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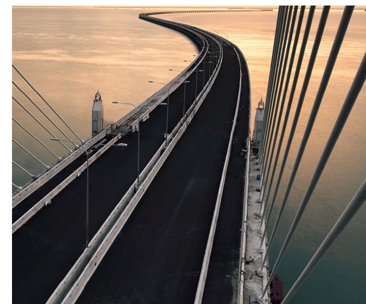

Investment Strategy

Weekly guidance from our Investment Strategy Committee **June 12, 2023**

Global Macro Spotlight: Why an economic soft landing is unlikely in 2023 2

- Past Federal Reserve (Fed) tightening cycles demonstrate that the Fed has rarely executed soft landings while raising interest rates to control inflation.
- We believe the economy's slow, but steady, wind-down reinforces our defensive portfolio strategy favoring high quality, liquid large-cap stocks, and bond investments barbelled between short- and long-term securities.

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- The artificial intelligence-fueled year-to-date rally has been one of the narrowest on record, with only a relative few large cap names driving S&P 500 Index returns.
- With a recession on the horizon, we suspect that the average stock will continue to struggle, suggesting to us that the current rally is on shaky ground.

Fixed Income: Fading rate-cut hedges lift the dollar 5

- Fear of financial crisis or debt-ceiling disaster has been the main factor causing the market to hedge against multiple Fed rate cuts in 2023.
- Now that the debt-ceiling crisis is resolved, we would expect the market to continue to price out expected rate cuts in 2023, and for the dollar to remain supported until rate cuts become more likely in 2024.

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- Following its June meeting, OPEC+ (Organization of Petroleum Exporting Countries + Russia) kept production targets unchanged; however, Saudi Arabia announced that it would voluntarily cut oil production by 1 million barrels per day in July.
- We believe Saudi Arabia's unilateral move to cut oil production is another clear sign of its commitment to supporting higher oil prices.

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- In private real estate, the office property type continues to face myriad challenges, including shifting worker preferences, a tighter lending market, and rising debt costs.
- The vacancy rate for the U.S. office property type has steadily increased over the past three years and now stands at a high point of 12.9%.

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Global Macro Spotlight

Mary Anderson
Investment Strategy Analyst

Gary Schlossberg
Global Strategist

Why an economic soft landing is unlikely in 2023

The economy's resilience in the face of aggressive Fed tightening since early last year has prompted talk of a soft landing, in which the Fed and other policy makers avoid a recession while attempting to lower inflation or keep it at a satisfactory level. Support to the economy has come from the beneficial effect of falling inflation on spending power, pockets of strength in capital-goods spending, and adequate liquidity in the financial market.

A summary of the past 11 Fed tightening cycles can be found in the below table and can give context to the risks associated with the current cycle.

Table 1. Hard landings have been the norm during a Fed tightening cycle

Tightening cycle	Basis point change*	Recession within a year	Landing type	Context
Sep 1965 - Nov 1966	174	No	Soft	This landing could be viewed as a pause, as inflation did not remain under control
July 1967 - Aug 1969	540	Yes	Moderate	Recession was mild; fiscal policy was the primary method of slowing the economy and inflation
Feb 1972 - July 1974	962	Yes	Hard	Outcome affected by supply shocks, price controls, and a backtracking and wavering Fed
Jan 1977 - Apr 1980	1300	Yes	Hard	Fed Chair Paul Volcker was seeking inflation control, not a soft landing
July 1980 - Jan 1981	1005	Yes	Hard	Volcker was seeking inflation control, not a soft landing
Feb 1983 - Aug 1984	313	No	Soft	Could be seen as a recalibration of policy, rather than a tightening cycle
Mar 1988 - Apr 1989	326	Yes	Hard	Oil price shocks were a catalyst for recession
Dec 1993 - Apr 1995	309	No	Soft	Fed acted early, before inflation became worrisome
Jan 1999 - July 2000	191	Yes	Moderate	Recession was mild, impacted by the dot-com bust
May 2004 - July 2006	424	Yes	Hard	Recession not brought on by Fed policy
Nov 2015 - Jan 2019	228	Yes	Hard	Recession not brought on by Fed policy

Sources: Bloomberg and Blinker, Alan, "Landings, Soft and Hard: The Federal Reserve, 1965-2022", 2023.
*Based on effective federal funds rate. 100 basis points equal 1%.

