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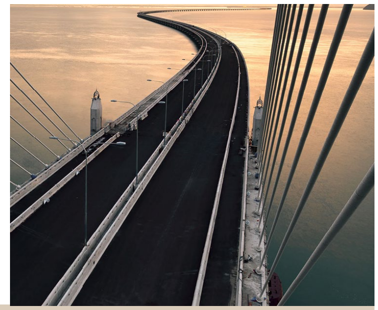
Investment Strategy



Weekly guidance from our Investment Strategy Committee **May 15, 2023**

Global Macro Spotlight

Michelle Wan, CFA
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Investment Strategy Analyst

Navigating volatility around the debt ceiling debate

U.S. Treasury Secretary Janet Yellen recently announced the "X" date could be June 1, instead of later in the summer as the Treasury previously expected. The "X" date is an estimated date on which the Treasury Department may run out of funds to pay for current obligations and cannot issue new debt unless the debt ceiling is lifted.

The paths of the economy (slower) and interest rates (higher) have increased the government's funding challenge. Revenue has declined by 3%, while spending grew by 13% (as of March 2023) compared to a year ago.[1] Anticipating deteriorating economic conditions and corporate earning challenges, we do not expect a strong tax collection season either. Higher interest rates also exacerbated the government's payment burden. Interest expense as a percentage of revenue has trended higher and will continue to rise, based on the Congressional Budget Office's (CBO's) projections.[2]

Secretary Yellen's announcement propelled the debt ceiling debate forward. Congress has very limited time in session during May, and the tough discussions that lie ahead could increase near-term volatility in both equity and bond markets. As of May 9, U.S. Treasury securities maturing in June were down slightly in price and up slightly in yield from a month ago. That gap may widen in the coming days but should reverse if Congress finds a compromise, as we expect. (For more on managing volatility in Treasuries that mature in June, please see page 5 of this report.)

We believe the risk of default is low and strongly prefer not to manage portfolio exposure around the debt ceiling.

The path forward in the near term

President Biden and congressional leaders met on May 9 and scheduled further discussions, as of this writing. Meanwhile, congressional staffers are working on compromises, even though media reports continue to highlight the partisan differences. We take these developments as encouraging.[3]

We believe it will be a tough negotiation, but the risk of a debt default should be low for several reasons. First, 2024 is an election year, and we believe that neither Democrats nor Republicans would want to be blamed for a default so close to the start of the 2024 election campaigns. Second, the CBO expects high interest rates to raise interest expense to 14% of tax revenues, a level that has historically led to spending cuts (see chart). We believe Congress will be more engaged in spending-cut discussions than what the political rhetoric has indicated so far. Finally, if time gets short, we could see a small increase in the debt ceiling, or even a temporary suspension of the ceiling. We see evidence that some in Congress are already planning for such a contingency.[4] We believe the government has strong incentives to reach resolution on the debt ceiling, even if not until the 11th hour, resembling episodes of past debt ceiling impasses.

