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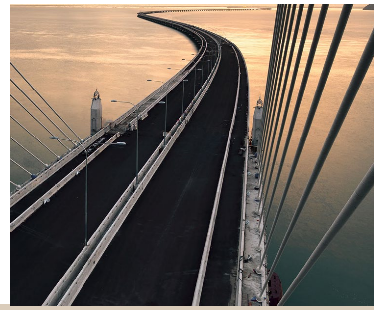
Investment Institute

Investment Strategy



Weekly guidance from our Investment Strategy Committee **April 10, 2023**

1. The Organization of the Petroleum Exporting Countries Plus (OPEC+) is a loosely affiliated entity consisting of the 13 OPEC members and 10 of the world's major non-OPEC oil-exporting nations.

Asset Allocation Spotlight

Michelle Wan, CFA
Investment Strategy Analyst

Michael Taylor, CFA
Investment Strategy Analyst

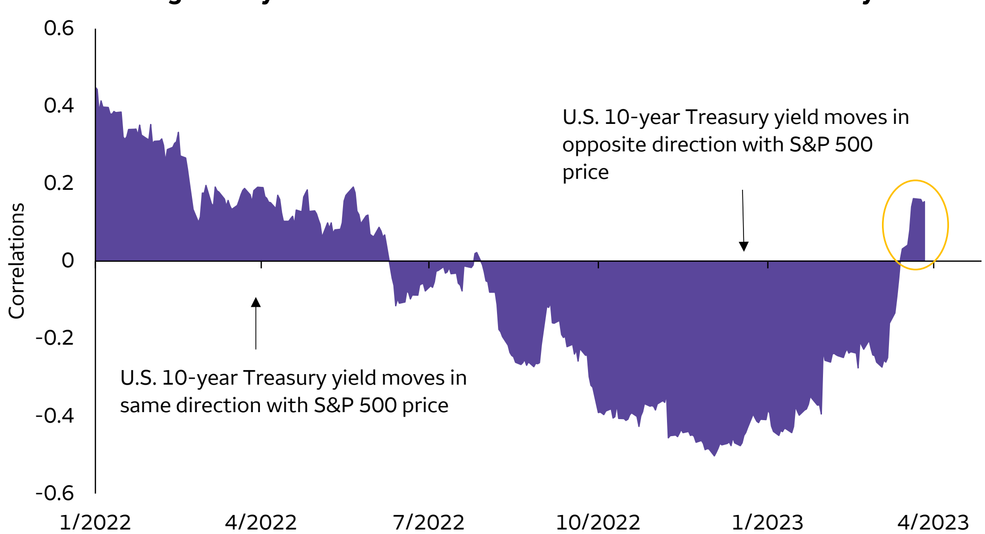
When the price of risk exceeds potential returns

The first quarter of 2023 proved challenging for investors as they navigated a labyrinth of rising interest rates, potential recession, and individual financial institution failures, prompting fears reminiscent of the Great Financial Crisis. Yet, given these headwinds, our diversified three-asset-group allocations' returns remained broadly positive year-to-date.[2] Looking ahead, Wells Fargo Investment Institute continues to encourage investors to be proactive by maintaining defensive positioning in portfolios. In this piece, we provide updates on stock-bond correlations and the equity risk premium, and remind investors to review their allocations, and if necessary, rebalance portfolios back to strategic and tactical targets.

Stock and bond correlations on the mend

Looking at a rolling 60-day correlation between U.S. stocks and bonds, we notice a recent shift in this relationship.[3] Throughout March 2023, the S&P 500 Index and the U.S. 10-year Treasury yield showed signs of moving in the same direction once again. As bond yields rise, bond prices deteriorate. So, when bond yields and stock prices move in tandem, bond and stock prices advance in opposite directions. This negative correlation between stocks and bonds provides diversification benefits for portfolios holding both. Since 2000, negative correlations between the two asset groups have served as hedges for diversified portfolios. More recently, elevated inflation coupled with a change in Federal Reserve interest rate policy in 2022 inverted this relationship, leaving investors few places to hide when stock and bond prices declined concurrently. This may have led some investors to disregard the diversification benefit and tilt toward a higher allocation to bonds or stocks in pursuit of higher returns. We now are seeing a reversal in this trend as inflation peaks and its dominating power over stock and bond markets is waning. In this environment, investors may want to consider holding stocks and bonds based on our favored levels to help mitigate portfolio risk.

