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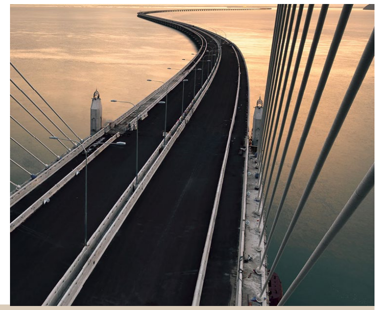
Investment Institute

Investment Strategy



Weekly guidance from our Investment Strategy Committee **May 1, 2023**

- What some view as the U.S.'s "exorbitant privilege" from the dollar's international role is in fact a mixed bag of benefits, costs, and responsibilities as the guardian of global finance.
- The central issue in the debate over the appropriate international benchmark is less about the dollar than conflicting domestic and international goals of any country issuing a world currency.

- Near-term industrial indicators suggest further weakness in the months ahead. However, several longer-term forces could support capital spending over the medium term.
- We favor more stable areas within Industrials such as services and defense contractors, while also looking to multi-industrials as potential longer-term beneficiaries of a larger U.S. manufacturing base.

- The corporate debt markets are beginning to show signs of stress, increasing the risks of a credit crunch.
- In the face of uncertainty, we believe larger companies with stronger balance sheets will provide more stable investment opportunities.

- Wells Fargo Investment Institute recently reduced its year-end 2023 oil price forecast to $85 – $95 per barrel.
- We reiterate our favorable view on energy equities despite our lowered oil price expectations.

- The market for merger and acquisition deals remains challenging, highlighted by the declining volumes and increasing premia witnessed during the first quarter of 2023.
- We continue to maintain our unfavorable guidance on the category and remain patient for a more opportune entry point after the economy recovers from a looming downturn.

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

Currency Spotlight

Gary Schlossberg
Global Strategist

Economic implications of the dollar's global role

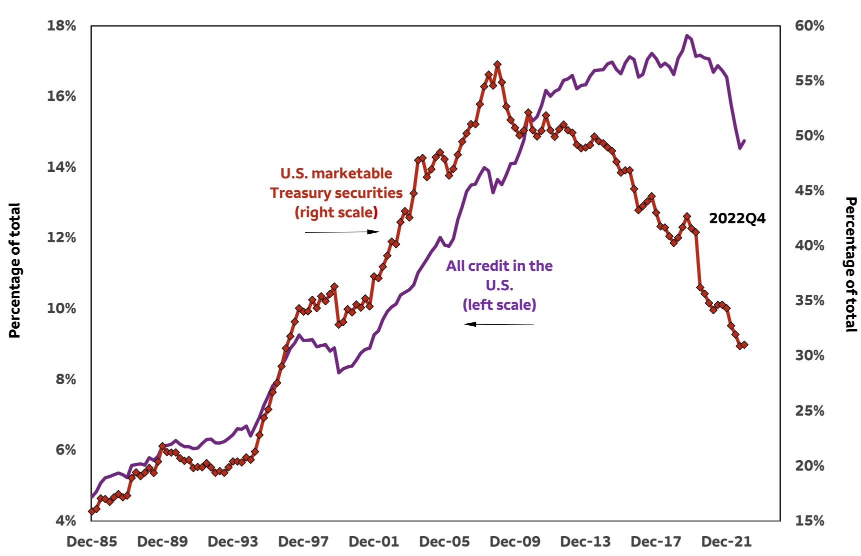
The dollar's "exorbitant privilege"[1] and "… our currency but your problem"[2]: These two quotes get to the heart of using a national currency as the world's financing vehicle. The debate over the dollar's international or "key-currency" role is just the most visible issue over its status, which we documented in our April 18 *Investment Strategy* report. However, that role has important implications for economic performance in the U.S., overseas, and in international trade and finance.

A global-currency balance sheet

The most visible advantage to the U.S. in its world currency role is the added leeway to finance outsized trade and budget deficits. Large deficits are tolerated (to a point) by the rest of the world because of the welcome increase in dollars flowing abroad from those deficits that finance trade, investment, and economic growth worldwide.

Overseas funds recycled to the U.S. for deficit financing has meant a still-elevated presence of foreign investors in the U.S. debt market, illustrated in the chart below. This is despite recent declines in the foreign share of holdings of U.S. Treasury debt. That overlay of foreign demand for dollars leaves added room for monetary and fiscal stimulus without disruptions from tumbling exchange rates and, ultimately, tightening U.S. credit conditions common elsewhere. U.S. living standards also benefit from the added funding, through lower interest rates and capital costs, along with a stronger dollar's lift to import purchasing power.

