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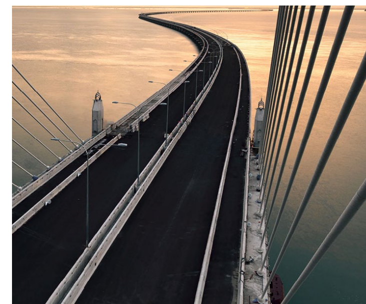
Investment Strategy



Weekly guidance from our Investment Strategy Committee **May 22, 2023**

Global Equity Spotlight: You're killing me, Smalls 2

- Lower quality small and microcap equity indexes have significantly underperformed their larger counterparts since the mini-financial crisis began in early March.
- We maintain our most unfavorable rating for U.S. Small Cap Equities. However, once the recession appears to be fully priced in to market valuations, we likely will begin to position for the early cycle recovery we see emerging in 2024.

Fixed Income: What to expect as the X-date approaches 4

- High-quality fixed income, including Treasury securities, remains a key diversifier of portfolio risk.
- Our Global Manager Research team expects money fund managers to continue to position on the shorter end of their weighted average maturity ranges leading up to the X-date; they also expect managers of Treasury funds and government funds to generally avoid Treasuries maturing around the X-date.

Real Assets: The role of commodities in electric vehicles 5

- Electric vehicles (EVs) require six times more metals and minerals than conventional gas-powered vehicles.
- We expect strong demand for the metals used in electric vehicle batteries over the coming years, as the adoption of EVs grow.

Alternatives: Venture capital valuations continue to trend downward 6

- After peaking in late 2021, early- and late-stage venture capital valuations have declined, a trend that continues through the first quarter of 2023.
- While we expect the environment for venture capital to remain difficult through 2023, we look to become more constructive as the economy nears an eventual recovery.

Current tactical guidance 7

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

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Global Equity Spotlight

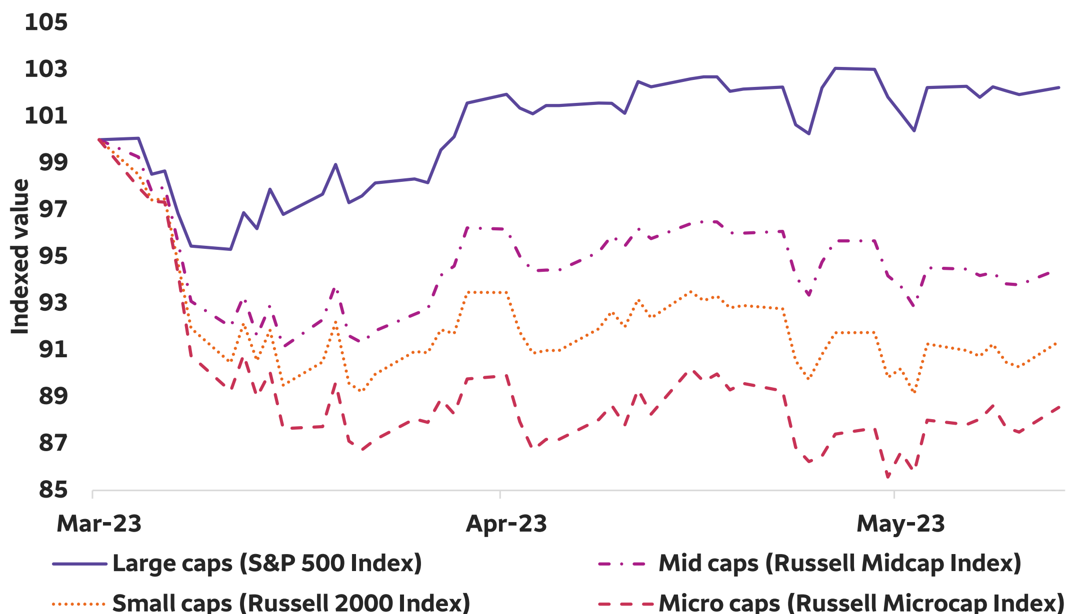
Chris Haverland, CFA
Global Equity Strategist

You're killing me, Smalls

The S&P 500 Index has weathered recent market turmoil, posting positive returns year-to-date driven mainly by strength in mega-cap technology companies. However, not all areas of the market have been as resilient.

