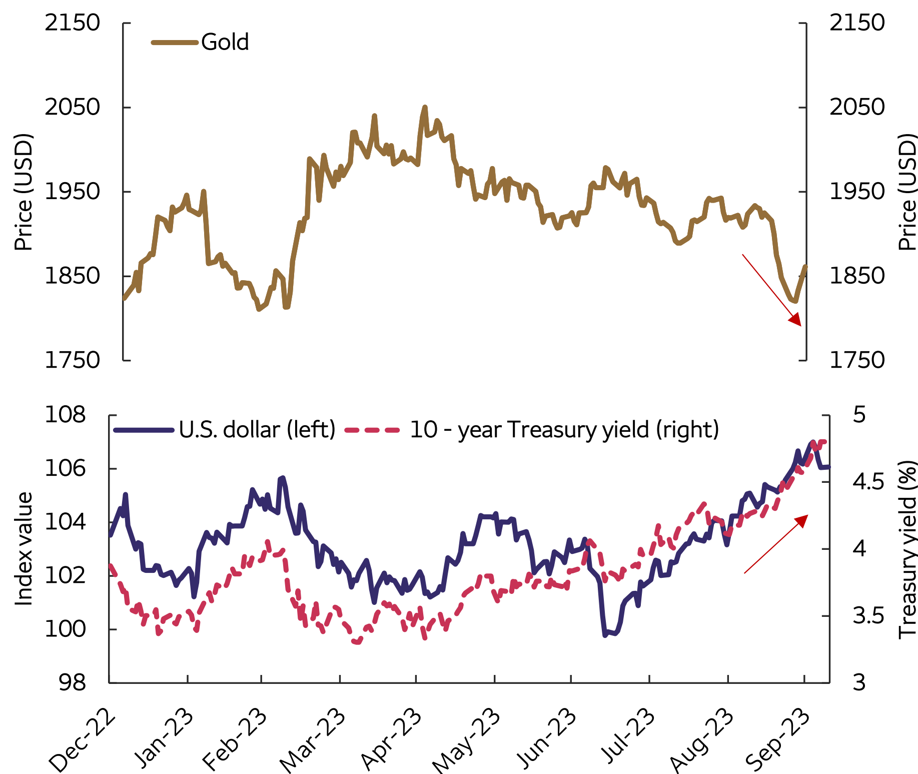
Golden woes

Gold prices started 2023 strong, up 8% by the end of March (see top panel of chart). While the price of gold is still positive year-to-date (through October 9), the gain has dropped to 1.2%. We believe three macro headwinds are to blame: 1.) rising and positive global real interest rates, 2.) comparatively high U.S. Treasury yields (see bottom panel of chart, red dashed line), and 3.) a rising U.S. dollar (see bottom panel of chart, solid blue line).

Of these three headwinds, we view the rising U.S. dollar as the most influential in recent months (although all the headwinds are somewhat connected). The U.S. dollar has an impact because gold is traded globally in U.S. dollars, but 92% of global gold demand comes from consumers outside the U.S. Most of these consumers begin the buying process with local currencies, which must be exchanged for U.S. dollars first. As the U.S. dollar rises, so does the cost of this exchange, which ultimately reduces the amount of gold that can be purchased. When the U.S. dollar is falling relative to other currencies, the cost of the exchange falls and more gold can be purchased.

As for the rest of 2023, we suspect that the U.S. dollar could have a bit more upside still, as much of the globe is bracing for recession. On the plus side, we expect the U.S. dollar to weaken by year-end 2024, which should benefit gold prices. Underneath it all, gold's fundamentals remain strong, especially the supply side, which remains tight. It has been a tough few months recently, but we remain constructive on the yellow metal as we roll into 2024.

