Investment Strategy

Weekly guidance from our Investment Strategy Committee **January 17, 2023**

Asset Allocation Spotlight: A year when bond and stock prices retreat in sync 2

- The U.S. stock and bond markets declined concurrently in 2022, and the 60/40 blend[1] declined over 16%.
- Looking ahead, Wells Fargo Investment Institute's forecasts for stocks and bonds in 2023 suggest that the 60/40 blend may potentially rebound from its double-digit loss of this past year.

Equities: Sector weight versus earnings contribution 4

- S&P 500 Energy, Financials, and Materials sectors over-earned their weights- in the index while Consumer Discretionary under-earned for the year.
- We expect the Energy sector to continue to offer earnings power for the buck in 2023, while the Financial and Materials earnings power buffer should help these sectors in an effort to weather our expectations for an upcoming recession relatively better than Consumer Discretionary.

Fixed Income: U.S. Treasury yields decline – Long-term bonds benefit 5

- U.S. Treasury yields have been trending lower in the first two weeks of the year, influenced largely by the macroeconomic outlook, and the bias remains to the downside.
- Our tactical move to extend duration[2] has been supported as yields have declined significantly since late October, allowing long-term fixed income the potential opportunity to experience a strong recovery.

Real Assets: Global food prices are declining 6

- Global food prices have declined for nine consecutive months, and we are expecting the same to start 2023 as recessionary conditions sink in.
- By the second half of 2023, however, we are expecting the commodity bull super-cycle[3] to reassert its dominance and begin pushing food prices higher.

Alternatives: Slowing pace of mergers and acquisitions 7

- Merger and acquisition activity has softened significantly throughout the past year, a trend we expect to continue in 2023.
- We maintain our unfavorable guidance on Merger Arbitrage strategies, as declining deal volumes, an uncertain economic environment, and increased regulatory scrutiny combines to provide further headwinds.

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

[1] The 60/40 blend is 60% stocks and 40% bonds, comprised of the annual returns of the S&P 500 Index and the Bloomberg U.S. Aggregate Index.
[2] A measure of a bond's interest rate sensitivity.
[3] Bull super-cycles are an extended period of time, historically 15-20 years, where commodity prices move upward together.

© 2023 Wells Fargo Investment Institute. All rights reserved.

Asset Allocation Spotlight

Michael Taylor, CFA
Investment Strategy Analyst

Douglas Beath
Global Investment Strategist

A year when bond and stock prices retreat in sync

2022 was an unusually challenging year for investors as stocks and bonds declined simultaneously, a rare event that has occurred only twice since 1976. In the years following these episodes — 1994 and 2018 — both stocks and bonds rebounded sharply with the S&P 500 Index advancing 27% and 20% respectively, while the Bloomberg U.S. Aggregate Bond Index rose 19% and 9%, respectively. The 60/40 blend, 60% stocks and 40% bonds, is comprised of the annual returns of the S&P 500 Index and the Bloomberg U.S. Aggregate Bond Index lost more than 16% last year, its second-worst performance behind 2008.

Several factors contributed to the concomitant decline in equity and bond prices this past year, including persistently high inflation, aggressive Federal Reserve (Fed) policy, the war in Ukraine and its impact on global supply chains, and intermittent COVID-19 lockdowns in China.

Periods when equity and bond markets experience negative returns concurrently have been historically unusual, taking many investors by surprise. Typically, when equity prices fall, investors have turned to bonds as a perceived safe haven, driving bond prices higher and yields lower. Yet, the recent trend has called into question the role of bonds as a perceived portfolio stabilizer. Below, we consider the impact of this trend on the 60/40 blend and implications for its near-term performance based on our 2023 outlook.