Chart 1. Rolling 60-day correlation between S&P 500 Index and U.S. 10-year Treasury yield



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of April 3, 2023. **Past performance is no guarantee of future results.**

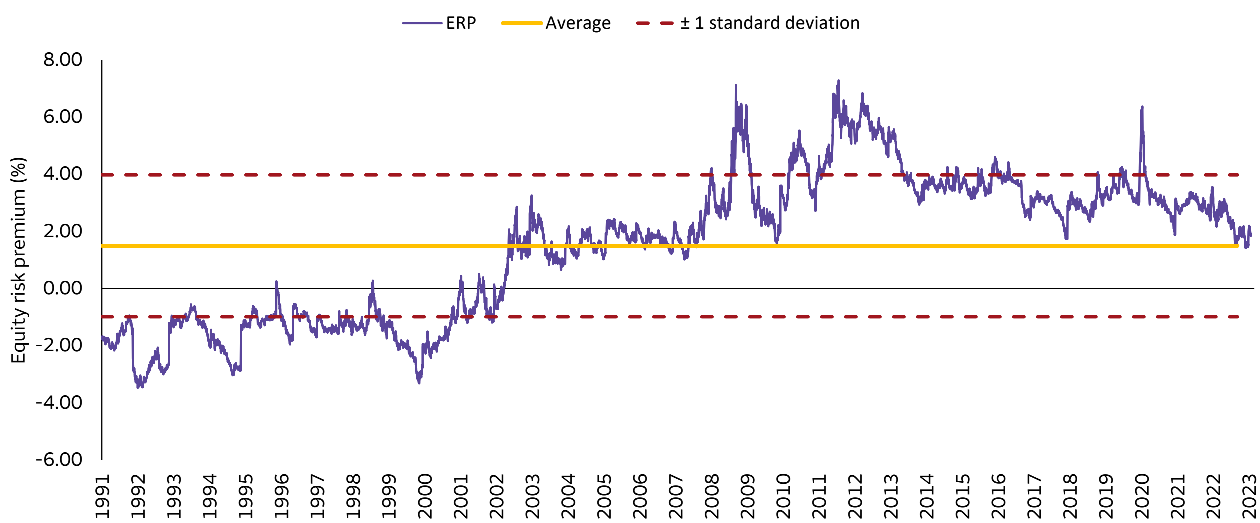
2. Bloomberg and Morningstar. Data as of March 23, 2023.
3. Correlation measures the degree to which two securities move in relation to each other.

Alongside the diversification benefit, fixed-income yields are higher than they were a year ago, offering investors potential income sources beyond stock dividends and real estate holdings. More broadly, in fixed income we currently favor a barbell approach, overweighting positions in short- and long-term maturities. High credit quality assets may also provide cushion from credit and default risks.

Does it pay to take risks through equities?

Besides increasing income for portfolios, higher bond yields also impact equity prices. They reduce the equity risk premium (ERP) — measured by subtracting the 10-year bond yield from the earnings yield (earnings per share divided by price). Typically, a higher ERP corresponds to higher expected equity returns. However, as we discussed in a recent Investment Strategy Report, the current ERP is near a multi-decade low. We believe at these low ERP levels, equity markets would be particularly sensitive to interest rate moves, making stocks less attractive than bonds in the near term.[4] As the ERP trends back toward its historical average, we do not believe equities offer an especially attractive opportunity for investors. Yet, we also believe it is disadvantageous to liquidate equities entirely in favor of holding cash, which is expected to underperform stocks and bonds over the longer term. Instead, we favor that investors overweight Fixed Income and underweight Equities in the near term (the next 18 months), based on our tactical guidance.