Rising Treasury yields and dollar strength weigh on gold prices



Source: Bloomberg, and Wells Fargo Investment Institute. Daily Data is from December 20, 2022 – October 9, 2023. Dollar strength measured by the U.S. Dollar Index. **Past performance is no guarantee of future results.**

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Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

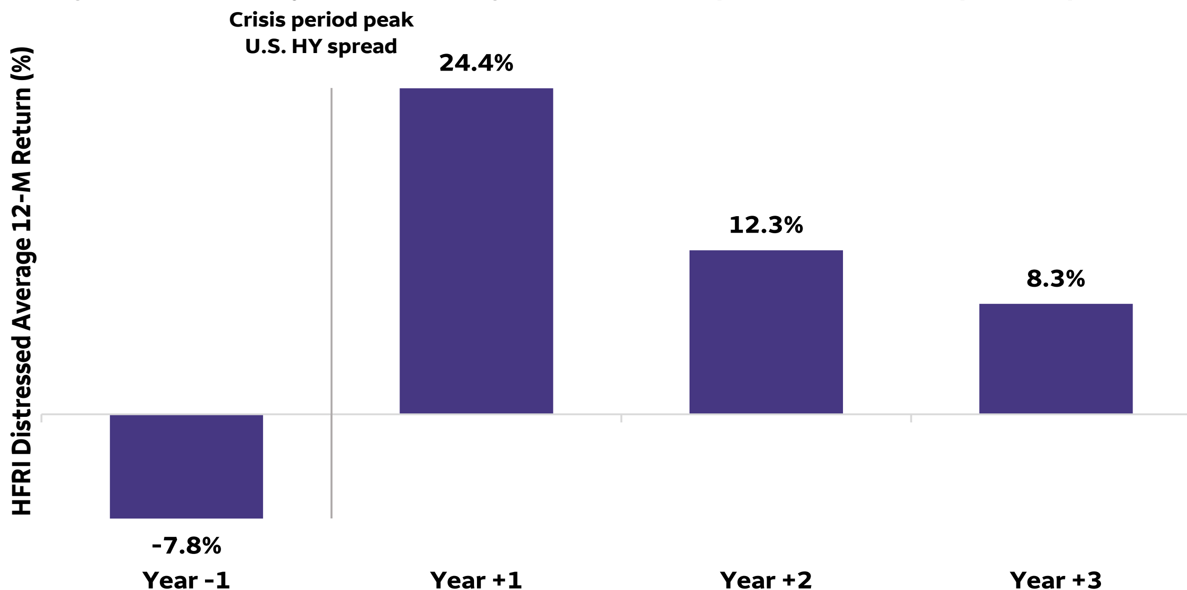
Rapid rise in rates may lead to distressed opportunity

The past decade of low interest rates led to the dramatic growth in debt markets as companies rushed to take advantage of cheap financing. However, the era of "free money" seemingly ended in March 2022 when the Fed embarked on its campaign to stamp out mounting inflationary pressures by raising interest rates 11 times over the course of the following year and a half.

Fed officials have continued to reiterate their belief that "higher for longer" rates may be required to ensure inflation is tamed, as price trends remain above preferred levels in many areas. While the Fed's interest rate hiking cycle may be nearing its peak, the lagged impact of the elevated interest rate environment continues to weigh on overleveraged small and mid-sized businesses. Although credit market stress has eased during the past several months on the belief that the worst may be behind us, we believe the reality of a sustained period of higher rates will likely lead to higher levels of stress, especially among the lower-quality, floating-rate borrowers that remain overly indebted.

Distressed credit hedge funds appear well positioned to capitalize on the rising stress and distress. These funds serve the important role of helping to restructure debt obligations, which can improve a company's overall financial health. As highlighted in the chart, distressed hedge funds have tended to perform well after crisis periods, as the number of investment opportunities expanded. As the data show, outsized returns have been most common during the first year following a crisis, yet the environment historically has remained constructive during subsequent years as opportunities remain abundant.