The 60/40 blend underperformed in 2022

The traditional 60/40 blend returned -16.4% in 2022, the second-worst performance behind the -21.6% downturn of 2008 during the throes of the Great Financial Crisis (GFC). Since the inception of the Bloomberg U.S. Aggregate Bond Index in 1976, the 60/40 blend has produced negative returns in 10 calendar years; over rolling five-year periods on just one occasion, from 2004 – 2009; and over three-year rolling periods investors experienced negative returns 6.5% of the time, or approximately 1 in 15 observations.

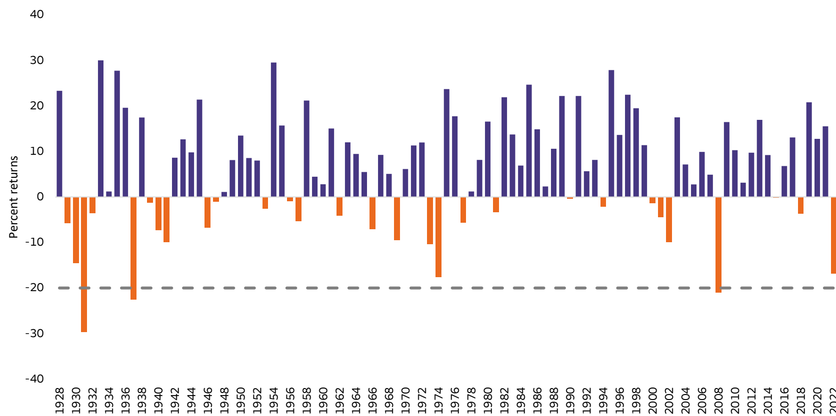
While a steep decline in the 60/40 blend historically has been rare, it is not unprecedented. In addition to the -21.6% and -16.8% declines in 2008 and 2022 respectively, the blend produced consecutive years of negative returns from 2000 – 2002. There was also the “lost decade” from 2000 to 2009, in which the 60/40 blend generated a meager 2.3% annualized return. Looking back further, the 60/40 blend produced negative returns exceeding -20% during the two depression era downturns of 1931 and 1937 (see chart below).

60/40 blend performance following negative years

Based on history, when a 60/40 blend experiences a negative calendar year return, the following years have exhibited strong performance. For example, years when the 60/40 blend produced negative returns in 1977 (-3.2%), 2008 (-21.6%), and 2018 (-2.3%) were followed by positive double-digit average returns over the following three years, respectively. And after the severe downturn in 2008, the 60/40 blend through calendar year 2021 experienced positive returns in 12 of the next 13 years with double-digit returns in 8 of those years.

© 2023 Wells Fargo Investment Institute. All rights reserved.

60/40 blend annual returns



Sources: Bloomberg, Morningstar Direct, and Wells Fargo Investment Institute. Annual data from December 31, 1928 – December 30, 2022. Prior to 1976, equal weightings of long-term corporate and government bonds were used to represent the bond portion of the portfolio. After 1976, the Bloomberg U.S. Aggregate Bond Index was used. An index is unmanaged and not available for direct investment. Please see end of report for index definitions. **Past performance is no guarantee of future results.**

Not surprisingly, stocks were the main laggard during years when blended returns were negative, but the main driver during the rebound phase. For example, the 60/40 blend experienced two severe equity bear markets, from March through November 2001 and December 2007 through June 2009 (technology bubble and GFC), followed by annualized positive returns of 13.5% in the subsequent decade prior to the pandemic versus 3.7% for the U.S. Aggregate Index from 12/31/2009-12/31/2019.

2023 forecast and potential implications for the 60/40 blend

Wells Fargo Investment Institute's (WFII's) forecasts for stocks and bonds in 2023 suggest that the traditional 60/40 may potentially rebound from the double-digit loss of this past year. Although we expect that stocks are likely to experience some near-term volatility, the midpoint of our year-end price target for the S&P 500 Index this year is 4,400, or nearly 15% higher than its current level as of this writing (and that does not include dividends).