Chart 2. The equity risk premium is hovering around its long-term historical average



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of April 3, 2023. ERP = equity risk premium: Earnings yields less 10-year Treasury yield. Standard deviation is a statistic that measures the dispersion of a data set relative to its mean and is calculated as the square root of the variance. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Stay committed to long-term goals

As market uncertainty persists, it is prudent to revisit long-term investment objectives and their related asset allocation targets. Our strategic allocation recommendations and tactical guidance consider potential risks, potential returns, and asset correlations seeking to align with an investor's objectives for growth, income, and risk tolerance. Once an investment objective is determined, it is important to monitor the allocation between fixed income, equity, and other asset classes and periodically rebalance holdings to help avoid portfolio drift away from an investor's desired risk level. Taking too much risk in a portfolio may overexpose an investor to downside risk, essentially paying a high price to achieve the desired level of return. A long-term investment plan that includes an appropriate strategic mix with occasional tactical adjustments and periodic rebalancing should help smooth portfolio performance over time and help investors stay committed to their goals.

4. "Equity risk premia at multi-decade lows," Investment Strategy Report, March 13, 2023.

Equities

Chris Haverland, CFA
Global Equity Strategist

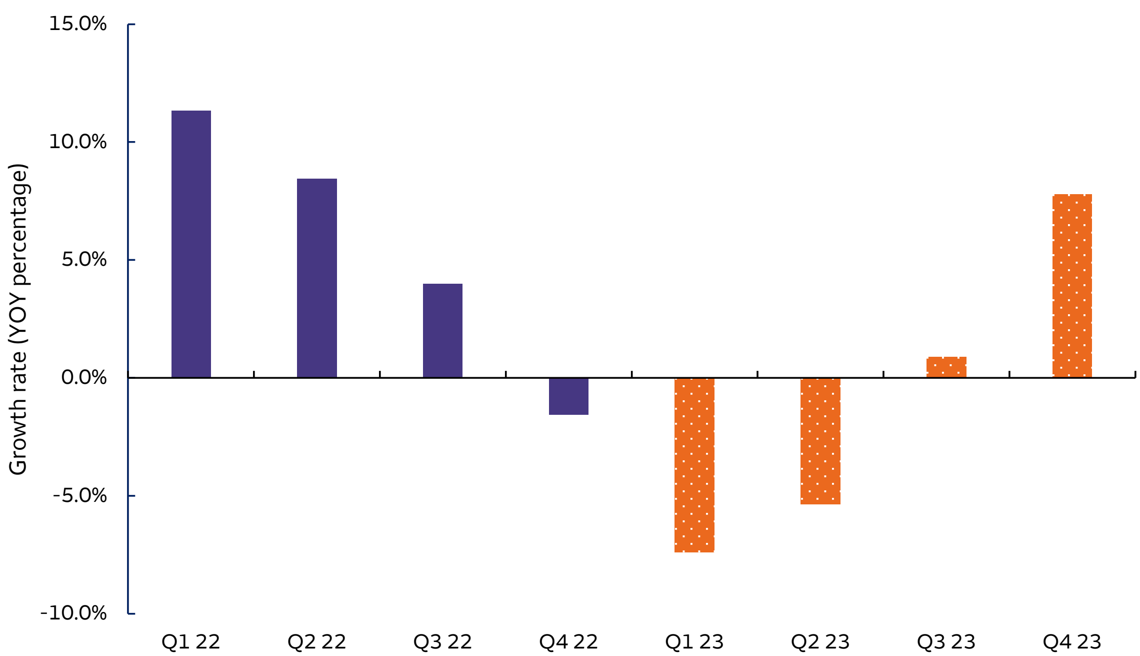
Has the earnings recession begun?

While the timing of the next economic recession is debatable, the corporate earnings recession is likely upon us. Fourth-quarter 2022 earnings per share (EPS) for the S&P 500 Index declined on a year-over-year basis for the first time since 2020. First-quarter 2023 earnings season kicks off this week and Bloomberg consensus is calling for a second consecutive drop in EPS (see chart). Consensus estimates show another EPS decline in the second quarter before rebounding later this year.