A soft landing was achieved in only three of the past 11 Fed tightening cycles, a reminder of how difficult it is to get the policy balance between growth and inflation just right. In fact, a soft landing was not even the goal behind the Fed's aggressive policy tightening in the late 1970s and early 1980s. And the two most recent recessions, triggered by the global financial crisis and the first wave of the pandemic, respectively, were not preventable by the Fed nor instigated by a too-hot economy. In looking at the remaining four recession cycles, we see the biggest risks to successful soft landings, including fiscal policy mistakes and outside shocks. Conversely, a successful soft landing in 1994 points to effective methods, like early action, refusal to waver, and plain good luck.

Soft landing prospects in 2023

We believe that the Fed will be unsuccessful in executing a soft landing in this cycle and that a recession will occur before inflation is under control. One reason is that the Fed began its tightening process late, as inflation was less transitory than expected. Moreover, the real federal funds rate — the effective interest rate less inflation and a measure of the true bite to interest rates on economic activity — remains negative. In past cycles, the real federal

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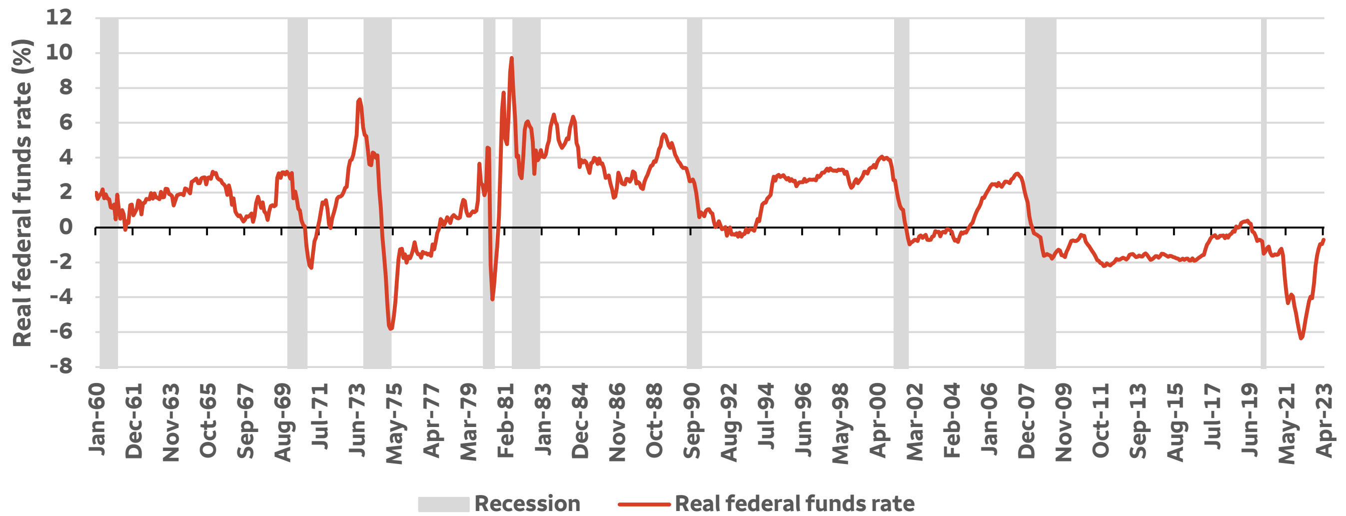
funds rate has become positive (and above 1-2%) before recession. As such, the Fed may have to continue raising rates to quell inflation, increasing the risk of a recession.

Chart 1. Real federal funds rate remains low compared to previous recession periods



Sources: Federal Reserve Board, U.S. Labor Department, and National Bureau of Economic Research, as of April 30, 2023. The real federal funds rate is the effective federal funds rate less the year-over-year percent change in the core Consumer Price Index.

High inflation and increased interest rates historically haven't tended to trigger a recession abruptly but have cascaded through the economy in a sequential way. Economically sensitive manufacturing has been in an uneven slowdown much of this year. Interest-sensitive housing has closely followed the ebb and flow of borrowing costs much of this year, with the effects of any future recession yet to have their full impact. And the boom in artificial intelligence (AI) has masked the impact of a worsening earnings outlook and higher interest rates on the stock market. More broadly, we believe, the economy's true trajectory has been masked by post-pandemic support to job growth, services, and autos. Our view is that its unwind will become more apparent as these tailwinds weaken and headwinds from tightening liquidity conditions build further.