In terms of fixed income, we believe that long-term interest rates are approaching peak yields in this cycle. Our guidance on duration and U.S. long-term taxable fixed income were recently upgraded to favorable and most favorable, respectively. It is also noteworthy that the bond market declined for the second year in a row in 2022, a feat not seen since 1958 – 1959. U.S. bonds historically have never posted three consecutive years of negative returns.

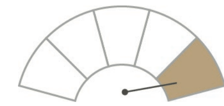
Finally, we believe that the correlation of stocks and bonds should return to negative as this was the case from 2000 - 2022 when the correlation turned positive. Historically, stock and bond correlations have turned negative during cycles when inflation and interest rates are stable or falling. Our forecast of rapidly declining inflation in 2023, coupled with a peak in long-term rates near current levels suggest that bonds may offer diversification benefits during periods of market duress in our view. We believe a well-diversified portfolio that also includes Commodities, which have historically tended to rise with inflation, and alternative investment strategies like Macro and Relative Value, which historically have held low correlations to stocks and bonds, may help in an effort to limit investors' downside exposure through choppy markets. We encourage investors to talk with their advisor about portfolio positioning in today's market environment.

© 2023 Wells Fargo Investment Institute. All rights reserved.

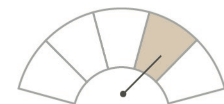
Equities

"It is better to sleep on things beforehand than lie awake about them afterwards." — Baltasar Gracian

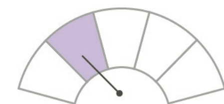
Austin Pickle, CFA
Investment Strategy Analyst



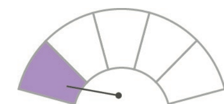
Most favorable
U.S. Large Cap Equities



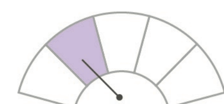
Favorable
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Most unfavorable
Developed Market
Ex-U.S. Equities



Unfavorable
Emerging Market Equities

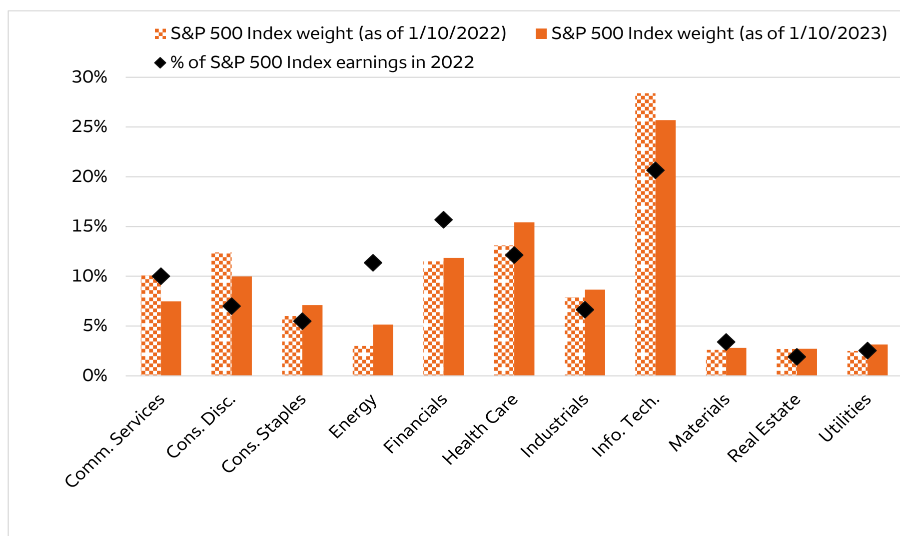
Sector weight versus earnings contribution

The S&P 500 Index posted a -18% annual return in 2022. The underlying sectors had varying performances; the outliers being the Energy sector's 66% annual return for the year, while both Communication Services and Consumer Discretionary dropped nearly 40%. S&P 500 Index earnings was a bright spot and actually increased in 2022 as companies were generally able to push through higher costs. Yet not each sector contributed proportionately. Today, we examine how S&P 500 Index sector weights changed this past year, as well as each sector's 2022 earnings contribution to the overall S&P 500 Index (see chart below).

