WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee

April 3, 2023

Alternatives spotlight: A case for private infrastructure 2

- We believe the private infrastructure asset class may offer attractive attributes, including relatively stable cash flow and income growth potential, as well as a hedge against elevated levels of inflation.
- The U.S. infrastructure systems have deteriorated over the course of several decades and will likely require a significant investment from both public and private sources to bridge the funding gaps required to improve the overall quality and capacity of the assets.

Equity sector analysis: Investors take a fresh look at the financial sector.4

- Changes to the Global Industry Classification Standard (GICS) structure, which became effective this month, adjusted several sectors, including Financials.
- Recent disruptions in regional banking, and the addition of a new sub-industry in payment processing, may give investors reason to take a fresh look at their exposure to financial services.

Fixed Income sector analysis: Lack of financials = more muni rating withdrawals..5

- Due to a lack of timely financial information from municipal borrowers, there has been an increase in ratings placed on S&P's CreditWatch since the beginning of the year.
- Rating withdrawals due to a lack of financial data could lead to pricing volatility and illiquidity for impacted municipal bonds.

Real Estate sector analysis: REITs report solid earnings in fourth quarter 2022..6

- Despite a challenging comparison quarter, real estate investment trusts (REITs) were able to generate attractive growth in funds from operations per share and same-property net operating income.
- Along with fourth-quarter earnings, most REITs provided initial 2023 earnings guidance.

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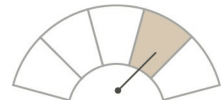
Alternatives spotlight

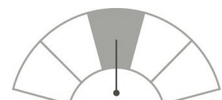
Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist



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.

A case for private infrastructure

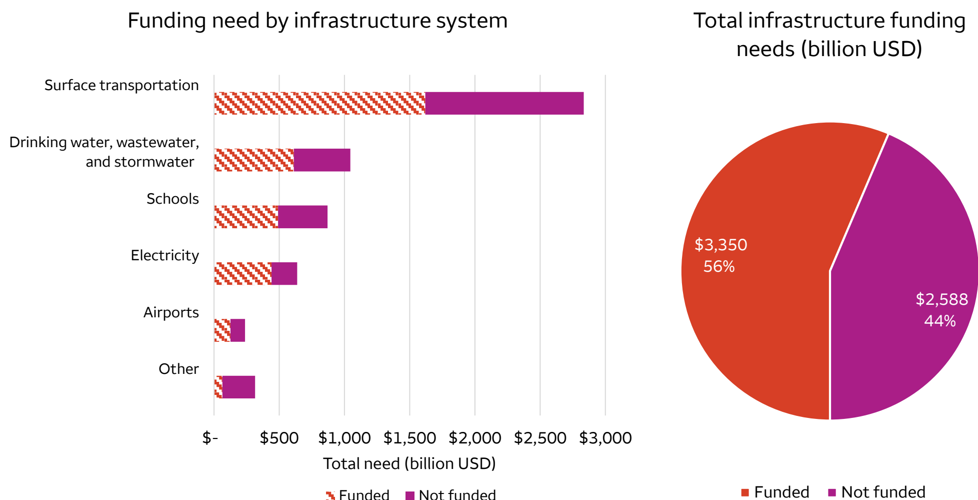
Private infrastructure investments are often overlooked by investors in favor of other asset classes that have historically generated income such as private credit and real estate. Yet, we believe that the category warrants attention given its history of resilient cash flows, ability to protect against inflation, and attractive risk-return characteristics. Additionally, the cumulative lack of funding over several decades has led to the current situation where aging and outdated infrastructure assets will require significant investment to maintain, replace, or add capacity to meet future demand.

Infrastructure assets span a wide range of public and private facilities, systems, and networks that provide a public good or service to a country or region. Examples include bridges, roads, airports, power grids, communication and data networks, water systems, schools, and hospitals. The projects are typically often large in scale, high in cost, and require extensive involvement from city, state, or federal governments. The broad regulation of infrastructure-related projects has resulted in high barriers to entry and limited competition.

Current state

Every four years, the American Society of Civil Engineers publishes an assessment of the country’s infrastructure health and assigns a grade based on the quality of current assets, as well as an appraisal of funding levels relative to future needs. As of the latest draft in 2021, the overall rating was upgraded to C- (from a D+ in 2017). Although the upward trend is encouraging, the current grade remains far from what most would deem acceptable for any developed market country. Infrastructure that is aging, lacking capacity, or unaligned with current technological advancements may be an inconvenience at best, but we believe may be a potential safety concern or a national defense vulnerability at its worst. The chart below highlights the capital requirements through 2029 and the funding gap that will need to be bridged.