Lower quality small and microcap equity indexes have significantly underperformed their larger counterparts since the mini-financial crisis began in early March (see chart 1). The failure of several regional banks has weighed on the Russell 2000 Index, which has a relatively high allocation to the Financials sector (15%). The resulting tighter lending standards likely will be a headwind for not only the regional banks, but also the smaller companies in the index that rely more heavily on borrowing to fund business operations.

Chart 1. Smaller stocks have underperformed larger stocks since the banking crisis started in March



Sources: Bloomberg, Wells Fargo Investment Institute. Daily data: March 3, 2023 – May 15, 2023. Indexed to 100 as of the start date. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.**

Small-cap equities are highly cyclical and historically have tended to underperform large-cap equities late in the economic cycle and early in a recession. With our expectation for a recession later this year, combined with the economic sensitivity of smaller companies, we have been unfavorable on U.S. Small Cap Equities since early 2022. The latest turmoil in the Financials sector prompted us to downgrade U.S. Small Caps another notch to most unfavorable, given enhanced exposure to banking system strains and tightening credit conditions.

Restrictive monetary policy, coupled with a looming recession, keeps us defensive in our portfolio positioning, focusing on high-quality companies with consistent and stable earnings growth. We classify U.S. Small Caps as a low-quality asset class with high debt levels, inconsistent earnings growth, and low return on equity (ROE). In addition, the Russell 2000 Index struggles with many non-earning firms. The current percentage of so-called

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"zombie companies" — that is, financial distressed companies on the brink of insolvency — is well above the long-term average (see chart 2).

Chart 2. There is an elevated number of small cap "zombies"

Sources: Bloomberg and Wells Fargo Investment Institute. Data as of May 15, 2023. An index is not managed and not available for direct investment.

While investors have punished the low-quality segment of the market, small businesses themselves are increasingly pessimistic. The latest NFIB Small Business Optimism Survey[1] hit its lowest level since 2013, and the percentage expecting the economy to improve is at a lower point than any of the past four recessions. Sales and profits optimism declined in the latest survey, and capital expenditure plans fell to the lowest level since the COVID recession in 2020. Analysts have taken note, cutting 2023 consensus earnings estimates for the Russell 2000 Index by nearly 10% over the past three months. If the economy slows and liquidity recedes as we expect, it will become more difficult for these firms to remain profitable and maintain healthy cash positions.

All is not lost, however, when it comes to investing in small-cap equities. While today our bias is toward high-quality large-cap companies, there will come a time when small-caps have the potential to outperform. Just as smaller companies lag in performance when growth slows or contracts, they historically have led performance early in economic recoveries. In fact, small-cap stocks have outperformed large caps in the 12 months following the past six recessions. Of course, past performance is not an indication of future results.

Once the recession appears to be fully priced in to market valuations, we likely will begin to position for the early cycle recovery we see emerging in 2024. In 2024, we foresee the recession ending, the Fed cutting interest rates, an economic rebound in the U.S. and abroad, and easing credit conditions — all of which we view as positives for small cap equities.

1. April 2023

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Fixed Income

Brian Rehling, CFA
Head of Global Fixed Income Strategy

What to expect as the X-date approaches

The debt ceiling has been used for political brinkmanship in the past, and once again, increasing the debt ceiling has become a contentious issue for politicians. While the risks of a political miscalculation are higher than in the past, in our view it is unlikely that either party will want to be responsible for a U.S. government default. At some point, we expect politicians to pass an increase to the debt ceiling, just as they have many times before. We expect this increase to occur before the U.S government is unable to pay its bills.

Should an unexpected technical default occur, it would likely be short-lived and may result in a delay in payment for certain Treasury maturities until a debt ceiling resolution. We are seeing Treasury bills with a maturity date at or near the X-date (the date the federal government is expected to run out of extraordinary measures to pay its bills, currently expected in early June) offering higher yields. Out of an abundance of caution, we would advise that investors who cannot tolerate a small delay in payment avoid Treasury Bills that mature on or near the X-date. Our Global Manager Research team expects Treasury and government money market funds to maintain a stable $1.00 net asset value through the debt ceiling resolution period.

We believe that fixed income investors should not make any meaningful adjustment to their portfolios due to the debt ceiling. If a debt ceiling solution is not apparent as the deadline approaches, we expect market volatility will increase, boosting the value of perceived safe-haven assets. We would expect Treasury securities that do not mature on or near the X-date to move higher in value in such a scenario.