As we have noted for some time, earnings peaked in the third quarter of 2022 and should be lower in 2023. Our call for a recession in the back half of the year leads us to be skeptical of the consensus forecast for EPS growth in the third and fourth quarters. We believe revenues will be challenged as the economy slows. Coupled with sticky wage and input costs, margins likely will be squeezed, leading us to our below-consensus 2023 EPS forecast of $205 for the S&P 500 Index.

2023 consensus estimates have been cut by more than $30 since mid-2022, but we believe further adjustments are warranted. Downward EPS revisions have slowed since the end of fourth-quarter reporting season. We expect revisions to pick up in the coming weeks as companies provide greater clarity on their 2023 outlooks. As earnings contract in 2023, we favor focusing on high-quality, larger-cap companies that have strong balance sheets and cash flow to weather an uncertain economic environment.

S&P 500 Index EPS likely declined for the second consecutive quarter



Sources: Bloomberg and Wells Fargo Investment Institute. Quarterly data from March 31, 2022 — December 31, 2023. 2023 growth rates are based on Bloomberg consensus estimates for 2023. YOY = year-over-year. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Fixed Income

Brian Rehling, CFA
Head of Global Fixed Income Strategy

High yield holding on for now

After falling over 11% in 2022, the high yield asset class, measured by the Bloomberg U.S. Corporate High Yield Index, has performed admirably so far this year, posting year-to-date returns near 3.5% as of April 1, 2023. While near-term performance in the high yield asset class has done better than expected, we reiterate our unfavorable recommendation as we view risks to lower credit quality issuers as heightened in the current deteriorating economic environment.

Credit spreads tend to increase during periods of economic uncertainty as investors question the stability of debt payments from lower-quality issuers. In general, as credit spreads increase, bond prices fall — leading to poor performance for current holders.

The average spread level of the Bloomberg U.S. Corporate High Yield Index going back to 2000 is 530 basis points (5.3%). The current spread level of the high-yield index is 455 basis points (4.55%). As credit spreads tighten (decline), valuations increase — all else being equal. The opposite occurs as spreads widen or increase.

In the past two recessions, spreads have widened to at least 1000 basis points (10%). While we do not expect to see the same extent of credit spread widening in the upcoming recession, we do expect spread levels to rise from current levels and the market value of high-yield securities to fall when the economy falls into recession.

Portfolio implications

We favor moving up in credit quality while avoiding lower-quality issuers as we enter more challenging economic times. Should high-yield credit spreads widen as expected during the upcoming recession, we at that time would look to upgrade the asset class in an effort to take advantage of better valuations and expected post-recession spread tightening.

Bloomberg U.S. Corporate High Yield Index

Sources: Bloomberg, Wells Fargo Investment Institute. Data as of April 3, 2023. 100 basis points equal 1%. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Real Assets

John LaForge
Head of Real Asset Strategy

Mason Mendez
Investment Strategy Analyst

Why OPEC+ matters again

Crude oil markets were rocked over the weekend, as OPEC+ unexpectedly announced a 1.2 million barrel per day production cut for 2023. News of this announcement sent West Texas Intermediate and Brent crude oil prices higher by 7% last week. Below, we will explain why the statement had such a dramatic impact on oil prices.

