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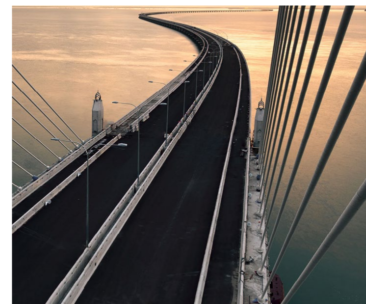

Investment Strategy

Weekly guidance from our Investment Strategy Committee **June 5, 2023**

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- The debt-ceiling agreement will likely result in a moderate economic impact but comes at a time when the economy is nearing recession.
- Our preference for quality and defensive positioning in equity portfolios remains in effect.

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- Our cautious rating on the Consumer Staples sector remains intact.
- Looking forward, we view the sector's defensive traits and relative earnings stability as positives.

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- Payment delinquencies and early red flags for potential defaults in the U.S. municipal bond market have dropped to their lowest levels since before the pandemic.
- Default disclosures fell during the first quarter after an uptick to close out 2022.

Real Assets: REITs report solid earnings in first-quarter 2023 6

- Despite a challenging comparison quarter, real estate investment trusts (REITs) were able to generate attractive growth in funds from operations per share and same-store net operating income.
- Along with reporting first-quarter earnings, most REITs updated their 2023 earnings guidance.

Alternatives: Widespread drops in private fundraising...................................7

- In the first quarter of 2023, all major private capital strategies experienced slowdowns in fundraising.
- Capital allocators remain hesitant to commit new capital to private capital strategies. However, lower valuations and capital scarcity may create opportunities over the longer term for patient investors.

Current tactical guidance 8

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Asset Allocation Spotlight

Doug Beath
Global Investment Strategist

Michael Taylor, CFA
Investment Strategy Analyst

The debt-ceiling deal — what comes next?

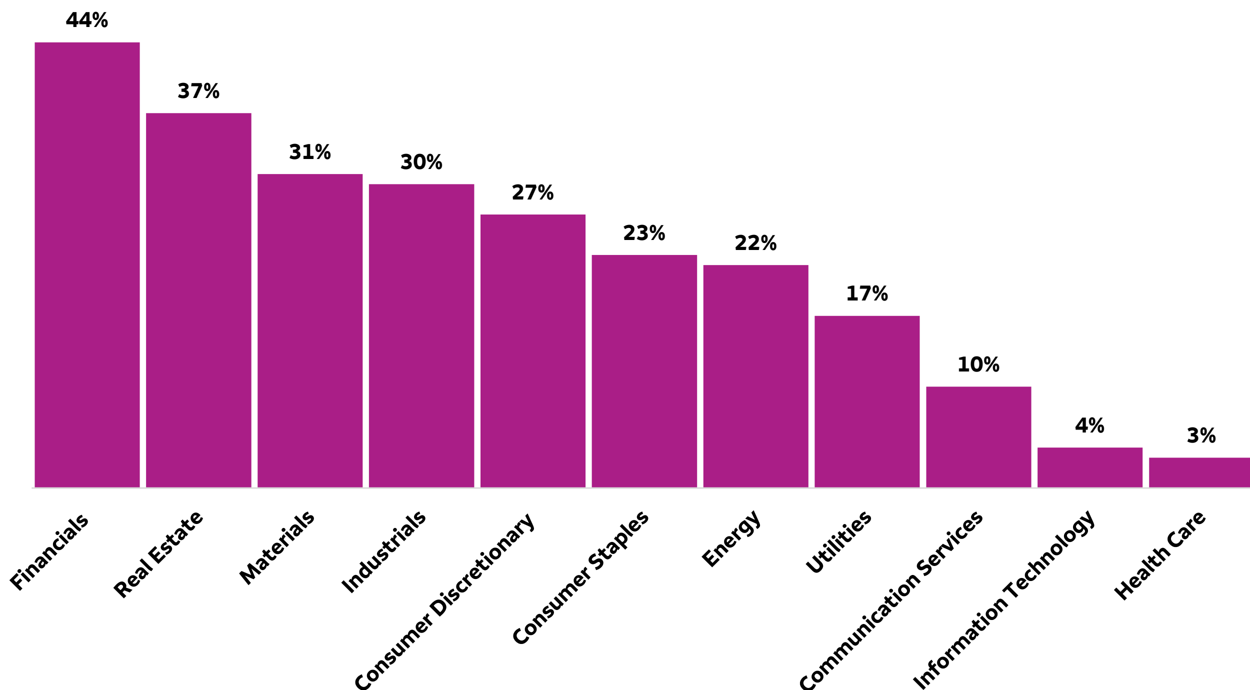
The announcement that President Joe Biden signed into law bipartisan legislation to raise the debt ceiling for two years brought relief to investors ahead of the updated June 5 X-date. We believe the agreement will impact economic growth and liquidity conditions. Below we discuss details of the agreement and potential market implications.