Chart 1: Cumulative U.S. infrastructure investment needs by system based on current trends, 2020 – 2029



Sources: Infrastructure Report Card, American Society of Civil Engineers; and Wells Fargo Investment Institute. 2021.

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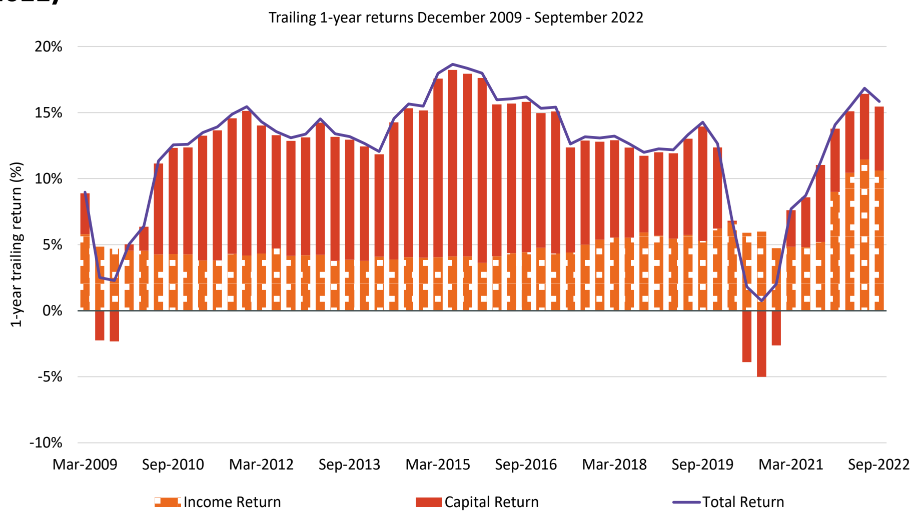
Investment drivers

Several trends are contributing to an environment that we expect may be constructive for private infrastructure investments in the coming decade. First, the Inflation Reduction Act (IRA) passed in late 2022 includes subsidies and incentives for infrastructure projects that will total approximately $1 trillion over the coming decade. While this may seem like a large sum, the current funding gap to repair, replace, and modernize the country's infrastructure far outweighs the commitment outlined in the IRA legislation. The ongoing transition to a more sustainable energy infrastructure will require significant up-front expense as fossil fuels are replaced by renewable technologies. At the same time, many governments around the world are facing record debt levels and increasing budget deficits that are likely to constrain future spending[1]. Infrastructure projects may likely require additional investment from the private sector to close funding gaps on future projects. Lastly, in addition to funding needs in the U.S., emerging market economies such as China and India are witnessing a burgeoning middle class that we anticipate will lead to demand growth across most major infrastructure sectors.[1]

Benefits for a diversified portfolio

Within the Private Real Estate category, we believe an allocation to private infrastructure can potentially offer benefits to a diversified portfolio of traditional stock and bonds. Infrastructure assets are often characterized by stable cash flows and income growth potential. Growth rates in these heavily regulated industries are often indexed to inflation and have the potential to insulate investors against the impact of rising price levels. In addition to a source of stable income and inflation protection, we expect the low correlation to other asset classes may improve the overall risk-adjusted returns of a diversified portfolio. The chart below shows the trailing 1-year returns for private infrastructure, measured by the MSCI Global Quarterly Private Infrastructure Index, and highlights the contribution from the relatively consistent income component over time. When considering private capital strategies, we favor targeting their strategic allocations, yet also favor diversified exposure within Private Real Estate that includes Private Infrastructure.

Chart 2: Trailing 1-year returns for private infrastructure (December 2009 – September 2022)



Sources: CBRE Group, Inc. and Wells Fargo Investment Institute, Data as of September 30, 2022. Returns measured by the MSCI Global Quarterly Private Infrastructure Index, published quarterly, returns are in local currency and are not de-smoothed. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

1. "Infrastructure Investing: Why now?" Brookfield Asset Management, July 14, 2021; "Cantor Perspectives: Global Infrastructure – an Overview," Cantor Fitzgerald, September 9, 2022.