In any given year, one would expect some difference between earnings contribution and index weight, but there are some notable gaps. Energy, Financials, and Materials punched well above their earnings weight class in 2022, while Consumer Discretionary was the worst under-earning offender on a percentage basis. Energy was again the standout of the standouts and significantly over-earned, with its earnings contribution more than double its 2023 weight in the S&P 500 Index and more than triple its 2022 weight.

We expect the Energy sector to continue to offer earnings power for the buck in 2023, although the gap should shrink as the stellar earnings growth the sector enjoyed these past two years levels off at the same time the sector outperforms. Meanwhile, we believe the likely upcoming recession could pressure cyclical sector earnings and prices. In our view, the Financials and Materials earnings power buffer may potentially allow these sectors to weather the storm relatively better than Consumer Discretionary.

S&P 500 Index sector weights versus earnings contribution



Sources: Bloomberg, Goldman Sachs, and Wells Fargo Investment Institute, data as of 01/10/2023. 2022 earnings data as of 12/31/2022. A diamond below the top of the orange bars illustrates that sector under-earned relative to its market cap weight, and vice versa. An index is unmanaged and not available for direct investment. Please see end of report for index definitions. **Past performance is no guarantee of future results.**

© 2023 Wells Fargo Investment Institute. All rights reserved.

Fixed Income

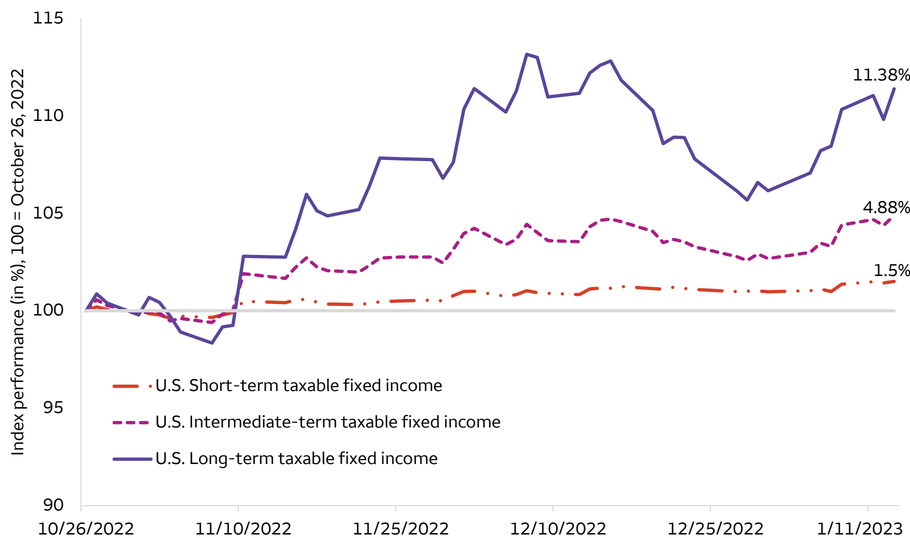
Luis Alvarado
Investment Strategy Analyst

U.S. Treasury yields decline – Long-term bonds benefit

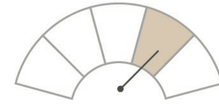
U.S. Treasury yields have been trending lower in the first two weeks of the year, influenced largely by the macroeconomic outlook. Although possible, we believe it should be difficult for the 10-year U.S. Treasury yield to cross above 4% in the near term, especially as inflation has also continued to trend lower and the markets expect the Fed to pause interest rate hikes in a few months. For the first half of 2023, we expect the 10-year Treasury yield to remain range bound between 3.4% and 3.9%, but our bias is to the downside. Another important factor that should affect yield levels is the timing of the start of the recession, and the depth and length of such recession thereafter.