Chart 1. Foreign investors' share of credit debt in the U.S.



Source: Federal Reserve Board. Data as of March 9, 2023.

U.S. multinationals gain an inside track against competitors through the cheaper cost of capital, foreign exchange, and other transactions tied to invoicing in the home currency. These advantages typically outweigh any loss of

1. A phrase attributed to Valéry Giscard D'Estaing, French minister of finance, in 1965.
2. Former U.S. Treasury Secretary John Connally, G-10 ministers' meeting in Rome, 1971.

international competitiveness from a dollar often inflated by the added foreign demand. The dollar's key-currency role also has supported the growth of U.S. banks as global financial institutions.

For U.S. investors, "home-currency advantage" takes on added meaning from the dollar's international role. Like the exchange rate, U.S. stocks, bonds, and other assets typically get a boost from added foreign demand, both directly and through resulting increases in the depth, liquidity, and efficiency of U.S. markets. Downward pressure on U.S. interest rates and capital costs is particularly noticeable when financial or other turbulence boosts perceived safe-haven demand for U.S. securities, particularly for high-quality bonds and stocks.

And the disadvantages? Policy excesses at home are projected globally, destabilizing international financial markets, much like they did in triggering the 1971 collapse of the Bretton Woods system of fixed exchange rates. At the other extreme, excessive credit restraint or other policy tightening might exacerbate global deflation by pressuring overseas interest rates higher and drawing funds to higher-yielding dollar investments, adding to the local financing cost of dollar debt repayments, and suppressing commodity prices and export earnings. Resulting turbulence in overseas markets may in turn feed-back into a loss of policy control in the U.S. Past emerging-market debt crises, currency-market instability, and a U.S.-induced credit squeeze abroad have forced the Federal Reserve into policy reversals at odds with domestic goals.

Similarly, having large overseas ownership of the dollar and U.S. bonds may risk capital flight from highly mobile foreign investors, which may complicate the impact of U.S. policy on domestic interest rates and economic growth. In this context, an abrupt, politically motivated liquidation of dollar investments may be a red herring because of the losses incurred by major holders of dollar securities, such as China. However, even a more gradual exodus from dollar markets by foreign investors, like that of the late 1970s, has aggravated U.S. inflation and interest rate volatility. Loss of control over the domestic money supply and policy through currency internationalization discouraged removal of capital controls in Japan decades ago and, more recently, by China, despite its world-currency aspirations.

Weighing the dollar alternatives

At the heart of the debate over the dollar's international role is an inevitable conflict between domestic and international objectives of any world-currency country. Criticisms of the U.S. aside, few, if any, candidates are as suited for the role of international currency as the dollar. Gold's past use as an international benchmark has been deflationary because its limited supply forced painful domestic adjustments to balance-of-payments deficits, which proved politically intolerable. A multi-currency reserve system (another suggested alternative) involves less efficient cross-currency transactions without eliminating the problem of national versus global objectives.

A supranational currency like the euro or one created by the International Monetary Fund is far more vulnerable to a breakup than a national currency, with its clearer line of sovereign authority. And a system of fully floating exchange rates — untethered to the dollar, gold, or another benchmark — reduces the need for domestic adjustment to trade deficits, but at the risk of adding to potential financial instability by placing all the adjustment burden on more volatile exchange rates.

A drift away from the dollar — but nothing more than that — could get a mild tailwind from any number of sources. Re-globalization and geopolitical divisions are leaving the world economy more vulnerable to a fragmented multi-currency system of world trade and finance. Added moves to weaponize the U.S. currency would add to "de-dollarization" efforts, as we mentioned in last week's cover story. The inward tilt of U.S. foreign economic policies, via industrial policies, re-shoring, and overall support for the local tradeable goods sector, risks strengthening the dollar's more national policy bias. Also at work is a natural erosion of the U.S. role in global trade and economic activity, as world development fosters secular broadening and balancing of global economic activity.

Equities

Lawrence R. Pfeffer, CFA
Senior Lead Retail Investment Research Analyst

Peaks and valleys in Industrials

To describe it succinctly, the industrial economy is at an unusually challenging place. Certain areas, including electronic equipment, building products, and most of the transportation industry have already experienced recession-like conditions since last fall. We also observed several examples of incremental weakness in March, based on reports from what we view as bellwethers in industrial distribution, enterprise technology, big-box retail, and trucking.

