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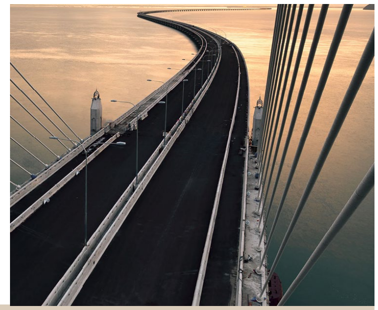
Investment Strategy



Weekly guidance from our Investment Strategy Committee **May 8, 2023**

Equities Spotlight

"Preparation, I have often said, is rightly two-thirds of any venture." — Amelia Earhart

Austin Pickle, CFA
Investment Strategy Analyst

Highlighting updated guidance — Focus on the storm ahead

On April 21, we made a number of guidance and target changes across equity asset classes and announced our 2024 targets. Today, we highlight those updates.

Since early 2022, our plan has favored defensively allocating toward quality, and two weeks ago we took further steps in an effort to reduce portfolio risk. This resulted in one-notch downgrades to U.S. Large, Mid, and Small Cap Equities to favorable, neutral, and most unfavorable, respectively. In our view, as the stock rally brought prices near the top end of their year-long trading ranges, the risk-reward balance tilted unfavorably and provided a good opportunity for us to trim exposure. The move looked particularly attractive given the relative safety of, and high yields available in, U.S. Short Term Taxable Fixed Income.

It is important to note that we maintain our preference for large-cap over mid-cap equities, and mid-cap over small-cap equities. Leaning on the quality available in large-cap equities remains a key consideration as the economy likely approaches a recession as we expect. Additionally, there have been several recent events that have weighed on our outlook toward the lower-quality small-cap index. This includes the regional banking crisis that began in March, with echoes that may continue. While we do not anticipate a global banking crisis,[1] increased banking system strains likely will tighten credit conditions further, which may impair sentiment toward and performance of credit-dependent U.S. Small Cap Equities. Announced alongside our guidance changes was our new, lower 2023 price target range for our small-cap benchmark, the Russell 2000 Index.

Straightening the U.S.-over-international equities lean

China's reopening, Europe's avoidance of an energy crisis this past winter, and expectations of policy normalization in Japan have improved our Emerging Market (EM) Equities and DM ex-U.S. Equities outlooks. We increased price and earnings targets for both benchmarks and also upgraded DM from most unfavorable to neutral.

Our view toward DM equities improved over the past several months, culminating in an upgrade. After over 15 years of DM struggles with performance, we believe that we have reached an inflection point. We expect DM equities to be supported by a better-than-feared economic and earnings environment, multi-decade-low relative valuations, and our forecast for a flat-to-lower dollar.