In the face of likely recession in 2023 and part of 2024, we favor remaining defensive. We favor high quality large-cap U.S. stocks and caution toward economically sensitive smaller caps and non-U.S. stocks. In bonds, we prefer using a barbell strategy of investing in shorter-maturity investments, which have attractive yields amid the possibility of further rate increases, and longer-term bonds, which we expect to ride attractive yields for now.

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Equities

"It's not what you look at that matters. It's what you see." — Henry David Thoreau

Austin Pickle, CFA
Investment Strategy Analyst

Narrow market rally: What does it mean?

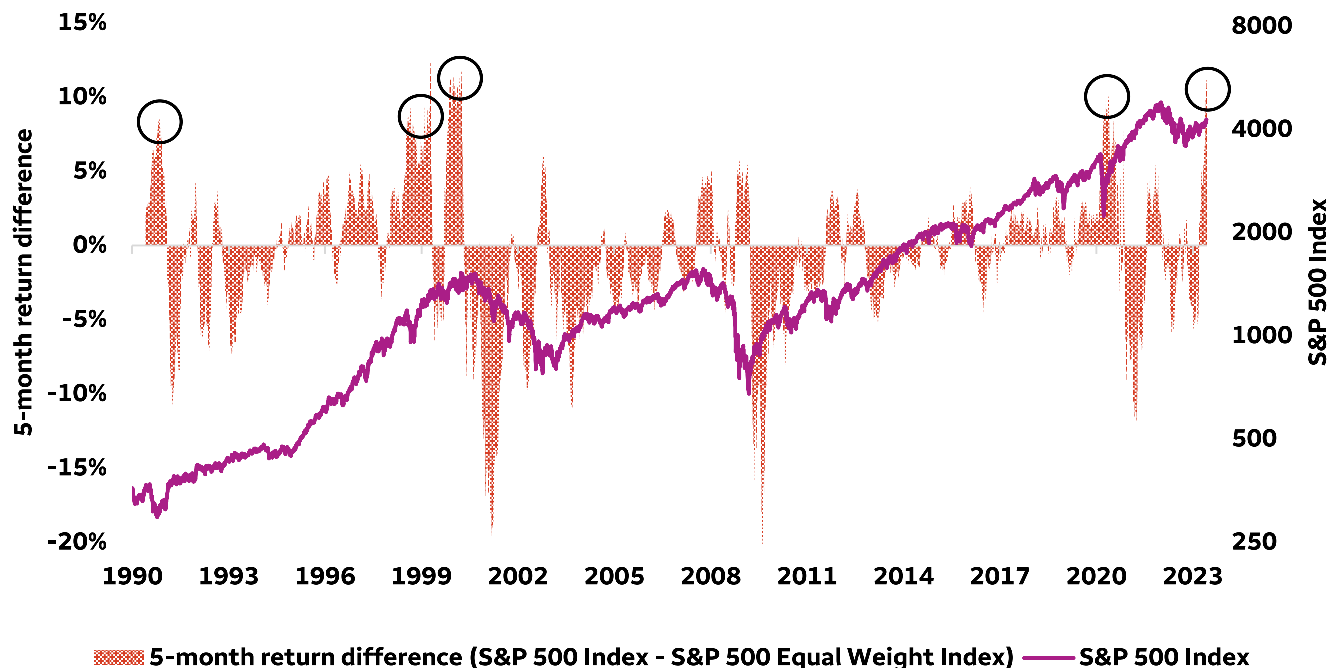
The narrowness of the year-to-date rally fueled by AI has been stunning. As of June 5, the seven mega cap technology-related names driving the majority of equity returns have jumped 73% on average, whereas the typical stock, as measured by the S&P 500 Equal Weight Index, is essentially flat, up only 1%. The most common questions we have received center on how rare of an occurrence this is and what history teaches us from past narrow markets.

The chart below makes clear that today's market narrowness has few comparisons. The patterned red bars measure the rolling 5-month return difference between the S&P 500 Index, which is market cap weighted, and the S&P 500 Equal Weight Index. Black circles indicate the handful of periods where the divergence between the larger cap stocks and the average stock reached an extreme resembling today's market.

What is not clear are the conclusions we can draw from history about what may happen next. The extreme divergences observed near the tech bubble peak would urge caution, yet the 1990 and 2020 divergence peaks preceded multi-year periods of strong stock returns.