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Real Assets

"He who owns the spice controls the universe" – Frank Herbert, American author

Mason Mendez
Investment Strategy Analyst

John LaForge
Head of Real Asset Strategy

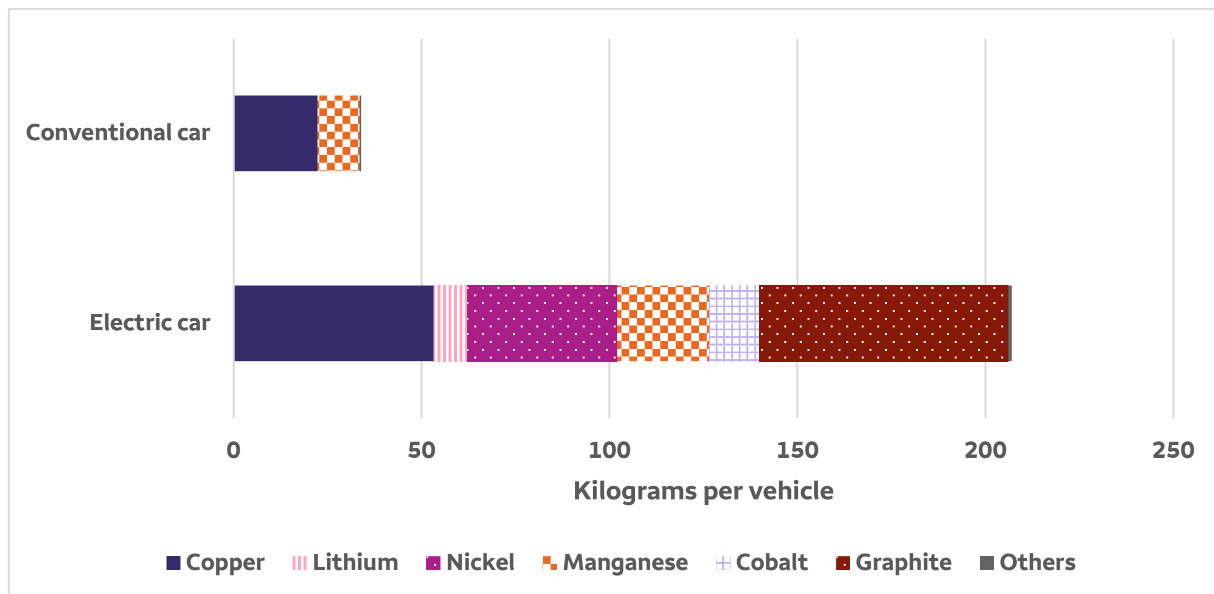
The role of commodities in electric vehicles

Global electric vehicle (EV) sales were up 63% in 2022 and are projected to grow another 268% by 2030 according to Bloomberg estimates. Given such growth, we feel it is important to understand the role commodities are playing in this green transition and whether there will be investment opportunities in the future.

Commodities have played an important role in advancements in green energy, and specifically the growing popularity of EVs. Unlike conventional gas-powered vehicles, EVs require six times the amount of metals (see chart). This can mainly be attributed to the EV batteries, which include double the amount of copper and manganese, along with large amounts of lithium, nickel, cobalt, and graphite not found in conventional gas-powered vehicles (chart). As a result, these metals are in high demand and necessary for the large-scale adoption of EVs.

Many governments are already planning to replace their existing gas-powered fleets with EV's — translating into higher demand for metals. For example, the U.S. Federal Sustainability Plan requires that all federal agencies transition their gas-powered fleets to 100% electric by 2027. To achieve this goal, extensive amounts of commodities will be needed. Therefore, we expect strong demand growth among these metals over the coming years, leaving potential opportunities for investors along the way.

Electric vehicles require six times the amount of metals needed for a gas-powered vehicle



Source: International Energy Agency, and Wells Fargo Investment Institute. Data is as of October 31, 2022.