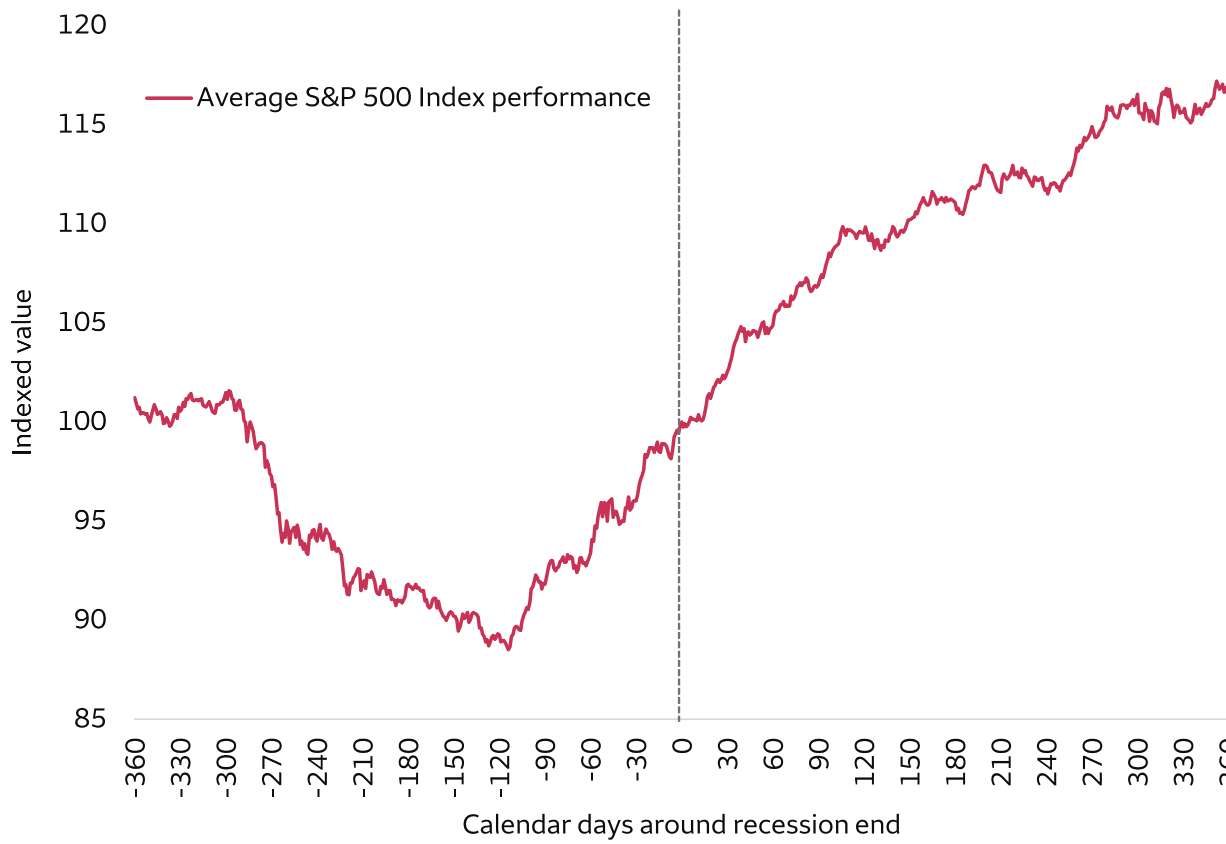
We believe EM equities, on the other hand, face headwinds that ultimately keep us unfavorable, such as ongoing political risks from Chinese regulatory reform, U.S.-China diplomatic and economic strains, and China's slower growth potential as it shifts to emphasize domestic consumption. The greater risk of downside volatility within EM equities during a risk-off environment is also a concern as we expect we are near an economic downturn.

2024, not like 2023

As the economy weakens, our preference for quality and more defensive positioning in portfolios remains in effect. Once we believe the recession appears to be fully priced in to market valuations, however, we likely will begin to position for the early cycle recovery we see emerging in 2024. As this has most often been the case, we anticipate that time may likely come while the economy is still within the grips of the recession (see chart 1).

1. Please see "Keeping perspective on worries about banks" May 1, 2023 *Institute Alert*.

Chart 1. Stocks have typically bottomed four months prior to recession end



Sources: Bloomberg and Wells Fargo Investment Institute. Indexed to 100 as of the end of every recession since 1948. Please see page 8 for recession end dates. Data as of May 2, 2023. An index is unmanaged and not available for direct investment. **Past performance does not guarantee future results.** Please see end of report for index definitions.

2024 is likely to resemble a typical recovery year, in our view. We foresee the end of the recession, an economic rebound in the U.S. and abroad, and easing credit conditions — in short, an ideal environment for risk assets.

All equity asset classes should likely participate in the risk-on rebound we foresee, with strong returns for 2024 likely tilting toward lower-quality areas. This view is evidenced by our year-end 2024 targets, which imply that U.S. Small Cap Equities should outpace U.S. Mid Cap Equities, which in turn should outpace U.S. Large Cap Equities. Similarly, within international equities, we expect that EM will outperform DM next year.

While we believe it is important to look toward and plan for the early cycle 2024 recovery, it is too early to position for that eventuality. We believe risks in the system are building. We expect that we are in the midst of an earnings recession and are on the front porch of an economic one. We believe it unlikely that equities will surge meaningfully higher without first discounting this reality.

Be patient, stay diligent, and position accordingly as we believe the recessionary storm clouds are building.