Market extremes have not lasted. We expect recent outperformance of the larger cap names to eventually correct, as we've seen through history, either by those top names "catching down" to the average stock or the average stock catching up to the top names. For the latter scenario, we expect the macro environment would need to improve. With our forecast of a recession on the horizon, we believe the average stock will likely continue to struggle, suggesting to us that the current rally is on shaky ground.

There has been only a handful of extremely narrow markets since 1990



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data January 1, 1990 – June 6, 2023. The right axis is in log scale. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Fixed Income

Peter Wilson
Global Fixed Income Strategist

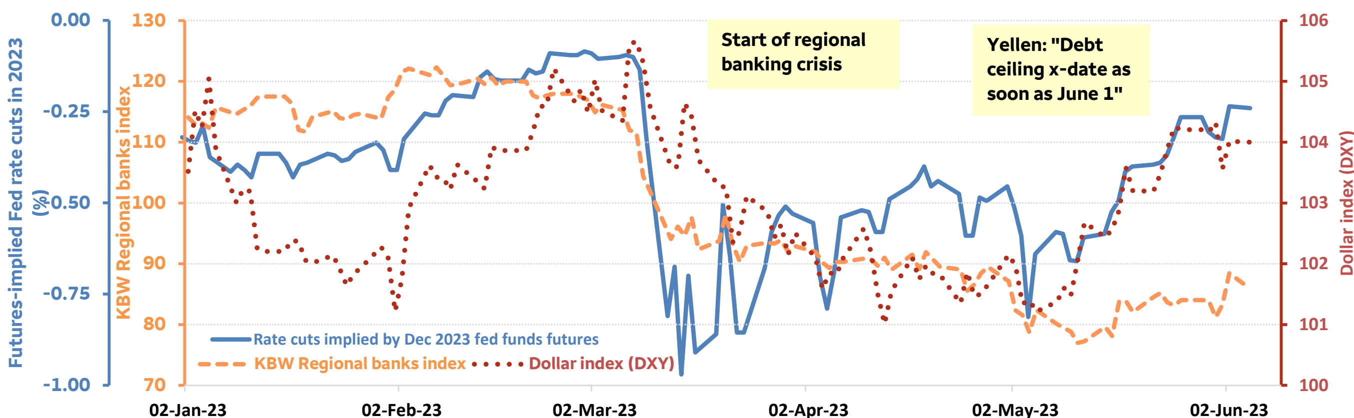
Fading rate-cut hedges lift the dollar

As we get nearer the end of the Fed's tightening cycle, much interest-rate commentary has focused on the "mystery" that the federal funds futures market has seemed to be expecting the Fed to cut rates before the end of the year, despite consistent Fed messaging to the contrary. As the chart below illustrates, this is not really a mystery at all, and the futures market is not really "expecting" the Fed to cut rates that soon. Rather, the market likely anticipates (as we do) that the Fed will hold rates at peak levels into 2024; but participants also need to hedge against the non-negligible risk that something breaks — meaning a financial shock of magnitude sufficient to force the Fed to cut multiple times.

The chart shows that it was first the onset of the regional bank crisis in March, then the acceleration of debt-ceiling urgency in May, that obliged the futures market to hedge the financial risk by pricing in rate cuts (solid blue line). It also suggests that this lower rate pricing was a key factor pushing the U.S. Dollar Index (DXY)[1] down in March and keeping it near the bottom of the range until mid-May (dotted red line).

Now that these risks have faded, it is reasonable that the futures market is pricing less than one 25-basis-point[2] cut by year-end and that the dollar has risen back into the top half of its 2023 trading range. We continue to expect the Fed to raise rates at least once more this year, and to keep rates at peak levels until 2024, when it may return to rate cuts if inflation is seen as sufficiently tamed. In line with this profile, we see the dollar maintaining its trading range for the rest of this year, only showing a clearer depreciation trend in 2024.

Fear of financial instability driving rates and the dollar



Sources: Bloomberg and Wells Fargo Investment Institute. Latest data as of June 5, 2023. Futures-implied Fed rate cuts in 2023 are calculated by subtracting the December 2023 contract implied rate from the peak rate implied by futures contracts over the rest of 2023. The KBW Regional Banking Index is a modified-capitalization-weighted index, created by Keefe, Bruyette & Woods, representing the performance of the U.S. regional banking industry. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

1. The Dollar Index (DXY) is a weighted average dollar exchange rate index against 6 major currencies, base year 1973, calculated by ICE Futures U.S.
2. A basis point in one hundredth of one percent (0.01%).