On October 26, 2022 we updated our tactical guidance and guided investors to increase duration exposure in their portfolios by favoring long-term fixed income, while also maintaining exposure in short-fixed income, effectively implementing a barbell strategy. So far, this tactical move has been supported as yields have declined significantly since late October, allowing long-term fixed income to experience a strong recovery. Although some investors may feel like they missed out on the move, given the rapid decline over the past two months, we still believe that current yield levels may also potentially provide opportunities as we expect lower yields 12 to 18 months from the time of this writing.

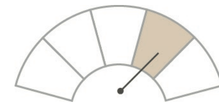
Long-term fixed income recovers as yields decline



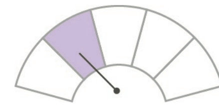
Sources: Wells Fargo Investment Institute and Bloomberg. Data as of January 11, 2023. Cumulative total return of short, intermediate, and long-term taxable fixed income from October 26, 2022 to January 11, 2023. U.S. Short-term taxable fixed income = Bloomberg U.S. Aggregate 1-3 Year Bond Index. U.S. Intermediate-term taxable fixed income = Bloomberg U.S. Aggregate 5-7 Year Bond Index. U.S. Long-term taxable fixed income = Bloomberg U.S. Aggregate 10+ Year Bond Index. An index is not managed and not available for direct investment. Please see end of report for index definitions. **Past performance is no guarantee of future results.**



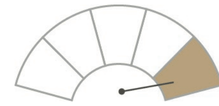
Favorable
U.S. Taxable Investment Grade Fixed Income



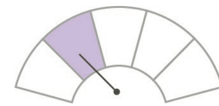
Favorable
U.S. Short Term Taxable Fixed Income



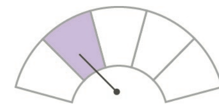
Unfavorable
U.S. Intermediate Term Taxable Fixed Income



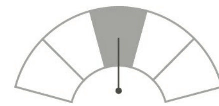
Most favorable
U.S. Long Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

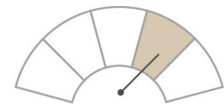
© 2023 Wells Fargo Investment Institute. All rights reserved.

Real Assets

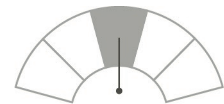
"Life is a combination of magic and pasta." — Federico Fellini

John LaForge
Head of Real Asset Strategy

Mason Mendez
Investment Strategy Analyst



Favorable
Commodities



Neutral
Private Real Estate

Global food prices are declining

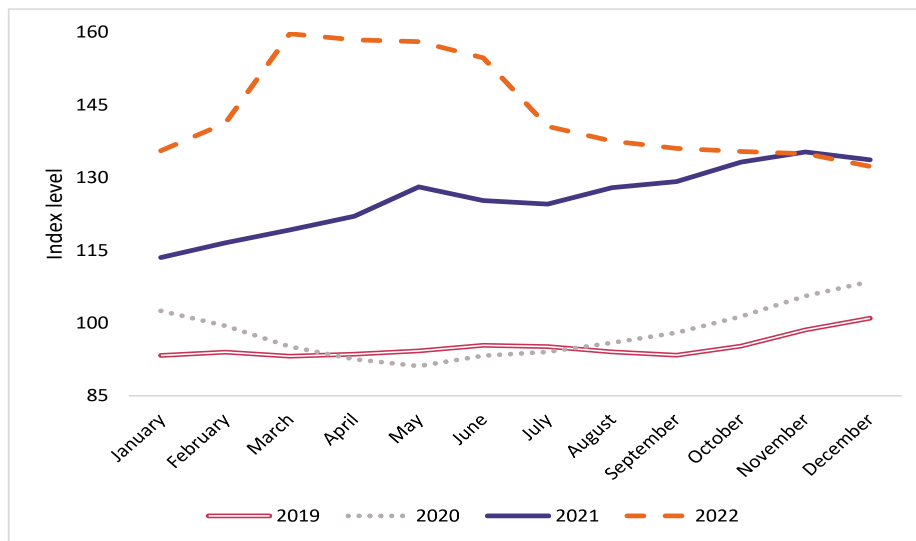
Global food prices, as measured by the FAO Food Price Index were on fire in early 2022. The combination of droughts, supply disruptions, high input costs, currency moves, and geopolitical conflicts pushed global prices to all-time highs by March (see chart below).