Fixed Income

Peter Wilson
Global Fixed Income Strategist

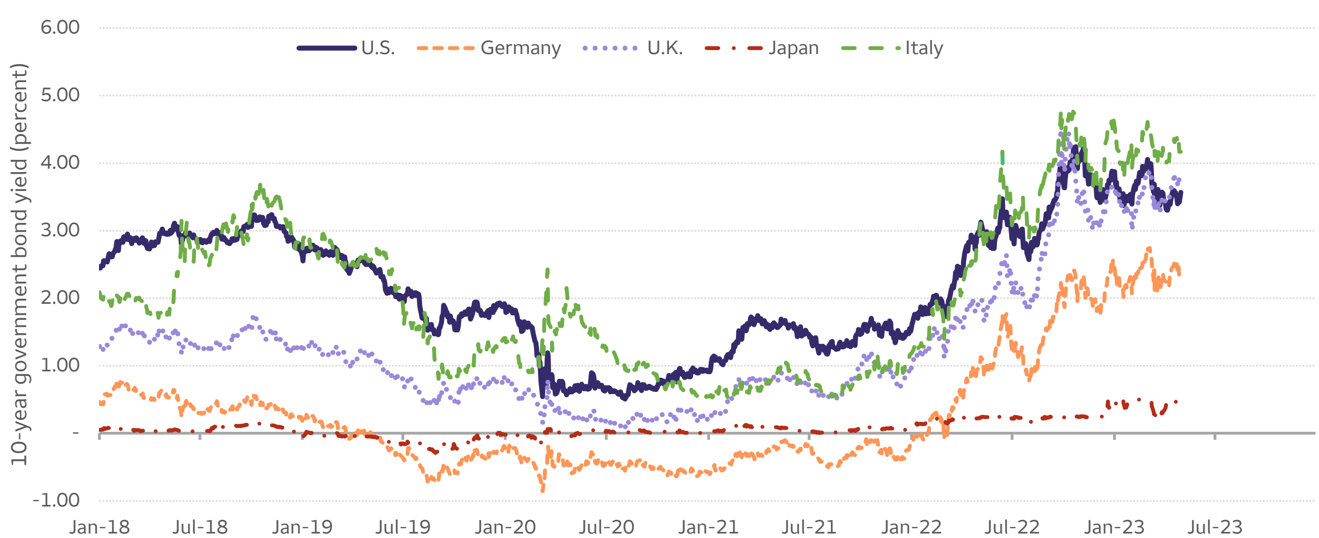
Value in developed market debt: Are we there yet?

We recently upgraded our guidance on DM ex-U.S. Debt from unfavorable to neutral, in recognition of the improving environment for this fixed-income class, along with its better relative value versus U.S. bonds. The backdrop brightened once the U.S. dollar's 2022 peak was behind us, and currency losses seemed to no longer threaten to drag heavily on returns. Further, the ECB has raised rates much more quickly than most expected, and yields have normalized across the curve — we believe the deeply negative rates once seen in the highest-quality markets are a thing of the past.

Is this a compelling value opportunity? Not yet, in our opinion. The chart shows that some markets, notably in Italy and the United Kingdom, have 10-year government bonds yielding higher than U.S. Treasury securities. But in our view these are the exceptions, as Italy continues to struggle with a high debt burden and the U.K.'s traditionally inflation-prone economy faces additional macroeconomic and fiscal policy challenges post-Brexit. These two debt markets account for more than 20% of the DM ex-U.S. benchmark index,[2] but in aggregate the index yield is lower, currently around 2.00% – 2.50%, similar to the yield range on 10-year German bunds.

In our view, 2024 may be the year for further upgrades. We expect the dollar to show a clearer downtrend, after range-trading for most of 2023. We believe value may improve more as yield spreads tighten further versus the U.S. if the ECB holds policy rates at peak levels for longer than the Federal Reserve (the Fed), as we anticipate. We believe one potential catalyst for a weaker dollar and attractive DM yields may be the eventual abandonment by the Bank of Japan of its yield curve control policy, potentially allowing 10-year Japanese yields to rise from the floor, and also facilitating further rises in European yields as Japanese investors may look to reallocate funds back to their domestic market.

Absolute and relative yields are both gradually improving



Sources: Bloomberg and Wells Fargo Investment Institute. Latest data as of May 1, 2023. **Past performance does not guarantee future results.**

[2] The JPMorgan Global Ex United States Index (JPM GBI Global Ex-US). See end of report for index definitions.