On the other hand, we continue to hear relatively constructive commentary from companies with exposure to more secular themes, such as the energy transition, supply-chain re-shoring, and aerospace and defense. For some perspective, construction spending on manufacturing grew 53% year over year in February 2023, according to the U.S. Census Bureau. We expect strong growth over the medium term in the areas mentioned, all three of which are supported by significant fiscal stimulus programs (the Inflation Reduction and CHIPS and Science acts of 2022) or national strategic priorities.

How does one tie this together? First, we would note that most leading indicators, such as purchasing managers' indexes, point to a further slowdown in shorter-cycle areas in the months ahead. Second, there may also be greater structural supports for the capital spending that the neutral-rated Industrials sector lives on in the years beyond. For now, we would be selective in our positioning. We favor commercial and professional services and defense contractors for their earnings stability in the near term. We also favor multi-industrials and railroads for their leverage to what we believe could be a larger U.S. industrial base over the long term.

U.S. construction spending for manufacturing (millions of U.S. dollars)

Source: U.S. Census Bureau. Data as of April 25, 2023.

Fixed Income

Paul Y. Kim, CFA
Lead Retail Investment Research Analyst

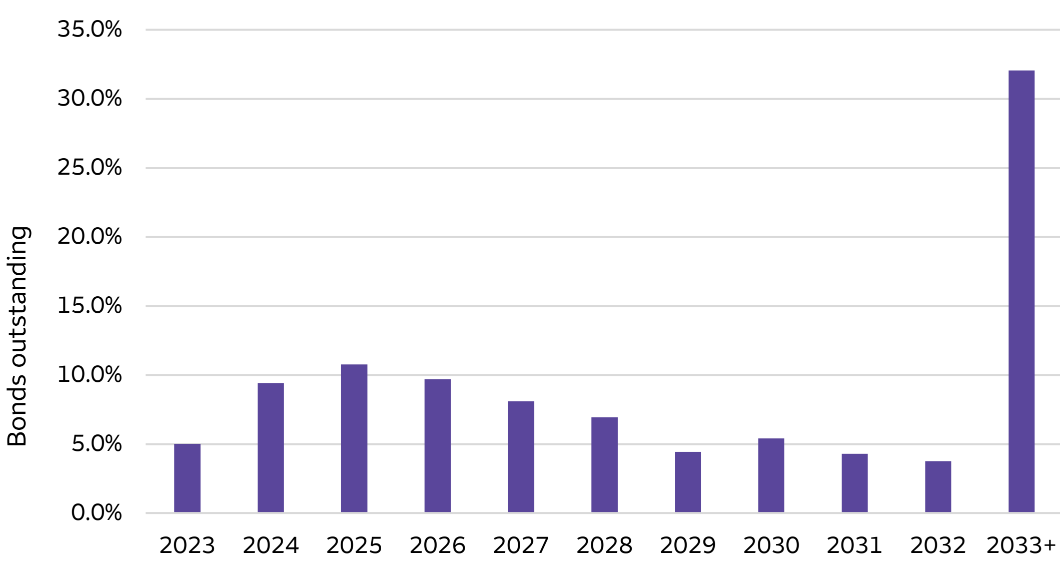
In volatile times, consider stronger, larger companies

As the credit cycle turns, tension points in the debt markets are beginning to appear. Companies are encountering a slowing economy in an environment of tightening monetary policy, and recent regional banking problems may have pulled forward growth pressures. The weaker macro environment, in combination with stressed banks withdrawing from lending, raises risks of credit contraction. Judging by current consensus expectations, first-quarter financial results will mark the first impactful earnings strain on the markets since the beginning of the pandemic.

Credit spreads on corporate debt have remained reasonably resilient. Compared to past down cycles, credit profiles are stronger, with companies maintaining more conservative balance sheets. Investment-grade issuers are also in an auspicious position, with nearly a third of their debt maturing in 10 years or more. Delayed refinancing will lead to a slower increase in interest expenses. A significant caveat to aggregate credit profile strength for the investment-grade universe is the concentration of cash flow among the largest companies. Slightly less than 10% of nonfinancial investment-grade issuers are generating approximately 50% of EBITDA (total earnings before interest, taxes, depreciation, and amortization). The likely first-quarter earnings contraction should lead to credit profile deterioration that disproportionately affects smaller issuers.

Now is not the time to become complacent on credit risk. While credit spreads have recently retreated from wide levels due to the perception of easing systemic issues, they could remain volatile going forward. We believe that credit risk within the corporate debt market is rising and larger companies with stronger balance sheets will provide more stable investment opportunities.

Investment-grade corporate bonds maturing annually



Sources: Bloomberg and Wells Fargo Investment Institute. Figures refer to all U.S.-dollar-denominated bonds outstanding that have a Bloomberg investment-grade composite rating as of April 25, 2023.