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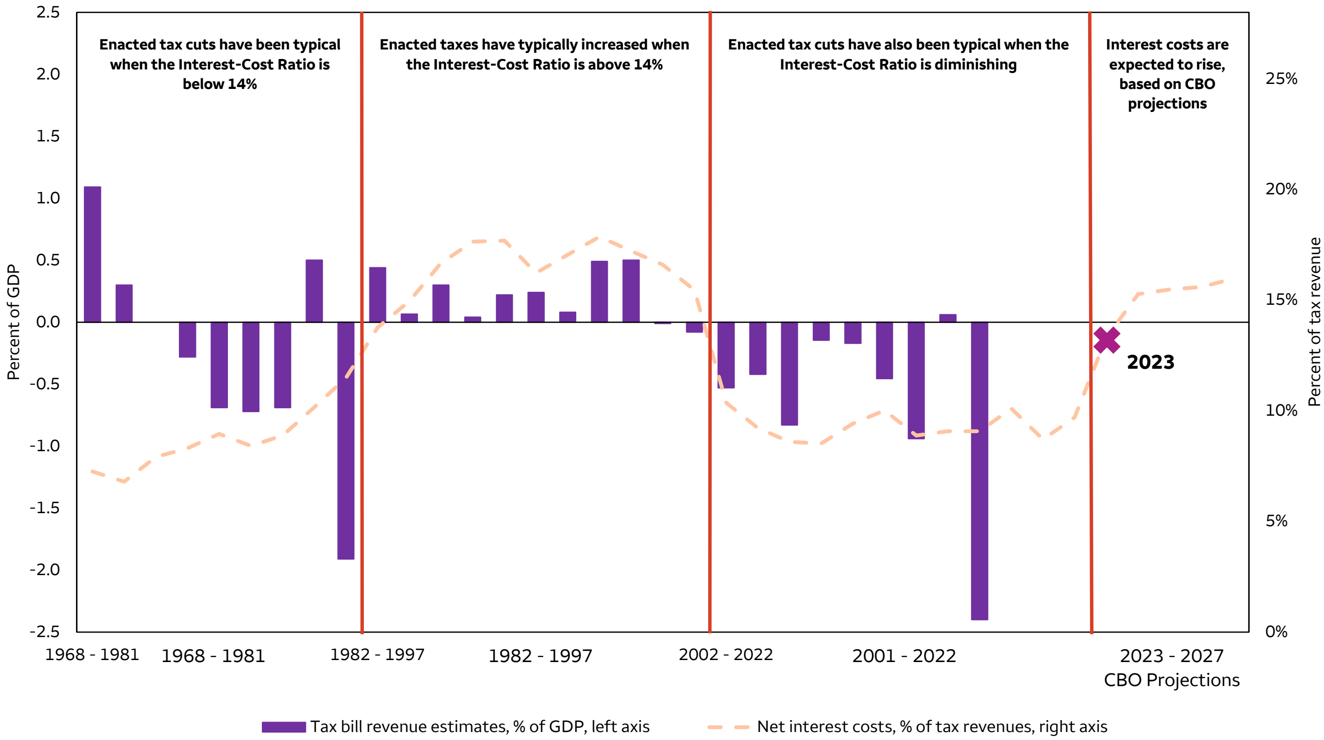
1. Fisacaldata.treasury.gov, data as of March 2023.
2. Congressional Budget Office, The Budget and Economic Outlook: 2023 to 2033, February 15, 2023.
3. Dan Clifton, Strategas Securities, "Debt Ceiling Negotiations Have Started, Now Comes the Hard Part," May 10, 2023.
4. The House Problem Solvers Caucus, a bipartisan group of moderate House lawmakers, has already initiated a backup plan by suspending the debt limit until the end of December. "House moderates float U.S. debt-limit extension until December," Bloomberg, April 19, 2023.

Chart 1. The U.S. government historically tightened spending in periods of high interest expense



Sources: Strategas Research Partners, Congressional Budget Office, Federal Reserve Bank of Saint Louis. Data displayed for all years for which data is available.
*Average impact of every tax cut or hike for the first two years after enactment as a % of GDP (gross domestic product).

Manage near-term volatility while positioning allocations for the long term

The debt ceiling debate is one issue that we believe will gather momentum in the coming weeks. But it's not the only one. The high risk of a near-term recession, further strain among regional banks, and market disappointments over Federal Reserve policy are risks that we believe will persist into year-end 2023.

Considering these risks collectively, and especially those most likely to generate downside risk to equity markets beyond the probable scope of the debt ceiling resolution, we took an additional defensive step in portfolio allocations last month.[5] We favor rebalancing from U.S. equities to Developed Market ex-U.S. Equities, mainly by reducing U.S. Mid Cap and Small Cap equity exposure. Additionally, we favor reducing the overweight to U.S. Large Cap Equities, in favor of additional allocations to U.S. Short Term Taxable Fixed Income. We anticipate an economic recovery in 2024, and this last move is intended to bridge over the volatile months to come in 2023, until a recovery provides new opportunities to expand and broaden equity exposure again.

