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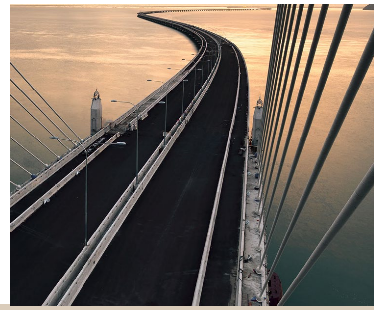
Investment Institute

Investment Strategy



Weekly guidance from our Investment Strategy Committee **May 30, 2023**

1. Bull super-cycles are an extended period of time, historically 15-20 years, where commodity prices move upward together.

Asset Allocation Spotlight

Michael Taylor, CFA
Investment Strategy Analyst

Doug Beath
Global Investment Strategist

Where debt-ceiling deliberations stand

As the debt-limit deadline looms, the White House and Congressional leaders are toiling to find middle ground. Partisan disagreements in Congress over federal spending amplified by the media have raised concerns that lawmakers might not be able to reach consensus in time to avoid a default on debt payments. We view the risk of default as low, especially because we believe a short-term debt ceiling extension should be easier to achieve than a full deal and avoids a default.

Our view is that a compromise by the cutoff is likely. Moreover, a drawn-out negotiation process is not unusual. Congress has raised the U.S. debt limit 78 times since 1960, and in recent years, a deal has often been struck in the 11th hour.[2] We recently published a full report on the debt ceiling, potential market implications, and our investment preferences.[3] Below, we highlight key debt-ceiling questions in greater detail and consider how we expect the outcome may impact markets and investor portfolios.

Where do the debt-ceiling negotiations stand today?

As of this writing, Congressional leaders continue to work toward a compromise. Democrats are aiming for the cap raised without any conditions attached to it. Republicans seek spending cuts coupled with certain conditions for raising the limit. The provisions mainly involve four points: repeal of unspent COVID funds, discretionary spending caps, energy permitting reform, and work requirements for entitlement programs. We believe that Republicans may have a slight upper hand in negotiations — not only due to their small House majority, but also because surveys have indicated that nearly two-thirds of Americans, including half of Democrats, support work requisites for entitlement benefits.[4]

Table 1. Debt-ceiling positions and priorities

Democrats	Republicans
Rescind unobligated COVID funds	Rescind unobligated COVID funds
No discretionary spending caps	Spending capped at 2022 level, and 1% growth rate for 10 years
Energy permitting reform for renewables	Energy permitting reform for pipelines
No work requirements for entitlement programs	Work requirements for Supplemental Nutrition Assistance Program (SNAP benefits) and Medicaid

Sources: Strategas and Wells Fargo Investment Institute, May 22, 2023.

2. Brookings Institution, January 19, 2023
3. See Wells Fargo Investment Institute *Institute Alert*: “10 questions on the debt ceiling and markets,” May 24, 2023
4. “Axios-Ipsos poll: Americans back work requirements for federal aid” May 18, 2023

What is the X-date and why is it important?

The debt ceiling is a cap on the amount of debt the federal government is permitted to accumulate. The X-date is the projected date (not a drop-dead date) on which the U.S. Treasury Department may reach the limit, exhausting funds to pay for current obligations. On the X-date, the government is not allowed to issue new debt unless Congress raises the spending cap. Treasury Secretary Janet Yellen announced the X-date could arrive as soon as June 1, but that date remains tentative. The government's operating funds largely depend on tax receipts — which have been weaker than expected — and accounting tactics. Even so, Speaker Kevin McCarthy's goal is to pass into law a debt-ceiling increase by June 1.[5]

If the debt limit is hit, how might it be lifted?

Once the debt ceiling is hit, Treasury has access to extraordinary measures in an effort to cover expenses. The $31.38 trillion limit was technically hit in January, and a series of accounting measures took effect aiming to manage day-to-day expenditures. As of May 17, Treasury had approximately $160 billion of cash and untapped extraordinary measures.[6] Once the federal government depletes its operating reserves, policymakers would need to prioritize (at least temporarily) payments due.

A deal could come in two steps. The first would be a temporary increase in the debt ceiling coupled with an agreement that outlines resolution for the four points listed in the table. The second step would fill in the details of appropriations and reforms. After the second step is completed, the limit could be raised past the 2024 elections. However, if Speaker McCarthy and Republican lawmakers seek a long-term debt limit increase, this could entail a single-step deal. Or, if time gets short, we could see a small increase in the debt ceiling, or a temporary suspension of it, as a provisional workaround while negotiations continue.