How may the debt-ceiling agreement impact economic growth?

The agreement would keep nondefense spending in 2024 at roughly the same level as fiscal year 2023 and increase it by roughly 1% in 2025. The deal also includes clawing back unspent funds that Congress passed to battle the COVID pandemic. Some federal programs will face budget cuts that have yet to be determined.

The economic impact is likely to be moderate, in our view, but comes at a time when the economy is nearing recession. U.S federal outlays as a percent of nominal GDP (gross domestic product) — ex- student loan forgiveness — peaked at 31% during the height of the pandemic and is expected to fall from roughly 27% to 23.9% in 2023.[1]

Chart 1. Percentage of S&P 500 companies citing "recession" on earnings calls in Q1 2023



Sources: Wells Fargo Investment Institute and FactSet as of May 31, 2023.

The contraction in government spending we anticipate from this deal should exacerbate the recession that we expect later this year. Yet, the modest size of these changes, and the ongoing strength in the labor market, lead us to maintain our base case for a moderate recession later in 2023. From a corporate earnings standpoint, we expect

1. Piper Sandler and CBO, May 25, 2023

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more earnings downgrades. A significant and rising percentage of S&P 500 companies have cited "recession" on earnings calls (see chart), while the percentage of small-cap companies reporting negative earnings has spiked.

What are the potential next steps for the Treasury Department in light of the debt-ceiling agreement?

The U.S. Treasury keeps an account at the Federal Reserve (Fed) called the Treasury General Account (TGA). The TGA functions as the U.S. government's checking account for paying its bills, such as Social Security, defense spending, and interest on the debt. Cash in the account has declined by more than $500 billion since January and currently sits at $39 billion, the lowest since 2017.[2] With an agreement pending, the Treasury may now raise funds to pay for expenses that Congress has authorized and replenish the TGA. Consequently, we expect a large issuance of Treasury bills by the end of the third quarter, potentially exceeding $1 trillion, as the Treasury rebuilds the TGA.

Is there a risk that a sizable Treasury issuance will drain market liquidity?

There is concern that a flood of Treasury issuance will drain liquidity from markets, weighing on risk assets. Specifically, a deluge of issuance to raise cash for the Treasury account would pull liquidity out of capital markets, as investors purchase Treasury bills. Simultaneously, the Fed continues to shrink its balance sheet, which also reduces the cash available for financial markets. The risk to investors is that the Fed's balance-sheet shrinkage and a large Treasury refunding could reinforce each other in draining cash available for investment. Much reduced market liquidity may make it more difficult for investors to find buyers if a shock leads to widespread desire to sell securities. Episodes of significant market volatility could increase.

But the Treasury could moderate the liquidity reduction by issuing enough Treasury bills that the yield on these bills might exceed what the Fed pays on deposits.[3] If Treasury bills have a more attractive yield, money-market funds could purchase them with funds already on deposit with the Fed. The deposits at the Fed are unavailable for the broader economy, so a transfer from the Fed to the Treasury would not reduce the cash available to the economy. Encouraging this neutral effect on liquidity appears to be the Treasury's plan, based on the Treasury's May 3 refunding documents, which indicate plans to borrow $1.032 trillion by the end of the fiscal year (September 30, 2023).[4]

What it means for investors

We believe the debt-ceiling agreement forged ahead of the June 5 deadline was a positive short-term development for capital markets. Longer-term, the fiscal restraints associated with the deal indicate to us that both monetary and fiscal policy are turning more restrictive, even as the economy slows toward recession under persistently high interest rates and inflation. Fortunately, we do not expect spending cuts to worsen the economic outlook from a moderate recession. We also expect the Treasury to issue enough new short-term securities that liquidity in the economy will not contract significantly.

In this environment, we retain our current preference for quality and more defensive positioning.[5] We expect there will be a time to turn more opportunistic in positioning portfolios for a recovery. However, we need to respect the signals and understand when the risk and reward dynamic changes. Historically, bear markets have created some of the best opportunities to grow capital, and we expect such opportunities again — just not yet.