Real Assets

"April showers bring May flowers." — Thomas Tusser

Mason Mendez
Investment Strategy Analyst

Update to crude oil targets for 2023 and 2024

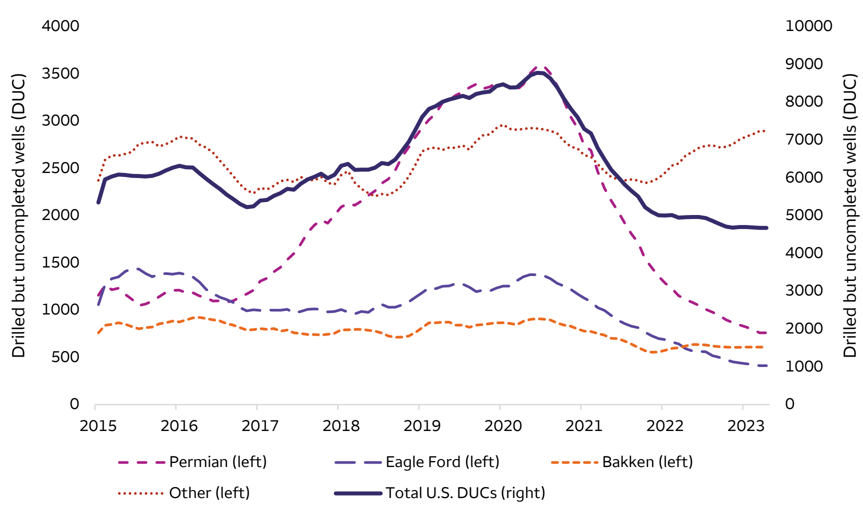
In light of our expectation for a looming recession in 2023, we are cautious about crude oil's near-term performance. We remain optimistic on crude, but with only eight months left in 2023, we believe it is prudent to lower our year-end targets while introducing our higher 2024 targets.

As the globe tilts toward recession and central banks continue to raise interest rates in an effort to quell inflation, we are anticipating softer commodity prices in the short term. We do not find it prudent, however, to lower our price targets too much, as the commodity bull super-cycle remains intact.[3] Therefore, we lowered our 2023 year-end WTI crude oil target from $100 – $120 per barrel to $85 – $95 per barrel, and Brent crude oil from $105 – $125 per barrel to $90 – $100 per barrel.

Looking through 2023 and the potential second-half recession, we suspect that the bull super-cycle should once again be the dominant driver of commodity prices, including crude oil. As a quick refresher, bull super-cycles have often been underpinned by supply challenges. One of the supply challenges in the U.S., the world's largest oil producer, is the number of drilled but uncompleted (DUC) wells, shown in the chart below. U.S. DUCs are down since peaking in 2020, even with oil prices consistently above $70 per barrel over the past year. A high number of DUCs provides producers an ample supply of crude oil that can be brought to market relatively quickly, while a low number indicates the opposite. In our view, such a low number of DUCs among key U.S. shale basins, such as the Permian, indicates demand may exceed adequate supply once demand recovers in 2024, as we suspect it should.

We believe the bottom line is that prices may turn soft in the short term as the globe aims to fight off a recession in the back half of 2023. Once in 2024, however, we suspect demand should recover, and with it, global oil prices.

Number of U.S. DUC wells by region



Sources: Bloomberg, Energy Information Administration, and Wells Fargo Investment Institute. Monthly data is from January 2015 – April 2023.