Since March, however, food prices dropped for nine consecutive months (see chart). From the March peak to year-end 2022, global food prices lost 17.1%. The correction was sparked by the reopening of key ports in the Black Sea, news of strong harvests from the southern hemisphere, and weakening global economic activity.

2023, we suspect, should be a tale of two halves for food prices. We expect prices are likely to stay soft in the first half of the year, as many parts of the world flirt with recession. In the second half of 2023, however, we believe that the commodity bull super-cycle will reassert itself as the main factor, pushing prices higher. Commodity bull super-cycles are driven by a structural lack of supply, and we believe this is the case with food today. The U.S. Department of Agriculture forecasts total grain supply growth to decrease in 2023, indicating continued supply tightness. Another factor that we believe may contribute to higher prices in the second half of 2023 would be higher input costs. Energy inputs, such as oil and natural gas, have remained supply-constrained too.

Overall, global food prices have retreated from highs in 2022, and in our view could continue to soften throughout the first half of 2023. However, the bull super-cycle is still young, and we believe that it may be supportive of rising prices in the second half of 2023 when recessionary conditions fade as we expect.

Global food prices (FAO Food Price Index)



Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data is from January 31, 2019 – December 31, 2022. An index is unmanaged and not available for direct investment. Please see end of report for index definitions. **Past performance is no guarantee of future results.**

© 2023 Wells Fargo Investment Institute. All rights reserved.

Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

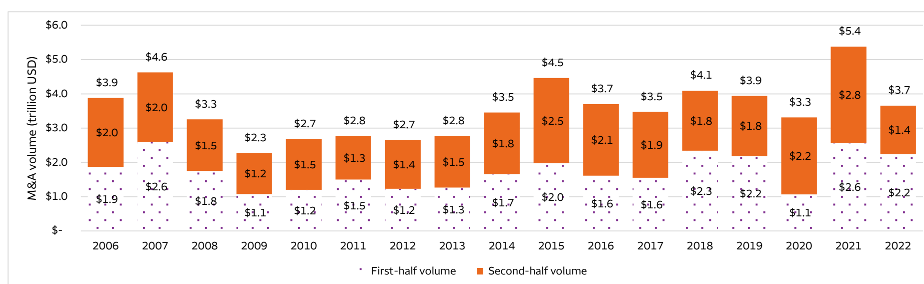
Slowing pace of mergers and acquisitions

Over the past year, falling equity and bond markets, higher inflation and interest rates, and a potential recession on the horizon created an environment where corporate leaders became increasingly hesitant to acquire or merge with other companies. While 2021 witnessed a record level[4] of merger and acquisition (M&A) activity as the global pandemic faded, 2022 can be characterized by declining confidence and greater uncertainty regarding the health of consumers and businesses alike. The amount of global M&A activity declined by approximately one third from 2021 to 2022, largely driven by weakening volumes observed throughout the second half of the 2022. Technology and Real Estate sectors accounted for the largest drop in deal volumes as higher financing costs negatively impacted lofty valuations. Other prominent trends in 2022 included a rising percentage of acquisitions by private equity firms (43% of North American deal volumes), and the trend of fewer larger-sized deals (>$20 billion) relative to historical levels. Although deal volumes for 2022 remain in line with pre-pandemic levels, we believe the steady decline of activity throughout the past year may be a harbinger of things to come in 2023.