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2. Wall Street Journal May 24, 2023 and Bloomberg May 18, 2023.
3. As the Treasury issues more bills, we would expect prices to fall and yields to rise.
4. See Treasury Borrowing Advisory Committee Recommended Financing Tables for 2Q23 and 3Q23. Both are publicly available under the "Most Recent Quarterly Refunding Documents" report. The $1.032 trillion figure is the sum of prospective bill auctions, as of May 30, 2023.
5. For detailed guidance on our investment preferences, please see our report, "Announcing 2024 targets and updated guidance,' Wells Fargo Investment Institute, April 21, 2023.

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Equities

Jack Russo, CFA
Equity Sector Analyst

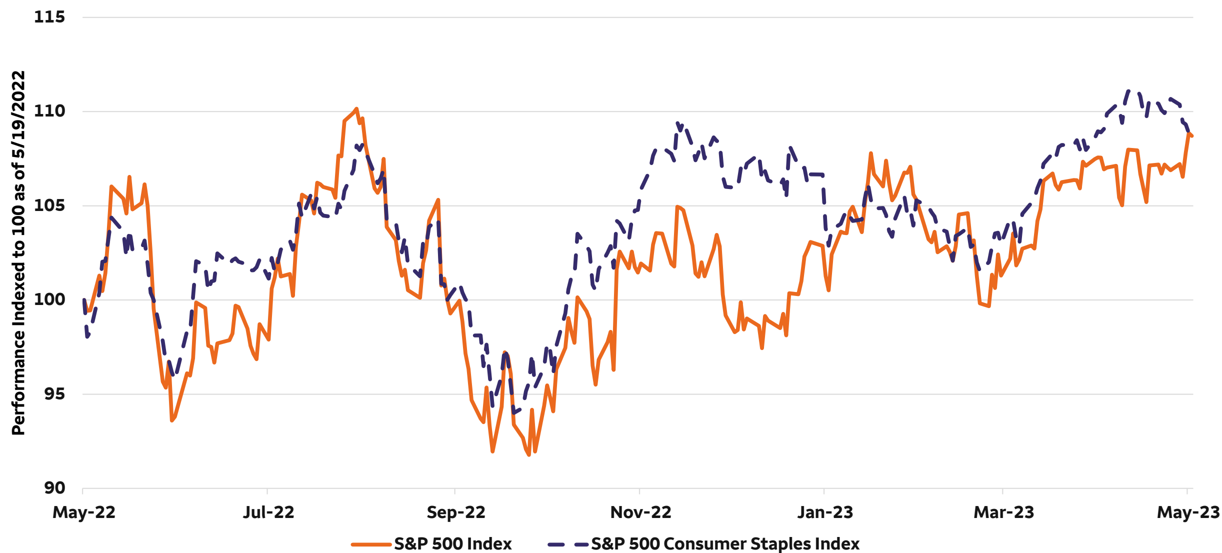
Consumer Staples may offer stability in stormy weather

Consumer Staples and many other defensive sectors have underperformed relative to the broader S&P 500 Index in 2023 (through May). With the Federal Reserve likely close to pausing rate hikes and with decreased overall market volatility, more offensive sectors like Information Technology have led the way in 2023 performance. However, given increasing economic weakness, we believe Consumer Staples remain an important part of portfolio diversification, given the group's earnings stability and overall defensive traits.

Our neutral rating on Consumer Staples is supported by the group's many challenges, including higher overall costs, private label advancements, fragile consumer spending patterns, and potential retailer pushback on price increases from manufacturers. However, the sector does provide many positives, including rising dividend income stories, relative earnings and sales stability, and both product and geographic diversification. We believe the group's relative earnings stability is key in 2023, as other sectors may have to deal with volatile earnings patterns due to the softening economy.

Consumer Staples companies' relative earnings power this year should be aided, in our view, by pricing actions, effective cost management, and consumers' need for everyday staples products. Our ranking of sub-industries remains unchanged from prior periods. We favor sub-industries with stronger sales growth potential and whose products have brand and pricing power, especially in this time of higher input costs. Consumer Staples Merchandise Retail, Soft Drinks & Non-alcoholic Beverages, and Household Products remain our favorites given their pricing power, size and scale advantages, leading brands, and above average sales growth.

Consumer Staples performance



Source: Morningstar Direct, Wells Fargo Advisors. Data through May 19, 2023. Performance data indexed to 100 starting on May 19, 2022. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment.