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Equities sector analysis

Mike Ruesy, CFA
Equity Sector Analyst

Sector analysis prepared by Global Securities Research

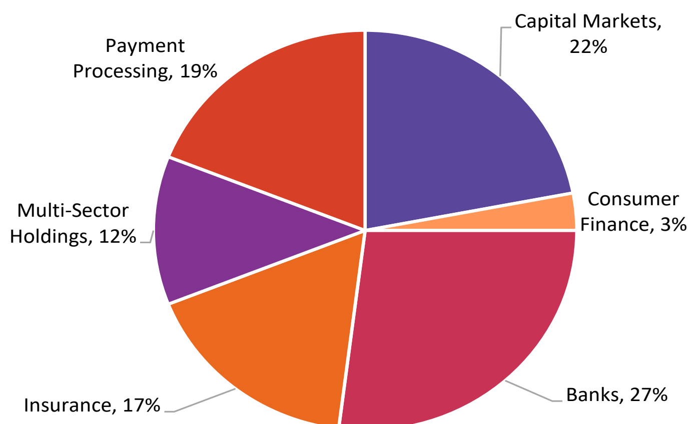
Investors take a fresh look at the financial sector

Changes to the Global Industry Classification Standard (GICS) structure, which were effective earlier this month, adjusted several sectors, including Financials. Given recent market disruption to many names in regional banking, the reclassification of the Financials sector might come as welcome relief to some investment managers. While the GICS distinction between universal and regional banks has been maintained, investors interested in keeping banking exposure can still choose from among the largest banks in an effort to avoid some of the risks believed to be inherent to smaller banking institutions.

As the turmoil in banking eventually subsides, there is likely renewed interest in supervision and regulation of banking institutions. The regulatory scrutiny of smaller banks probably rises with calls for them to hold more on-balance-sheet liquidity, as well as more capital. We see the higher liquidity and capital requirements, plus greater regulatory and supervisory expenses combining to reduce the return-on-equity potential of regional banks. This diminishes their investment appeal, we think, especially since a new and perhaps more interesting sub-industry, Transaction and Payment Processing Services, joined the sector this month.

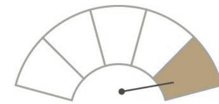
Constituents of this new sub-industry are imports from the Information Technology sector. Given their businesses are both established and new payments technologies, we believe these companies should have naturally higher growth rates than most current Financials sector names. Even though that growth may come with a higher volatility profile, these additions to the sector may be an option for investors wanting to take a fresh look at exposures in financial services.

S&P 500 Index Financials industry-level composition



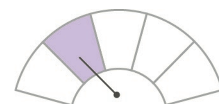
Sources: FactSet, S&P Global, and Wells Fargo Investment Institute. Data as of December 31, 2022. An index is unmanaged and not available for direct investment.

Wells Fargo Investment Institute guidance:

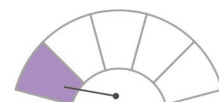


Most favorable
U.S. Large Cap Equities

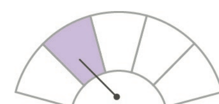
Favorable
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities



Unfavorable
Emerging Market Equities

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Fixed Income sector analysis

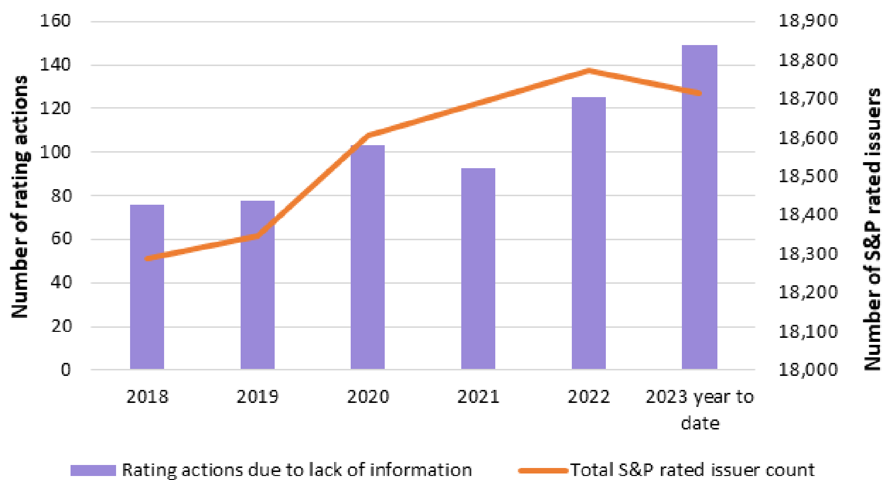
Sector analysis prepared by Global Securities Research

Lack of financials = more muni rating withdrawals

Municipal bond issuer disclosure practices generally lag those of their corporate counterparts. While municipal investors are accustomed to waiting many months for disclosure documents, the recent trend of delayed financial statements has impacted ratings. Year to date through March 13, S&P has placed 149 ratings on CreditWatch with negative implications due to delinquent 2021 financial statements. For perspective, the number of rating actions thus far in 2023 is nearly equivalent to the number of similar ratings actions in fiscal years 2018 and 2019 combined. S&P indicates that borrowers are attributing the unusually high number of missing financial statements to a lack of employees at both auditing firms, as well as a lack of employees at the municipal borrower level. The immediate bondholder risk is the withdrawal of S&P ratings after their 30-day grace period ends.