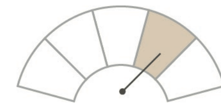
Impact on Merger Arbitrage strategies:

We maintain our unfavorable guidance on Merger Arbitrage strategies. In addition to restrained deal activity, we believe the potential for greater market volatility and heightened regulatory scrutiny of acquisitions by foreign and large technology acquirers may negatively impact the environment going forward. We remain patient as we look for a more opportune entry point, as we expect the economy should provide signs that it is on a path to recovery.

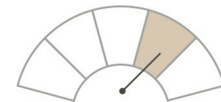
Global merger and acquisition volumes (2006 – 2022)



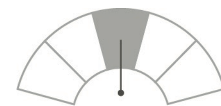
Sources: Dealogic, Citigroup, and Wells Fargo Investment Institute. Data as of December 31, 2022. First-half volume measured by the first full 6 months of each respective year, second-half volume measured by the last full 6 months of each respective year. For 2022, first half of the year is: 01/01/2022 to 6/30/2022. The second half of the year is: 7/1/2022 to 12/31/2022.



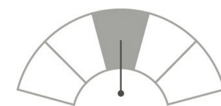
Favorable
Hedge Funds – Relative Value



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.

4. North America Executive M&A Summary, Citigroup Global Markets Inc., 2022.

© 2023 Wells Fargo Investment Institute. All rights reserved.

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. 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.

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**.**

Merger arbitrage involves investing in event driven situations such as reorganizations, spin-offs, mergers, and bankruptcies, and involves the risks that the proposed opportunities in which investments may not materialized as planned or may be renegotiated or terminated which can result in losses.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is appropriate only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

Bloomberg U.S. Aggregate 10+ Year Bond Index is composed of the Bloomberg U.S. Government/Credit Index and the Bloomberg U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 10 years or more.
Bloomberg U.S. Aggregate 1-3 Year Bond Index is composed of the Bloomberg U.S. Government/Credit Index and the Bloomberg U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 1-3 years.
Bloomberg U.S. Aggregate 5-7 Year Bond Index is composed of the Bloomberg U.S. Government/Credit Index and the Bloomberg U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 5-7 years.
Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.
FAO Food Price Index (FFPI) is a measure of the monthly change in international prices of a basket of food commodities.
S&P 500 Communication Services Index comprises those companies included in the S&P 500 that are classified as members of the GICS® communication services sector.
S&P 500 Consumer Discretionary Index comprises those companies included in the S&P 500 that are classified as members of the GICS® consumer discretionary sector.
S&P 500 Consumer Staples Index comprises those companies included in the S&P 500 that are classified as members of the GICS® consumer staples sector.
S&P 500 Energy Index comprises those companies included in the S&P 500 that are classified as members of the GICS® energy sector.
S&P 500 Financials Index comprises those companies included in the S&P 500 that are classified as members of the GICS® financials sector.
S&P 500 Health Care Index comprises those companies included in the S&P 500 that are classified as members of the GICS® health care sector.
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.
S&P 500 Industrials Index comprises those companies included in the S&P 500 that are classified as members of the GICS® industrials sector.
S&P 500 Information Technology Index comprises those companies included in the S&P 500 that are classified as members of the GICS® information technology sector.
S&P 500 Real Estate Index comprises those companies included in the S&P 500 that are classified as members of the GICS Real Estate sector.

© 2023 Wells Fargo Investment Institute. All rights reserved.

S&P 500 Utilities Index comprises those companies included in the S&P 500 that are classified as members of the GICS utilities sector.
S&P 500 Materials Index comprises those companies included in the S&P 500 that are classified as members of the GICS® materials sector.

An index is unmanaged and not available for direct investment.

General Disclosures

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS' opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability or best interest analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon. The material contained herein has been prepared from sources and data we believe to be reliable but we make no guarantee to its accuracy or completeness.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company. CAR-0123-01864

© 2023 Wells Fargo Investment Institute. All rights reserved.