5. For complete details of our guidance changes, please see Wells Fargo Investment Institute, "Announcing 2024 targets and updated guidance," April 21, 2023.

Equities

Chris Haverland, CFA
Global Equity Strategist

Earnings shrink for the second consecutive quarter

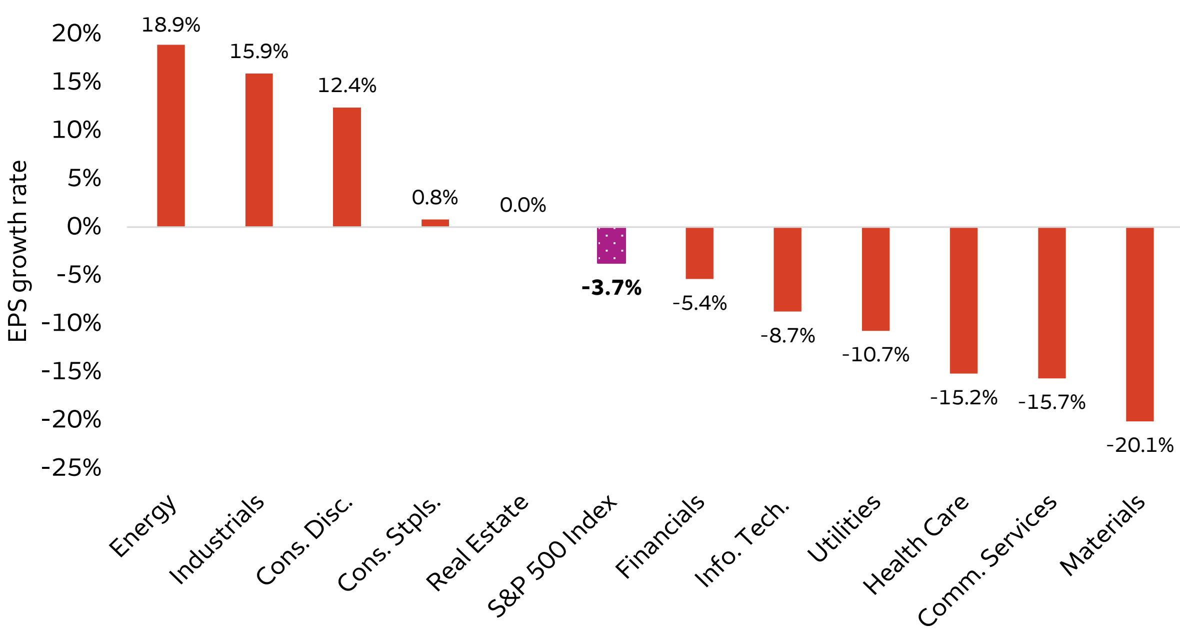
After falling 2.4% in the fourth quarter of 2022, S&P 500 Index earnings are tracking lower by 3% – 4% in the first quarter of 2023. With roughly 90% of the index reporting, earnings have beaten lowered expectations. However, the solid beat rate was not enough to show profit growth in the quarter. Revenues grew modestly, but at the lowest rate since the fourth quarter of 2020.

The Energy and Industrials sectors have led the way, with Consumer Discretionary not far behind. Most of the other sectors are reporting flat to negative earnings for the quarter, with Materials and Communication Services posting the steepest declines. The Information Technology sector, which has been a performance leader year-to-date (as of May 15, 2023), saw earnings contract by nearly 9%.

Forward guidance has been mixed, with many companies still dealing with high input prices, a tight labor market, and a slowing global economy. After peaking in the second quarter of 2022, operating margins declined to the lowest level in over two years. We believe margins and overall earnings likely will fall throughout 2023, before rebounding in 2024.