3. Bull super-cycles are historically recurring, multi-year periods when commodity prices tend to appreciate together.

Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

Consider hedge funds to navigate volatile markets

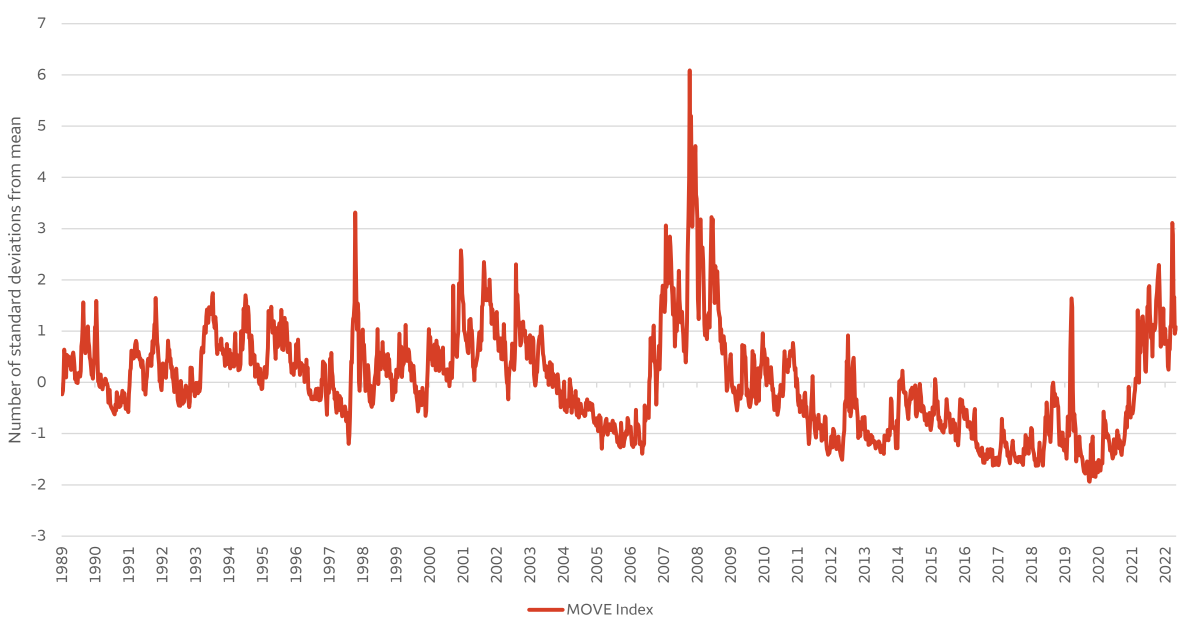
Ongoing signs that a recession is nearing, the continued stress in the banking industry, and a looming debt ceiling standoff have had investors on edge in recent weeks. In addition, the Fed's campaign to conquer inflation while attempting to limit damage to the economy has been contributing to above-average levels of volatility in fixed-income markets. Bond markets have registered above-average levels of volatility in recent periods.

As highlighted in the chart below, bond market volatility (as measured by the ICE BofA US Bond Market Option Volatility Estimate Index (MOVE)) is at levels only reached during 2008 and the late 1990s. This gauge of investor fear reflects the growing uncertainty as to whether the Fed may be able to finish the inflation fight without creating pain for investors or the economy. Moreover, many pundits question whether the Fed has the resolve to remain committed to holding interest rates high as markets become increasingly jittery, especially as the presidential election grows nearer and political pressure continues to mount.

Use alternative strategies in an effort to combat volatility

In our view, alternative strategies such as Long/Short Credit may potentially be equipped to mitigate risks in volatile markets. The ability to employ both long and short positions looks to allow the manager to dampen market volatility. A long position is one that allows the manager the potential to benefit when the price of an asset rises, and conversely, a short position is one that benefits when the price declines. We believe the greater flexibility may allow managers to reduce unintended risks as they seek to navigate difficult markets.

Bond market volatility as measured by the MOVE Index



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of April 30, 2023.
ICE BofA US Bond Market Option Volatility Estimate Index (MOVE) measures Treasury rate volatility through options pricing. The chart measures the number of standard deviations (a measure of volatility) from the mean between December 31, 1989, and April 30, 2023. An index is unmanaged and not available for direct investment. **Past performance does not guarantee future results.** Please see end of report for index definitions.
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. 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 8, 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 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. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. 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. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic condition.

Equity long/short investing refers to buying perceived undervalued equity positions and selling short perceived overvalued positions. The strategy attempts to capture returns from both types of trades. There is no guarantee such strategies will be successful. Short selling involves the risk of potentially unlimited increase in the market value of the security sold short, which could result in potentially unlimited loss for the investment. In addition, taking short positions in securities is a form of leverage which may cause a portfolio to be more volatile. Significant long or short exposure to a particular sector or sub-sector can also magnify the risk level of a particular long/short equity strategy.

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

ICE BofA US Bond Market Option Volatility Estimate Index (MOVE) formerly known as the Merrill Lynch Option Volatility Estimate Index, measures U.S. bond market yield volatility by tracking a basket of over the counter options on U.S. Treasury notes and bonds.

JPMorgan Global Ex United States Index (JPM GBI Global Ex-US) is a total return, market capitalization weighted index, rebalanced monthly, consisting of the following countries: Australia, Germany, Spain, Belgium, Italy, Sweden, Canada, Japan, United Kingdom, Denmark, Netherlands, and France.

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity 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.

An index is unmanaged and not available for direct investment.

Chart 1 recession end dates: 10/31/1949, 5/31/1954, 4/30/1958, 2/28/1961, 11/30/1970, 3/31/1975, 7/31/1980, 11/30/1982, 3/31/1991, 11/30/2001, 6/30/2009, 4/30/2020.

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