While secondary market pricing for bonds carrying multiple ratings may not be immediately impacted by a rating withdrawal, it is possible that Moody's and Fitch may remove their ratings if financial statement tardiness persists. In addition to potentially negative impacts on pricing and trading liquidity, nonrated bonds also lack continued rating agency monitoring and a bondholder warning system if financial trends of the borrower deteriorate. While it is difficult to predict which issuers may be unable to produce timely financial statements, we anticipate the more prolific issuers are likely to meet their requirements when compared to issuers who access the market on a less frequent basis. We believe that bondholders should stay abreast of disclosure filings to the Municipal Securities Rulemaking Board and any notices related to failure to file financial statements within the timeframe required in the official statement.

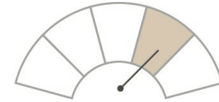
S&P rating actions due to lack of timely financial data



Sources: S&P Global Ratings as of March 13, 2023.

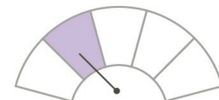
Sara Kisner
Municipal Analyst

Wells Fargo Investment Institute guidance:

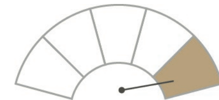


Favorable
U.S. Taxable Investment Grade Fixed Income

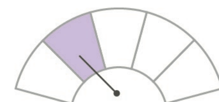
Favorable
U.S. Short Term Taxable Fixed Income



Unfavorable
U.S. Intermediate Term Taxable Fixed Income



Most favorable
U.S. Long Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income

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

Neutral
Emerging Market Fixed Income

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Real Estate sector analysis

John Sheehan, CFA
Lead Retail Investment Research Analyst

Sector analysis prepared by Global Securities Research

REITs report solid earnings in fourth quarter 2022

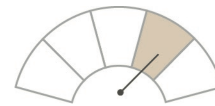
With fourth-quarter 2022 real estate investment trust (REIT) earnings season completed, we believe a quick review of REIT earnings is timely.

Data provided by the National Association of Real Estate Investment Trusts (Nareit)[2] shows the REIT industry generated growth in funds from operations (or FFO, the primary earnings measure utilized by REITs) per share of 10.8% over fourth-quarter 2021 results. These results follow third-quarter 2022 FFO per share growth of 14.5%. Additionally, REITs reported 6.5% growth in net operating income (NOI) from their same-property portfolios relative to fourth quarter 2021. Most REIT investors view same-property performance as a good indicator of internal growth.

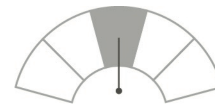
We view the FFO per share and same-store NOI growth generated by the REIT industry during the fourth quarter of 2022 favorably. It is worth noting that we believe REITs faced challenging comparisons with fourth quarter 2021; data from Nareit indicated REITs generated 17.6% growth in FFO per share (likely reflecting an economic recovery as business operating restrictions mandated by the pandemic were lifted) and a 7.8% increase in same store NOI in the fourth quarter of 2021.

In conjunction with their fourth-quarter 2022 earnings, the majority of REITs we closely monitor provided investors with initial earnings guidance for 2023. In general, we viewed the majority of 2023 REIT earnings guidance as relatively conservative, which we believe reflects the impact of higher capital costs, elevated inflation, and an uncertain economic outlook, which could impact REIT occupancy rates and rental growth during 2023.

Wells Fargo Investment Institute guidance:



Favorable
Commodities



Neutral
Private Real Estate

2. Source: Nareit. "Nareit T-Tracker®: Quarterly Operating Performance Series," n.d. https://www.reit.com/data-research/reit-market-data/nareit-t-tracker-quarterly-operating-performance-series.

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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. **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. **Municipal** bonds offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. 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.

There are special risks associated with an investment in real estate, including the possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions. Other risks associated with investing in listed REITs include the use of leverage, unexpected reductions in common dividends, increases in property taxes, and the impact to listed REITs from new property development.

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

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.

MSCI Global Quarterly Private Infrastructure Index the equity performance of infrastructure assets globally. The index is based on assets with a total enterprise value of CAD $70.45 billion as at March 2019.

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