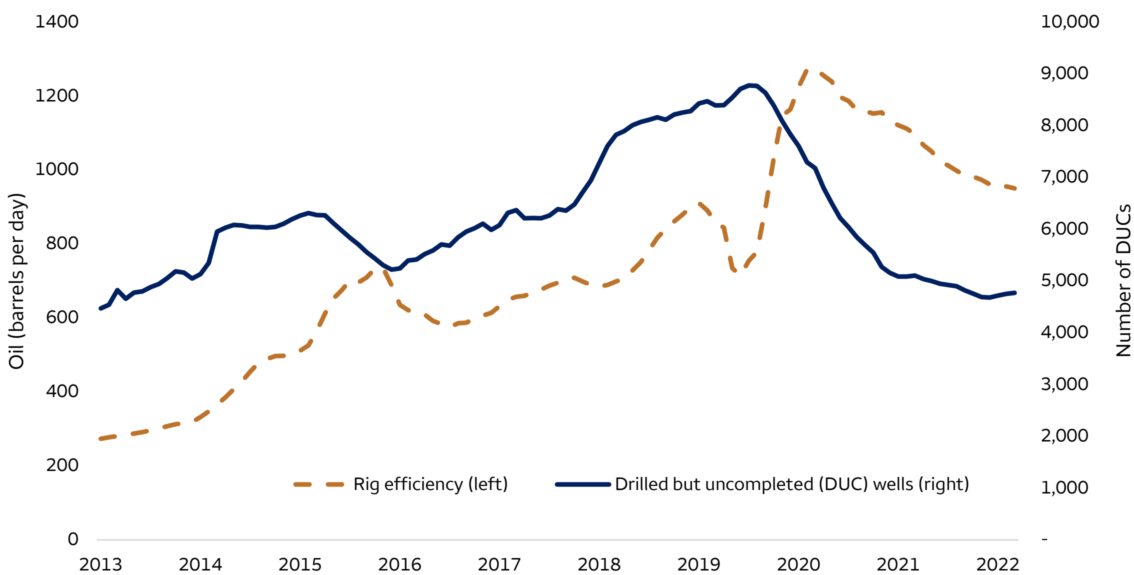
For context, OPEC+, led by Saudi Arabia, is the largest global oil consortium. Made up of 23 countries, one of which is Russia, OPEC+ controls 54% of global oil production.[5] Such dominance means that decisions by OPEC+ matter.

Production size, though, often comes second to production speed in commodity markets. The reason is that the global economy is constantly growing, demanding increasing amounts of commodities. Producers that can meet that extra demand with extra supply often dictate commodity prices.

So, as dominant as 54% of global production is, OPEC+ has not held the most influence over oil prices in recent years. That has been the U.S, thanks to the shale revolution. Over the past two decades, the U.S. has been one of the few countries able to increase its oil production to meet increasing global demand. In fact, growth has been so good that the U.S. surpassed Russia and Saudi Arabia in 2018 as the largest oil producing country, and it remains number one still today.

Which brings us back to why OPEC+'s announcement packed such an oil punch: the U.S. has recently been losing its sway as its production growth has been slowing. The dashed orange line in the chart highlights that since 2021, the amount of shale oil extracted per rig in the U.S. has been shrinking. The solid blue line shows that the number of wells held in reserve has been shrinking too. Without a resurgence in U.S. production growth, OPEC+ will likely become the dominant oil price influencer.

U.S. crude oil production challenges



Sources: Energy Information Administration, and Wells Fargo Investment Institute. Monthly data from December 31, 2013 – February 28, 2023.

5. Source: BP's 2022 Statistical Review of World Energy

Alternatives

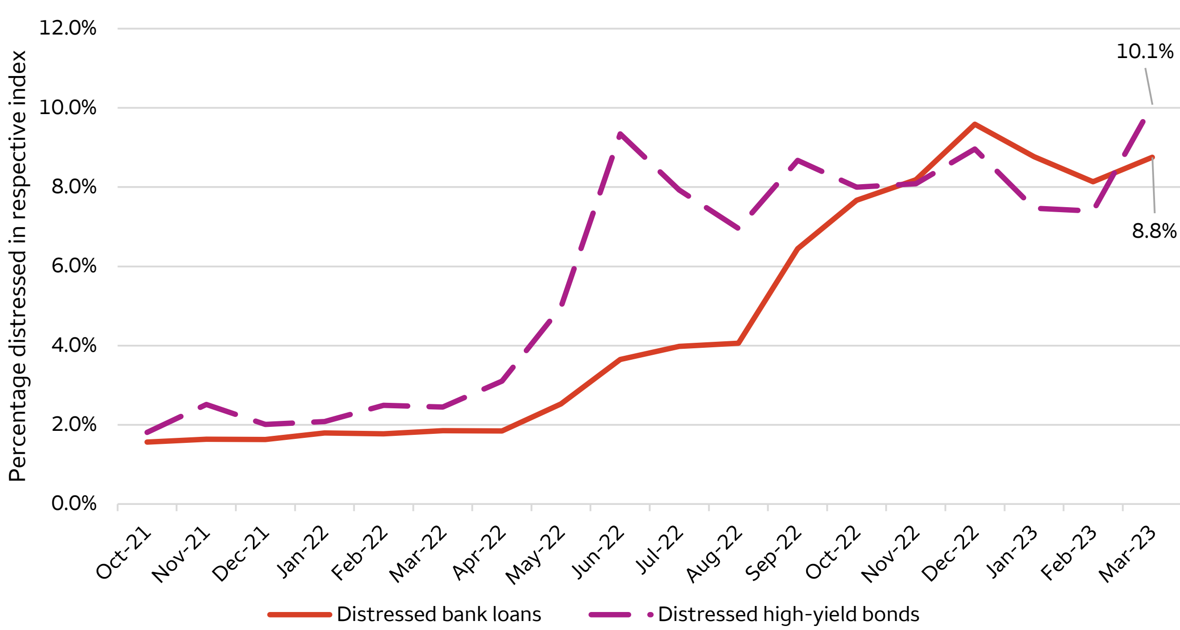
Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