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Fixed Income

Dorian Jamison
Municipal Analyst

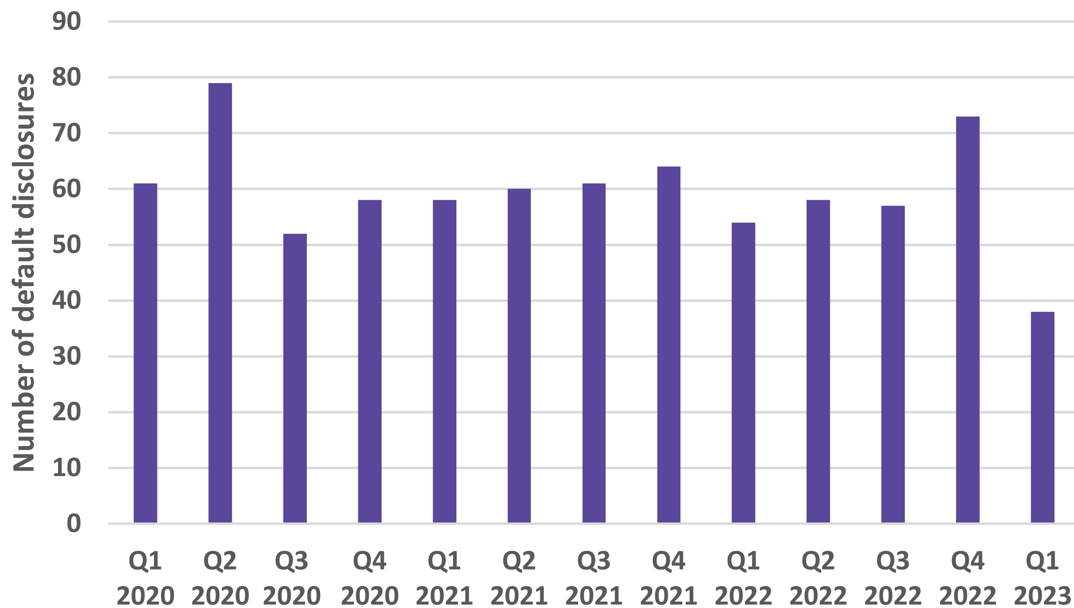
Red flags for muni bond defaults dropped in Q1

According to Moody's Investors Service (Moody's), payment delinquencies and early red flags for potential defaults in the U.S. municipal bond market have dropped to their lowest levels since before the pandemic. Default disclosures fell during the first quarter of 2023 after an uptick to close out 2022. Moody's also reported only four first-time municipal bond delinquencies (all unrated) during the first quarter, which was down compared with the prior quarter and the lowest total since the first quarter of 2021.

However, not all municipal sectors are immune from the current economic environment. We have a negative sector outlook for healthcare, private higher education, tobacco, tax increment financings, and special assessment districts. Roughly 7% of the $43 billion in outstanding senior-living bonds, or about $3.2 billion, is in default on a payment, according to data compiled by Bloomberg. That compares to a rate of less than 1% for all state and local government debt.

We continue to prefer A-rated or higher essential-service revenue and general obligation bonds in the traditional tax-free sector for their package of legal security provisions. Historically strong reserve levels, which have been bolstered through federal relief packages, position states to address a projected moderate recession. Even with an expectation of slower revenue growth, most U.S. states' budgets for fiscal year 2024 are structurally balanced with minimal use of reserves. We may also see additional strength from retail investors if an economic recession begins to take hold, given that investment-grade municipals are often viewed as perceived safe havens of general credit stability. During the past five recessions, municipal bonds have, on average, outperformed corporate bonds and recovered their value more quickly.

Municipal bond defaults by quarter (2020 – 2023)



Sources: Moody's Investors Service and Global Securities Research Municipal Research Group. Data as of April 20, 2023.

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Real Assets

John Sheehan
Equity Sector Analyst

REITs report solid earnings in first-quarter 2023

As first-quarter 2023 real estate investment trust (REIT) earnings have been reported, we believe a review of REIT earnings is timely.

Data provided by the National Association of Real Estate Investment Trusts (Nareit) shows the REIT industry generated growth in funds from operations (FFO) per share, the primary earnings measure utilized by REITs, of 6.8% over first-quarter 2022 results. These results follow fourth-quarter 2022 FFO per-share growth of 10.5%. Additionally, REITs reported 7.2% growth in net operating income (NOI) from their same-store portfolios relative to first-quarter 2022. Most REIT investors view same-store performance as a good indicator of internal growth.