Blend of a security's Moody's, S&P, Fitch, and DBRS ratings. The rating agencies are evenly weighted, and it is calculated by taking the average of the existing ratings, rounded down to the lower rating in case the composite is between two ratings.

Real Assets

Ian Mikkelsen, CFA
Equity Sector Analyst, Energy

Remaining positive on lowered expectations

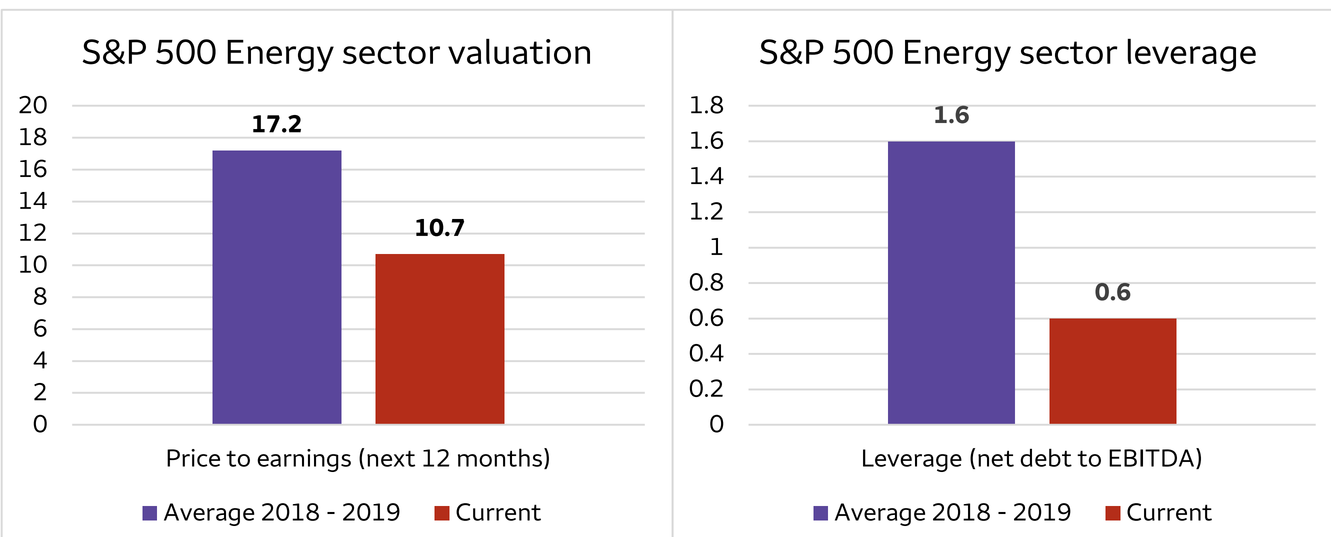
Energy was the best-performing sector in 2021 and 2022, but its momentum has stalled in early 2023 as Energy has been one of the worst-performing sectors year to date (as of April 24). Wells Fargo Investment Institute recently lowered its year-end forecast for West Texas Intermediate crude oil to $85 – $95 per barrel from $100 – $120 per barrel. This scenario begs the question — has our favorable view on energy stocks changed? It has not.

Energy tends to be a momentum-driven sector in which short-term performance is often dictated by the rate of change in fundamentals. Consensus earnings estimates have been revised lower and earnings growth is expected to turn negative in the second quarter, largely due to lower year-over-year commodity prices. Additionally, the specter of a coming recession has weighed on investor sentiment for energy because of its highly cyclical nature.

We expect continued macroeconomic-driven volatility in the near term, but we encourage investors to take a step back and appreciate that the underlying fundamentals for energy remain strong. Energy companies continue to prioritize capital discipline and are delivering competitive shareholder returns through dividends and share repurchases at current commodity price levels.

We believe that stock valuations are attractive and company balance sheets are much better positioned to withstand periods of downside volatility in commodity prices relative to history. To illustrate, we show current sector valuation and leverage from 2018 – 2019 to compare current sector fundamentals with pre-COVID-19 levels.

Chart 1. Energy sector valuation and leverage, current vs. 2018 – 2019



Sources: FactSet consensus estimates (as of April 24, 2023) and Wells Fargo Investment Institute. EBITDA = earnings before interest, taxes, depreciation, and amortization. The S&P 500 Energy sector is composed of companies in the S&P 500 that are classified as Energy companies by GICS.

Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

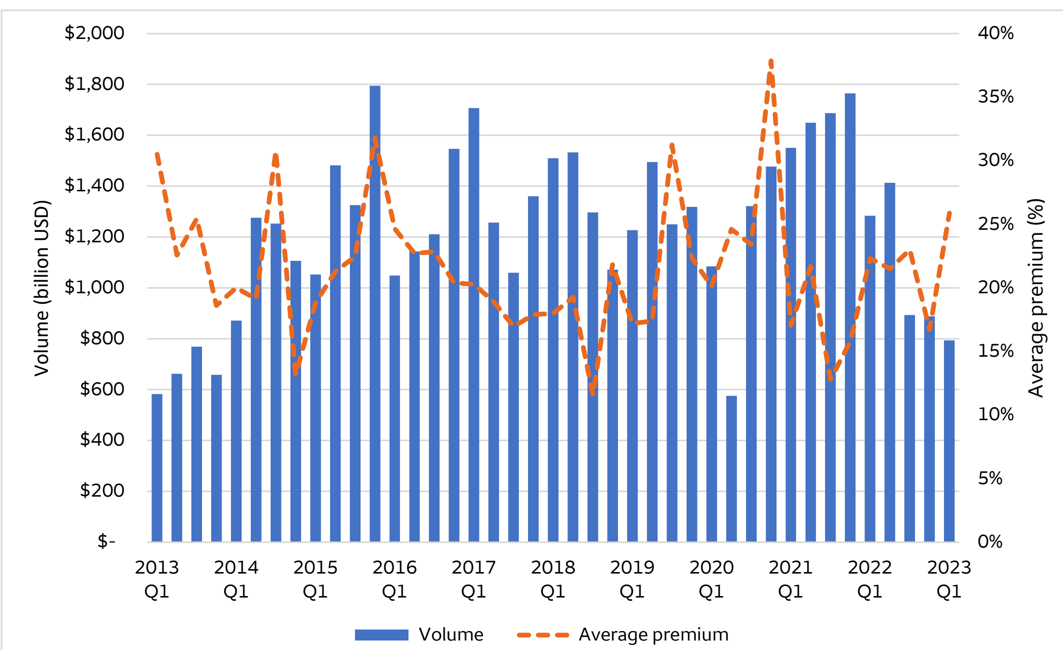
Merger and acquisition environment remains challenging

Merger and acquisition (M&A) activity has remained subdued in 2023 as volumes recorded the slowest start to the calendar year in over a decade, and the lowest levels in any quarter since mid-2020 during the global pandemic. In addition, the average premium (or spread between buyer bids and current market prices) of announced deals has widened from 17% to 26% over the past quarter (see chart). The increasing average premium continues a longer-term trend in place since the third quarter of 2021 and highlights the elevated uncertainty of deals making it to the closing stage.

Rising (albeit still relatively low) corporate credit stress and a recent banking crisis reflect the after-effects of the rapid rise in interest rates since early 2022. As corporate leaders continue to grapple with higher rates for longer, the increased cost to finance acquisitions and the uncertain economic outlook continue to weigh on M&A deal activity. In addition to the deteriorating economic outlook, increased regulatory scrutiny remains a growing risk as antitrust policies lead to greater delays and higher costs, creating significant barriers to closing deals.

In summary, we maintain our unfavorable guidance on Merger Arbitrage strategies. Lower levels of deal activity, widening deal spreads, and declining corporate leader confidence levels all contribute to an environment that remains challenging for Merger Arbitrage strategies over the near- to intermediate-term. We remain patient for a more opportune entry point as the economy provides signs that it is on a path to recovery.

Merger and acquisition deal volumes and average premia



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of March 31, 2023.

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.

Average Premium: The average premium all announced deals on a global basis that includes all pending, proposed, terminated, completed, and withdrawn deal status.
Volume: The aggregate value of all announced deals on a global basis, that include pending, proposed, completed, withdrawn and terminated deal status.

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, May 1, 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

Forecasts and targets are 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. **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. Investments in **currencies** involve certain risks, including credit risk, interest rate fluctuations, fluctuations in currency exchange rates, derivative investment risk and the effect of political and economic conditions. The use of currency transactions to seek to achieve gains in the portfolio could result in significant losses to the portfolio which exceeds the amount invested in the currency instruments. In addition, exchange rate movement between the U.S. dollar and foreign currencies may cause the value of the fund's investments to decline.

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 the fund may invest may not materialized as planned or may be renegotiated or terminated which can result in losses to the fund.

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.

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 Energy Index comprises those companies included in the S&P 500 that are classified as members of the GICS® energy sector.

Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

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