Credit stress continues to rise

The recent small and regional bank crisis revealed an unintended consequence of the Federal Reserve's (Fed's) fight against mounting inflationary pressures. The campaign to raise rates at the fastest pace since the 1980s appeared to be achieving its inflation-reducing goals, yet ripple effects are beginning to emerge as higher interest expenses weigh on banks, businesses, and new homeowners alike. Though distress levels remain well below historical credit cycle peaks, the recent upward trend may be a sign that we are in the initial stages of the next default cycle in credit markets.

As investors remain focused on policy moves, indications of declining inflation levels provide hope that future rate hikes will be limited in size and scope. While a peak in interest rates may be nearing, investors expecting a decline in rates may be disappointed as the Fed has communicated a desire to keep rates "higher for longer." The longer rates remain elevated, the more pressure it applies to overleveraged small- and mid-sized businesses, especially those that are unable to pass rising costs onto consumers. As highlighted from the chart below, the percentage of distressed bank loans and high-yield bonds continues to trend upward. Both segments have increased from a low near 1.7% in October 2021 to 8.8% (bank loans) and 10.1% (high-yield bonds) in recent months. Given the backdrop of a recession on the horizon, investors may want to consider an allocation to Distressed Credit strategies that should be well-positioned to capitalize on the growing stress that is likely to continue in the coming quarters.

Percentage of distressed high-yield bonds and bank loans continues to grow



Sources: Pitchbook and Wells Fargo Investment Institute. Chart shows percentage of loans priced below 80 in the Morningstar LSTA U.S. Leveraged Loan Index (bank loans) and the percentage of loans trading above 1000 basis points in the S&P U.S. High Yield Corporate Bond Index (high-yield bonds). Data as of March 2023. 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.

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. Short Term Taxable Fixed Income	U.S. Long Term Taxable Fixed Income

Equities

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

Real Assets

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
		Private Real Estate	Commodities	

Alternative Investments*

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

Source: Wells Fargo Investment Institute, April 10, 2023.

*Alternative investments are not appropriate for all investors. They are speculative and involve a high degree of risk that is appropriate only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. Please see end of report for important definitions and disclosures.

Risk considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. **Bank loans** are subject to interest rate and credit risk. They are generally below investment grade and are subject to defaults and downgrades. These loans have the potential to hedge exposure to interest-rate risk but they also carry significant credit and call-risk. Call risk is the risk that the issuer will redeem the issue prior to maturity. 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

Bloomberg U.S. Corporate High Yield Index covers the universe of fixed-rate, noninvestment-grade debt.

Morningstar LSTA U.S. Leveraged Loan Index is designed to deliver comprehensive, precise coverage of the US leveraged loan market.

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 U.S. High Yield Corporate Bond Index is designed to track the performance of U.S. dollar-denominated, high-yield corporate bonds issued by companies whose country of risk use official G-10 currencies, excluding those countries that are members of the United Nations Eastern European Group. Qualifying securities must have a below-investment grade rating and maturities of one or more months.

An index is unmanaged and not available for direct investment.

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