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Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

Venture capital valuations continue to trend downward

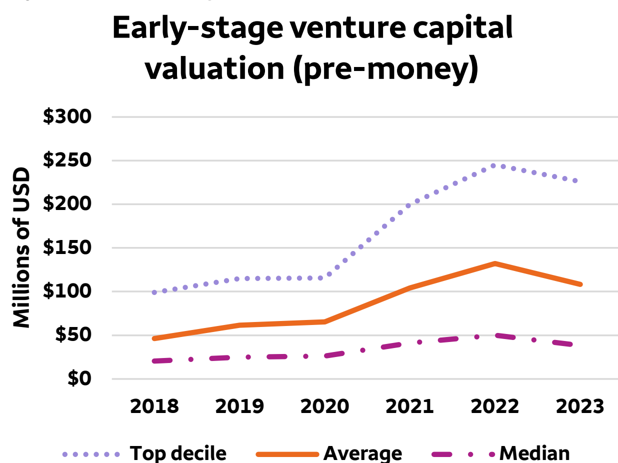
Stocks rebounded strongly in the first quarter of 2023 with the Information Technology and Communication Services sectors leading the way (up 21.8% and 20.5%, respectively).[2] Yet, valuations within early- and late-stage venture capital companies continued to trend downward, despite the category's focus on technology-related businesses.

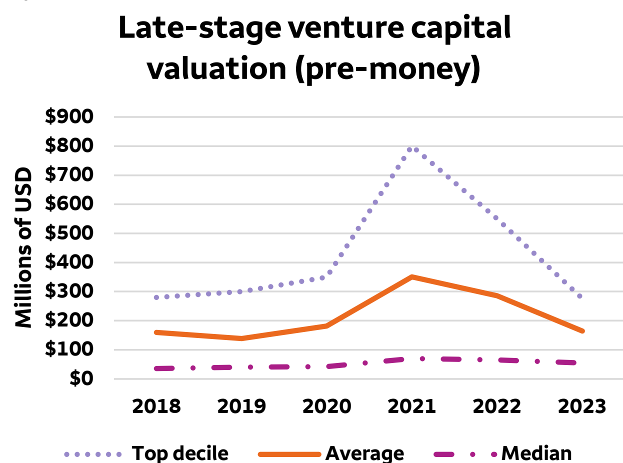
As the chart shows, valuations within the venture capital landscape reached lofty levels during the market peak in late 2021 and have remained on a steady downward trajectory through March of 2023. The largest declines occurred in the top decile as frothy valuations were impacted to a greater degree. As the economy continues to slow amid a host of recession warning signs, we expect the environment for venture investing will likely remain challenged throughout the remainder of the year. Several factors are contributing to the difficult environment for venture capital markets, including:

- The fundraising environment remains subdued.
- Cash burn rates at start-ups remain elevated.
- Credit conditions are tightening amid the on-going regional banking crisis.
- Companies have fewer exit options as the initial public offering market remains constrained.
- Institutional investors have been overallocated to private capital strategies and hesitant to commit new capital,[3] a result of the decline in public market stocks and bonds during 2022.

We expect lower-quality start-up companies to struggle over the coming recession as the lack of capital availability may restrict their ability to operate throughout the cycle. We continue to wait for a more opportune entry point for Private Equity – Venture Capital strategies, as we expect the environment will continue to become more investor friendly.

Early- and late-stage venture capital valuations (pre-money)





Sources: Pitchbook 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.

2. As measured by the S&P 500 Information Technology Sector Total Return Index and the S&P 500 Communication Services Sector Total Return Index
3. Lauren Hulme, "Private Funds 2023: Spotlight on the Denominator Effect", Torys, January 9, 2023.

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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 22, 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.

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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. **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 conditions.

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

An index is unmanaged and not available for direct investment.

Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 90% of the total market capitalization of the Russell 3000 Index.

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.

Russell Microcap Index measures the performance of the microcap segment of the U.S. equity market. Microcap stocks make up less than 3% of the U.S. equity market (by market cap) and consist of the smallest 1,000 securities in the small-cap Russell 2000® Index, plus the next smallest eligible securities by market cap.

Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000 Index.

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 Communication Services Index (Comm Svc): The S&P 500® Communication Services Index comprises those companies included in the S&P 500 that are classified as members of the GICS® communication services sector.

S&P 500 Information Technology Index (IT): The 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.

NFIB Small Business Optimism Index is the small business optimism index is compiled from a survey that is conducted each month by the National Federation of Independent Business (NFIB) of its members. The index is a composite of ten seasonally adjusted components based on questions on the following: plans to increase

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employment, plans to make capital outlays, plans to increase inventories, expect economy to improve, expect real sales higher, current inventory, current job opening, expected credit conditions, now a good time to expand, and earnings trend.

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