The better-than-feared earnings results have had little impact on analysts' estimates. Overall, 2023 earnings forecasts for the S&P 500 Index are flat during earnings season. Meanwhile, the Russell 2000 Index and the MSCI Emerging Markets Index have seen consensus earnings estimates revised lower. We believe earnings will be challenged in the coming quarters as companies deal with a recession. In this environment, we suggest focusing on quality and prefer U.S. Large Cap over U.S. Mid Cap and Small Cap Equities.

S&P 500 and sector Q1 2023 EPS growth rates



Sources: Bloomberg and Wells Fargo Investment Institute.
EPS growth measures consensus Q1 2023 EPS expectations as of May 9, 2023, versus Q1 2022 EPS. An index is unmanaged and not available for direct investment.
Past performance is no guarantee of future results.

Fixed Income

Luis Alvarado
Global Fixed Income Strategist

T-bills caught in debt ceiling crossfire

As short-term interest rates remain elevated, some investors may have decided to allocate some of their capital into short-term Treasury bills (T-bills), thinking they would enjoy an attractive interest rate with virtually no credit risk and plenty of liquidity.

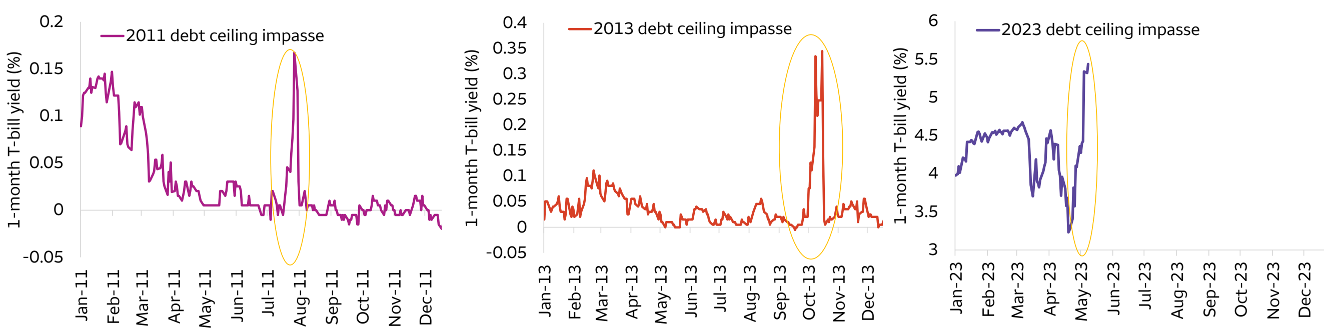
However, delays in raising the debt ceiling have created additional volatility in the T-bill market. The most volatile have been those T-bills maturing sometime in June 2023, which happens to be the month that the U.S. Treasury Department has targeted as the date it may run out of funds (also known as the "X" date).

Likewise, in 2011 and 2013, investors also took measures to avoid those T-bill securities that happened to mature around the corresponding "X" date. What occurred back then, and is also occurring now, is that we observed an increase in yields (lower prices) and less liquidity in the secondary markets for those specific securities.

Furthermore, a lack of progress toward some type of agreement could create additional problems for short-term U.S. Treasuries in that we may experience lower levels of demand at auctions and additional borrowing costs for the Treasury, just as we did in previous episodes.

For those investors who already own T-bills maturing around the current "X" date, we believe that the best course of action is not to panic and to wait for the maturity date to receive their principal and interest back. In the strange case that there is still no resolution when the security is due, we believe that investors will be made whole and paid additional interest once the situation is resolved. However, available liquidity for the specific date remains a risk.