What is the likely path forward?

We believe lawmakers have strong incentive to resolve the stalemate ahead of the X-date. Although we believe the negotiations will likely linger into the 11th hour, we view the risk of not reaching a deal — even a short-term limit increase that would give negotiators more time — as low.[7] With an election next year, neither party would want to be blamed for a default. In the 2011 debt-ceiling impasse, the entire political establishment was downgraded by U.S. voters. President Barack Obama's rating dropped by 11 percentage points in the 90 days leading up to the X-date. After winning 63 House seats in 2010, Republican political standing also eroded, based on polling data, resulting in lost seats in Congress and an unsuccessful presidential campaign in 2012.[8]

In the sections that follow, we consider portfolio implications for specific asset groups.

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5. "Sunday debt ceiling deal needed for June 1 X-date," Strategas, May 18, 2023
6. Wells Fargo Economics, May 22, 2023
7. See "Navigating volatility around the debt ceiling debate," in the WFII *Investment Strategy* report, May 15, 2023
8. "Sunday debt ceiling deal needed for June 1 X-date," Strategas, May 18, 2023

Equities

"For tomorrow belongs to the people who prepare for it today." —African Proverb

Austin Pickle, CFA
Investment Strategy Analyst

Debt ceiling Q&A: Equities

What has been the impact of the debt ceiling negotiations on equity markets to date?

While market attention on the debt ceiling has intensified only recently, the U.S. Treasury began implementation of "extraordinary measures" on January 19 as debt neared the current limit. Since that time, there have been numerous market-moving events, such as additional Federal Reserve (Fed) rate hikes, a mini financial crisis, an earnings recession, and increased worries of an impending economic recession. To decipher a market message directly attributable to the debt ceiling debate is difficult, but what we wrote on the subject in January[9] has borne out to be true.

We wrote: "A protracted debt ceiling debate likely will create volatility for equities, particularly the Health Care and Industrials sectors, which are closely tied to government spending." Whether we measure performance month to date, quarter to date, year to date, or from January 19, 2023 both sectors have underperformed the S&P 500 Index (as of May 23, 2023, and measured by the S&P 500 Industrials and Health Care sectors).

What can we learn from the 2011 analog?

The 2011 debt ceiling crisis has been often used as an analog for the one playing out today. And there are a number of similarities. Back then, like today, there was a Democratic president, a divided Congress, and concerns about a slowing economy.

After the 2011 debt ceiling agreement, the S&P 500 Index dropped roughly 18% between July 22, 2011 and October 3, 2011. What is often overlooked about the poor stock returns during this time is that the vast majority of the damage — 15% of the 18% drop — occurred after the 2011 deal was reached. Why? Because the deal came with greater austerity than the market had anticipated and growth estimates were revised lower.

The key lesson that we believe we can learn from the 2011 debt ceiling crisis is that the main influence on markets is likely not to be if a deal is reached — as we expect a deal to emerge at some point — but whether the details of the deal materially impact market expectations.

What should investors do?

The debt ceiling is dominating airtime right now, and it does warrant attention. However, we do not favor making any broad portfolio changes in response to the potential for near term volatility. In our view trying to time short-term market swings has generally not been a winning investment strategy. Instead, we would urge investors to focus on the longer-term factors that should impact relative performance, such as the economic cycle, Fed policy, or interest rates. Consider that in 2011, even after the 18% drop, it only took until February 2012 for the S&P 500 Index to recoup those losses as the broad backdrop — the longer-term factors — supported a rally.

Today, we see the broad backdrop as unsupportive of materially higher stock prices. In the event stock prices rise further toward the top end of the recent trading range on a debt ceiling deal, we would use that as an opportunity to trim exposure, especially in lower quality areas, as we brace for what we believe is a coming recession.

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9. "Q&A on the latest debt ceiling standoff," WFII *Institute Alert*, January 25, 2023

Fixed Income

Luis Alvarado
Global Fixed Income Strategist

Fixed-income implications of a potential debt default

In our opinion, if the U.S. government cannot reach agreement to raise the debt ceiling, volatility should spike, and liquidity could dry-up in riskier sectors as investors seek shelter in assets perceived as safe havens. U.S. Treasuries are still perceived as a safe haven and, during these periods of risk aversion, Treasury securities have historically rallied (yields decline and prices increase); however, we believe those securities that mature around the X-date could see slightly higher yields. Also, we would expect credit spreads to widen and credit defaults swaps to rise, given the uncertainty.