Average returns made by distressed hedge funds in 7 crisis periods since 1990 (pre- and post-crisis)



Source: Strategic Value Partners, LLC, Bloomberg, and Wells Fargo Investment Institute. Data as of October 4, 2023. Indexes referenced: HFRI Event Driven Distressed/Restructuring Index and ICE BofA US High Yield Index. **For more information on the source, please see source data on page 10. **Past performance is no guarantee of future results**. An index is unmanaged and not available for direct investment.

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, October 16, 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

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.

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 Commodity Index is a broadly diversified index of commodity futures on 20 physical commodities, subdivided into energy, U.S. agriculture, livestock, precious metals, and industrial metals sectors. Commodity weights are derived in a manner that attempts to fairly represent the importance of a diversified group of commodities to the world economy.

Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

HFRI Event Driven Distressed/Restructuring Index: Strategies focus on corporate fixed-income instruments, primarily corporate credit instruments of companies trading at significant discounts to their value at issuance or obliged (par value) at maturity as a result of either formal bankruptcy proceedings or financial-market perception of near-term proceedings. Managers are typically actively involved with the management of these companies; they are frequently involved on creditors' committees in negotiating the exchange of securities for alternative obligations, either swaps of debt, equity or hybrid securities. Managers employ fundamental credit processes focused on valuation and asset coverage of securities of distressed firms; in most cases portfolio exposures are concentrated in instruments that are publicly traded, in some cases actively and in others under reduced liquidity but in general for which a reasonable public market exists. Strategies employ primarily debt (greater than 60 percent) but also may maintain related equity exposure.

HFRI Fund Weighted Index is a fund-weighted (equal-weighted) index designed to measure the total returns (net of fees) of the approximately 2,000 hedge funds that comprise the index. Constituent funds must have either $50 million under management or a track record of greater than 12 months. Substrategies include: HFRI Event Driven, Distressed/Restructuring Index, and HFRI Event Driven (Total) Index.

HFRI Indices have limitations (some of which are typical of other widely used indices). These limitations include survivorship bias (the returns of the indices may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information self-reported by hedge fund managers that decide on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.

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IA SBBI U.S. Long-Term Corporate Bond Index is a custom index designed to measure the performance of long-term U.S. corporate bonds.

IA SBBI U.S. Long-Term Government Bond Index is a custom index designed to measure the performance of long-term U.S. government bonds.

ICE BofA U.S. High Yield Index tracks the performance of U.S. dollar denominated, below investment-grade rated corporate debt publicly issued in the U.S. domestic market.

S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value.

U.S. Dollar Index (USDX) indicates the general international value of the USD. The USDX does this by averaging the exchange rates between the USD and major world currencies.

****Source data:** HFR (for HFRI Distressed Index Returns) & Bank of America Merrill Lynch, US High Yield Index (for measures of the "Crisis Peak Date"). The HFRI Distressed Index Returns are presented for illustrative purposes only, and do not represent the actual return of any particular investor. The following chart represents average annualized return of the HFRI Distressed Index for four distinct periods, in each case, relative to the last day of the applicable month of the date of the widest high yield spreads (the "Crisis Peak Date") for seven different periods of "crisis" as selected by SVP. The four distinct periods are: (1) the twelve months immediately preceding the Crisis Peak Date except for the 1990 crisis ("Yr-1"), (2) the first twelve month period immediately following the Crisis Peak Date ("Yr+1"), (3) the second twelve month period following the Crisis Peak Date ("Yr+2") and (4) the third twelve month period following the Crisis Peak Date ("Yr+3"). The seven period of "crisis" and corresponding Crisis Peak Dates were as follows: 1990 Crisis – 10/31/1990, Asian Financial Crisis – 10/31/1998, 2001-2002 Recession – 10/31/2002, Great Financial Crisis – 11/30/2008, 2011-2012 Debt Ceiling/Euro Crisis – 9/30/2011, "Oil and Gas" Crisis – 1/31/2016, and 2020 COVID – 3/31/2020. It should not be assumed that distressed hedge funds overall, or the Fund, in particular, will perform in a similar manner as past "crisis" periods should another "crisis" period occur.

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