1-month T-bill yields tend to widen near debt ceiling "X" date



Sources: Bloomberg and Wells Fargo Investment Institute, as of May 9, 2023. **Past performance is no guarantee of future results.**

Real Assets

"Real gold is not afraid of the melting pot." — Chinese proverb

Mason Mendez
Investment Strategy Analyst

John LaForge
Head of Real Asset Strategy

Our view on gold — Rally may extend into 2024

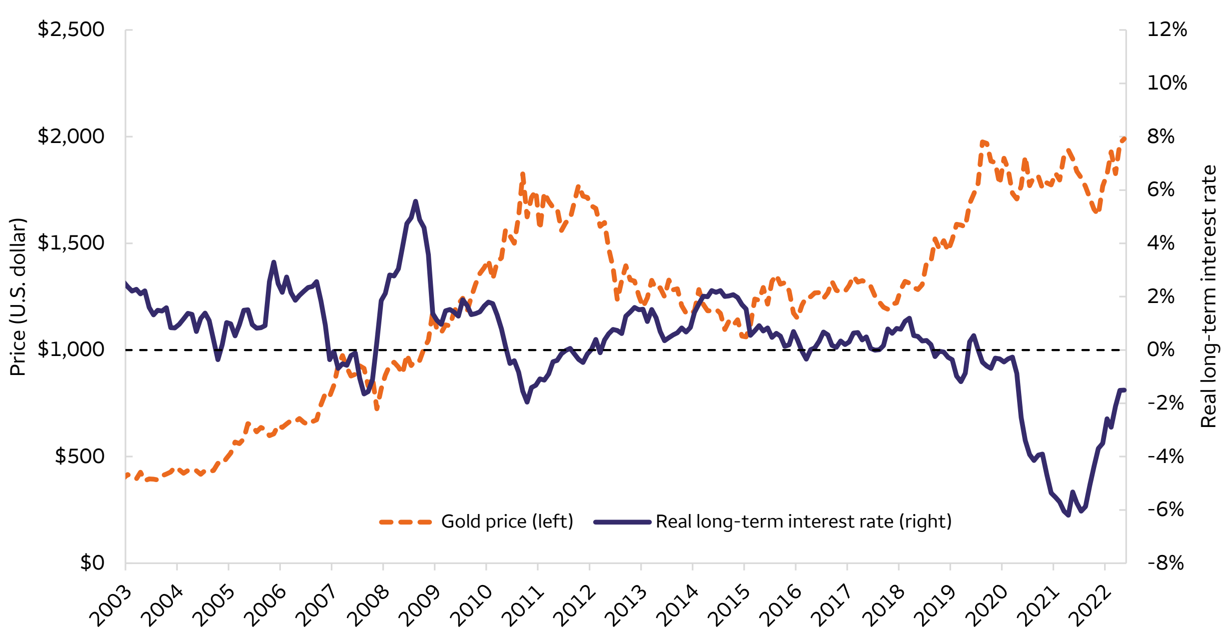
On April 21, based largely on weakening economic conditions and a looming recession, we raised our 2023 year-end target range for gold to $2,100 – $2,200 per troy ounce and established our 2024 year-end target range of $2,400 – $2,500. We also upgraded our guidance on Precious Metals from neutral to favorable. Below, we will discuss why we are finally warming up to the yellow metal.

Recent performance inside the commodity complex has renewed confidence in gold and other precious metals. Year-to-date (as of May 8), the Bloomberg Commodity Index (BCOM) is down 6.5%, while gold prices are up 10.9% and the Bloomberg Precious Metals sub-index is up 10.3%. These performances stand in stark contrast to the past three years, when gold and other precious metals were serious underperformers. As long as the potential for global recession looms, which we suspect that it will for the remainder of 2023, we believe gold and other precious metals should continue to march higher.

Another trend supporting gold prices is the low real long-term interest rate environment, thanks to sticky inflation rates. Historically, the combination of low real interest rates and weak economic conditions has often attracted investors to gold over other assets, even bonds. That's because inflation eats away at the interest earned on bonds.

The bottom line is that we suspect that the gold rally may have legs well into 2024. After underperforming other commodities since March 2020, gold may finally be ready for sustained price momentum.