We would also expect near-to-intermediate term repercussions, as credit rating agencies move to change their rating downward. We expect this set of events could create additional issues if investors demand higher interest payments to hold U.S. Treasuries, as well as a potential decline in demand from foreign investors that could become apparent in upcoming auctions. In sum, our view is the implication of a technical debt default would be net negative for fixed income pricing, as U.S. Treasury securities are generally considered risk-free and hence have been the base building block for fixed-income pricing.

Once the debt ceiling is raised, we believe that investors eventually should be made whole and receive back their principal and interest; however, access to liquidity could remain uncertain for some time. In our view, if investors cannot tolerate a potential delay in payment and are seeking access to funds by a specific date, they may need to reconsider their Treasury holdings.

Real Assets

"I have a great belief that everything is cyclical in life, particularly in the investment world." —Jean Marie Eveillard

John LaForge
Head of Real Asset Strategy

Mason Mendez
Investment Strategy Analyst

Commodity bull lessons learned

Performance leadership often shifts throughout commodity super-cycles, like what we've witnessed between 2022 and 2023.

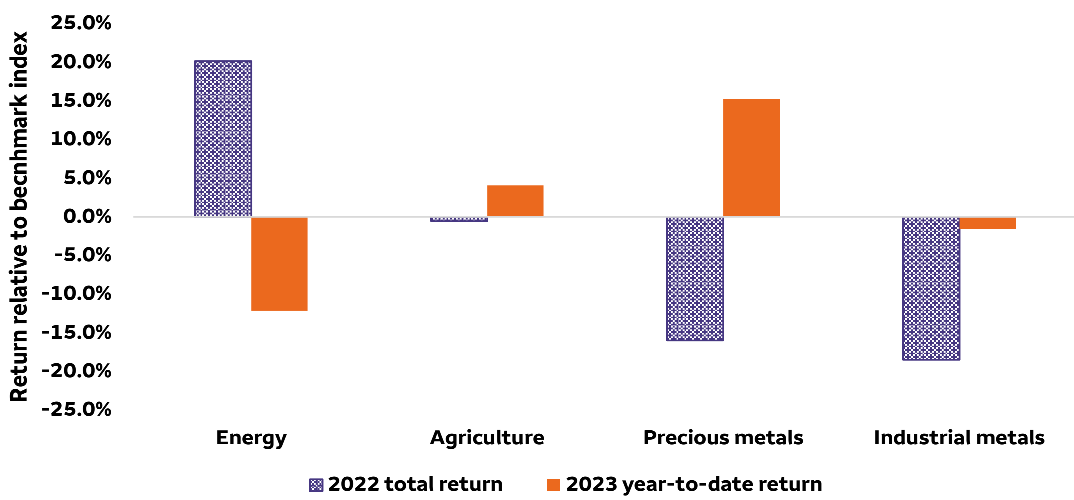
In 2022, shortages drove prices for many commodities notably higher. Early in the year, following Russia's invasion of Ukraine, energy, industrial metal, and agricultural commodities showed strong performance. By year end, though, energy was the only sector to maintain its outperformance (see chart).

Year-to-date in 2023, leadership has flipped once again. Precious metals[10], consistent underperformers for nearly two years, have surged, outperforming the Bloomberg Commodity Index (BCOM) in 2023 (through May 19) by 15.2%. Agricultural commodities, after limping into the end of 2022, have become relative outperformers, too, in 2023 — up 4.1% (through May 19) versus the BCOM.

Historically, changes in super-cycle leadership have been common. At the start of the last bull super-cycle in the year 2000, for example, the energy sub-index outperformed the BCOM by 89%, while precious metals underperformed by 38%. And then in 2001, energy underperformed the BCOM by 19%, and precious metals surged. Yet, for all the leadership jockeying, most commodity prices finished higher by bulls' end. Two important investment lessons learned from past bull super-cycles are: 1) performance chasing has been more likely to hurt a portfolio than help, and 2) buying and holding a general basket of commodities has often proven to be the smartest, and less stressful way, to maximize returns in a bull.