We view the FFO per share and same-store NOI growth generated by the REIT industry during first-quarter 2023 as attractive. It is worth noting we believe REITs faced challenging comparisons with first-quarter 2022; data from Nareit indicated REITs generated nearly 26% growth in FFO per share in first-quarter 2022 (likely reflecting an economic recovery as business operating restrictions mandated by the pandemic were lifted) and an 8.4% increase in same-store NOI.

In conjunction with their first-quarter 2023 earnings, the majority of REITs we closely monitor updated their 2023 earnings guidance. In general, the bulk of the REITs we closely monitor either reiterated their prior 2023 earnings guidance or made modest adjustments to their 2023 earnings expectations. In general, we would describe 2023 REIT earnings projections as relatively conservative. We believe this reflects the impact of higher capital costs, elevated inflation, and an uncertain economic outlook, which could impact REIT occupancy rates and rental growth during 2023.

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Alternatives

Chao Ma, PhD, CFA, FRM
Global Portfolio and Investment Strategist

Widespread drops in private fundraising

The slowdown in fundraising that began in 2022 has carried into the first quarter of 2023. The widespread trend is reflected across all major private capital strategies, as shown in the chart.

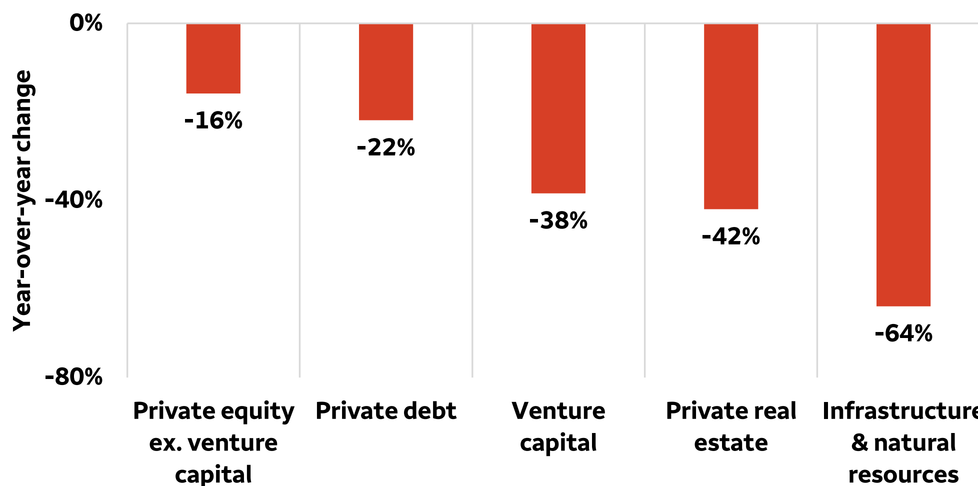
However, there are significant differences in the magnitude of the declines across the various categories. The decline in fundraising for buyout and private debt strategies was relatively modest (16% and 23%, respectively), while venture capital experienced a larger contraction (38%). Additionally, infrastructure and natural resources strategies that outperformed other private capital strategies in 2022 experienced dramatic reversals as fundraising shrank by over 60% in the recent 12-month span.

In our view, several economic and market factors contributed to this widespread fundraising challenge:

- Macroeconomic anxieties, market turmoil, and a looming recession lowered investors' confidence on the prospect of investment markets, including the less liquid private capital investments.
- Diminished opportunities for fund managers to exit investments and distribute returns to investors. This, in turn, reduced investors' capital available for future fund commitment.
- Significant drops in public market prices last year amplified the weight of private capital in investors' portfolios. Many institutional investors had to reduce capital commitment and even offload existing stakes to bring private capital allocations back to target.

We expect the fundraising downtrend to continue in the coming months as the economy enters what we believe will be a recession. Over the longer term, a lower valuation and capital scarcity can create a more investor-friendly market and present opportunities for patient investors.

Year-over-year change of 12-month private capital fundraising totals



Sources: PitchBook, Wells Fargo Investment Institute. Data as of March 31, 2023. The chart shows the year-over-year changes of rolling 1-year capital raised as of March 31, 2023. The assets are sorted by year-over-year changes.

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.

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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, June 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.

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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. 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.

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.

An index is unmanaged and not available for direct investment.

A-rating (S&P & Fitch/Moody's): Upper-medium grade and subject to low credit risk.

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