Gold versus real long-term interest rates



Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data is from December 31, 2003, to April 28, 2023. **Past performance is no guarantee of future results.**

Alternatives

Nick Sprague
Senior Investment Analyst

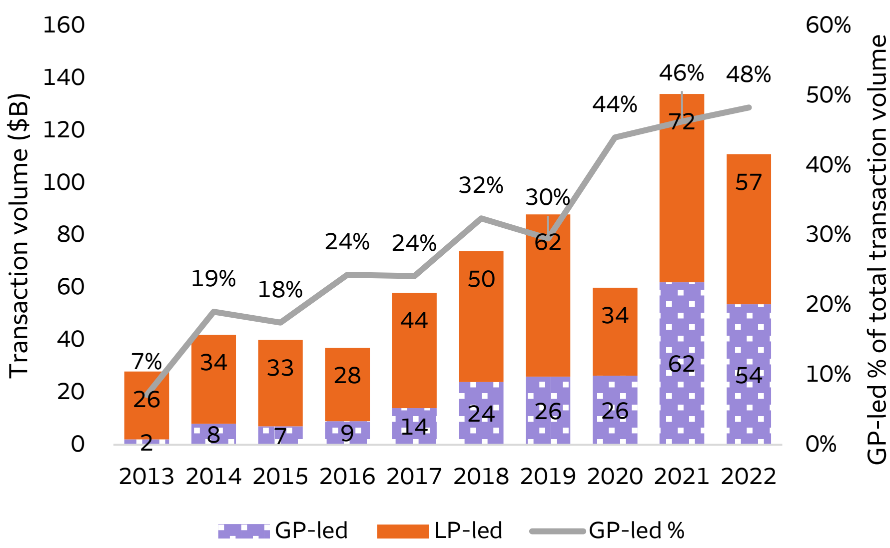
Demystifying General Partner-led secondaries

The secondary markets for private assets continue to grow and evolve, having achieved $111 billion in total transaction volume in 2022. General Partner (GP)-led secondaries, or secondary sales initiated by the asset manager, now represent 48% ($54 billion) of total volume.[6] Historically, the market has been dominated by Limited Partner (LP)-led transactions whereby an LP seeks to sell its fund interests to another investor. However, GP-led deals have outgrown LP-led deals as GPs increasingly view the secondary market as a tool for proactive fund management.

GP-led secondaries can take many forms, but continuation vehicles (CVs) represent approximately 85% of the market.[7] As the name implies, a CV is a vehicle used to purchase one or more assets from a GP's existing funds with the purpose of providing liquidity to LPs while simultaneously enabling the GP to continue to hold high-conviction assets. CVs have become a viable exit path — akin to an IPO (initial public offering) or traditional sale — that provides LPs the option to exit the asset, roll their existing stake, or reinvest. GPs can leverage CVs to extend the hold period for prized assets while resetting their economics in the vehicle.

GP-led deals can enable fund managers or qualified investors to assemble concentrated portfolios of seasoned assets that the underlying GPs know intimately and without blind pool risk. Given the challenging exit environment and capital market conditions, we expect GPs to increase their use of CVs — particularly as these vehicles generally do not trigger change-of-control provisions for existing credit facilities. As such, we believe the current environment presents a rich opportunity set for GP-led investors.

Historical secondary transaction volume and composition



Sources: Greenhill Global Secondary Market Review; annual data as of February 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.

6. Greenhill Global Secondary Market Review; data as of February 2023.
7. Jefferies Global Secondary Market Review; data as of January 2023.

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 15, 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. **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. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market. **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. Investments in **gold** and gold-related investments tend to be more volatile than investments in traditional equity or debt securities. Such investments increase their vulnerability to international economic, monetary and political developments. **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 Commodity Index is comprised of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity.

Bloomberg Sub Precious Metals Index is a commodity group subindex of the Bloomberg CITR. The index is composed of futures contracts on gold and silver. It reflects the return on fully collateralized futures positions and is quoted in USD.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

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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. The 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.

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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.

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

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

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