While no one knows the future, we suspect these past lessons will ring true again this bull super-cycle, and that's why a general basket of commodities is our preferred allocation. We continue to favor adding to commodities on price weakness, as, in our view, the bull super-cycle remains healthy and relatively young.

The split in commodity sector performance



Sources: Bloomberg and Wells Fargo Investment Institute. Year-to-date data is from December 31, 2022 - May 19, 2023. An index is unmanaged and not available for direct investment. Please see end of report for index definitions. **Past performance is no guarantee of future results**.

10. The Bloomberg Commodity Index (BCOM) was used to benchmark the sub-sectors performance.

Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

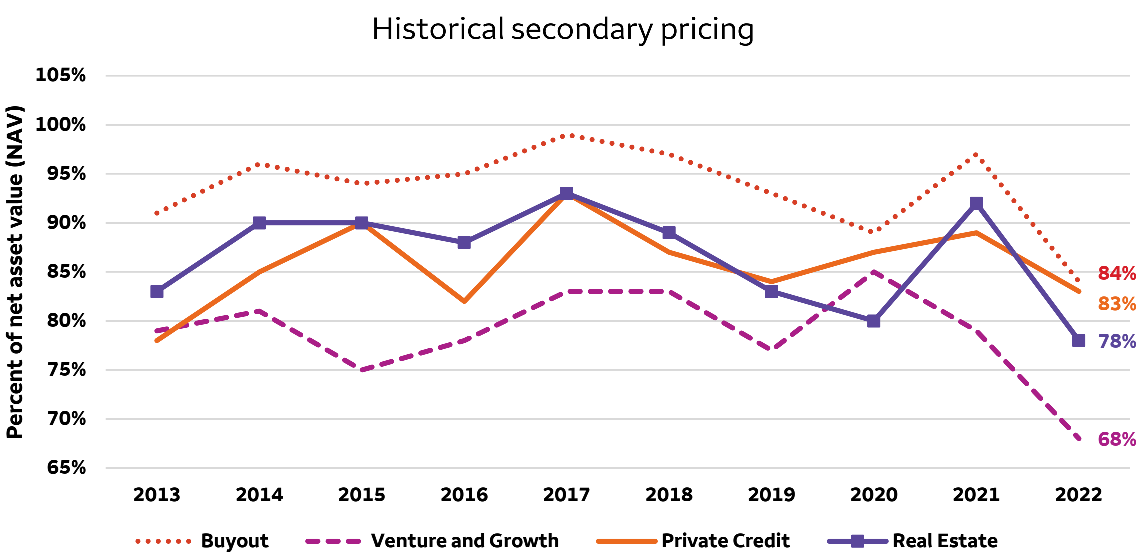
Discounted secondary markets may present an opportunity

Investors in private equity funds commit their capital for the duration of the fund's life, with a typical horizon of 6 to 12 years. While these investments have limited liquidity options, investors are able to sell their fund interests on the secondary market. The secondary market is typically only available for larger fund stakes and is a common solution for institutional investors looking to rebalance their portfolios.

Investors who purchase these secondary interests have often been able to buy at a discount to the fund's current net asset value (NAV). The discount to NAV has tended to increase in declining markets as investors have a greater demand for liquidity and valuations in the underlying portfolio companies become more uncertain. In addition to purchasing at a discount, other potential opportunities accrue to secondary investors, including improved visibility in the underlying portfolio holdings, a shortened path to potentially positive returns, and shortened fund life span. Given that secondary investors have often purchased these interests after the fund's investment period, the portfolio is often fully (or close to fully) invested and beginning to distribute capital as investments are exited.

We believe that in the current environment, declining valuations in secondary markets may present a potential opportunity for investors to buy into private market portfolios at attractive discounts, with all the aforementioned benefits. As public equity and fixed income markets declined in 2022, institutional investors sold private capital positions on the secondary market, leading to more selling pressure and rising discounts. The shift to a more buyer-friendly market is highlighted by the chart, which shows valuations declining since the market peak in late 2021. While this trend may continue for several quarters, investors may consider allocating to a skilled secondaries investment manager that seeks to identify high-quality portfolios believed to be selling at attractive prices.

Historical pricing of secondary market transactions across private capital categories



Sources: Greenhill Private Capital Advisory transactions and Wells Fargo Investment Institute. Data as of December 30, 2022. **Past performance is no guarantee of future results .**

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 30, 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. 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.

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

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.

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.

An index is unmanaged and not available for direct investment.

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