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Real Assets

"Whoever controls oil, controls much more than oil." — John McCain

Mason Mendez
Investment Strategy Analyst

John LaForge
Head of Real Asset Strategy

Two takeaways from the June OPEC meeting

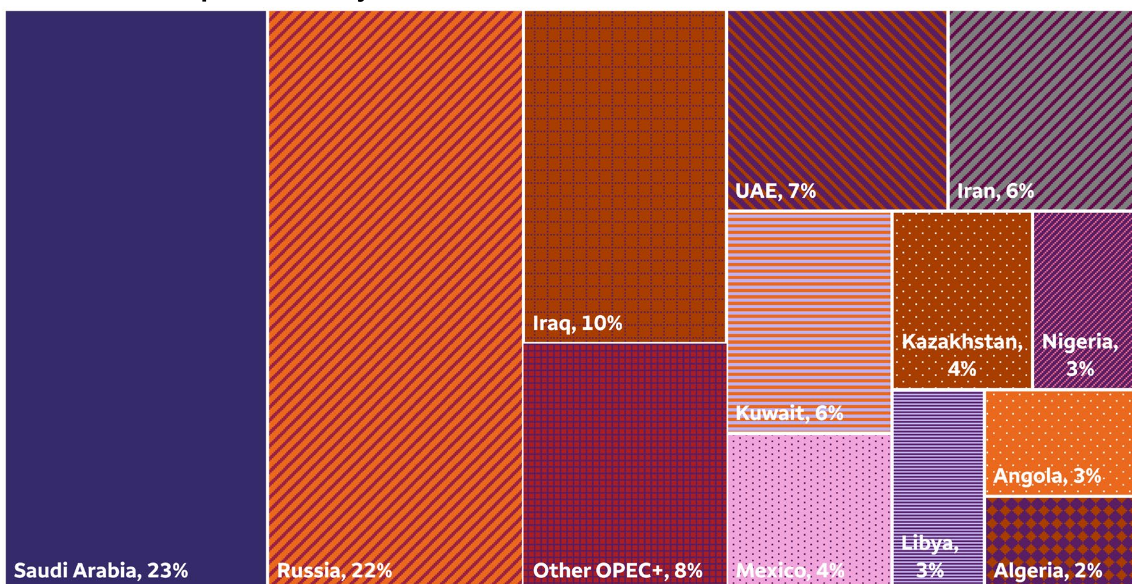
Saudi Arabia, the de-facto leader of the Organization of Petroleum Exporting Countries (OPEC), is displaying its influence over oil markets once again. In a bid to stabilize oil prices, OPEC's largest oil producing country, Saudi Arabia, voluntarily announced a 1 million barrel per day (bpd) production cut for July. It was also decided that the remaining OPEC+ members (OPEC+ includes Russia) would maintain their existing production levels.

Saudi Arabia's unilateral production cut is the latest in a string of OPEC+ production cuts, dating back to late 2022. In October 2022, OPEC+ announced a 2 million bpd cut, followed by an additional 1.66 million bpd cut in April 2023. The cuts announced last week, we believe, have two important takeaways:

- Saudi Arabia is committed to stabilizing prices, even at the cost of less market share: Saudi Arabia, the largest OPEC producer, accounted for 23% of total OPEC+ production as of May 2023 (see chart below). Given a 10% cut to the nation's oil production, Saudi Arabia will still be one of OPEC's largest producers, but at the cost of a reduced market share. Despite this, the Saudi energy minister stated that the country will do whatever is necessary to bring stability to oil markets.
- A unified OPEC is a strong OPEC: A reshuffling of production quotas among OPEC+ members resolved long-standing internal disputes over production quotas. The reallocation of quotas resulted in lower production quotas for smaller members struggling to meet targets and higher quotas for those able to meet their targets.

In our view, the results of the meeting signaled a strong and unified OPEC+, which may help offset some effects of lower demand during an expected recession. We suspect that these near-term actions could help buoy oil prices to a range closer to our 2023 year-end targets.

OPEC+ crude oil production by member



Sources: Bloomberg, and Wells Fargo Investment Institute. Monthly production estimates are as of May 2023. "Other OPEC+" includes Azerbaijan, Bahrain, Brunei, Congo, Equatorial Guinea, Gabon, Malaysia, Oman, South Sudan, Sudan, and Venezuela.

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Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

Challenges remain for U.S. office markets

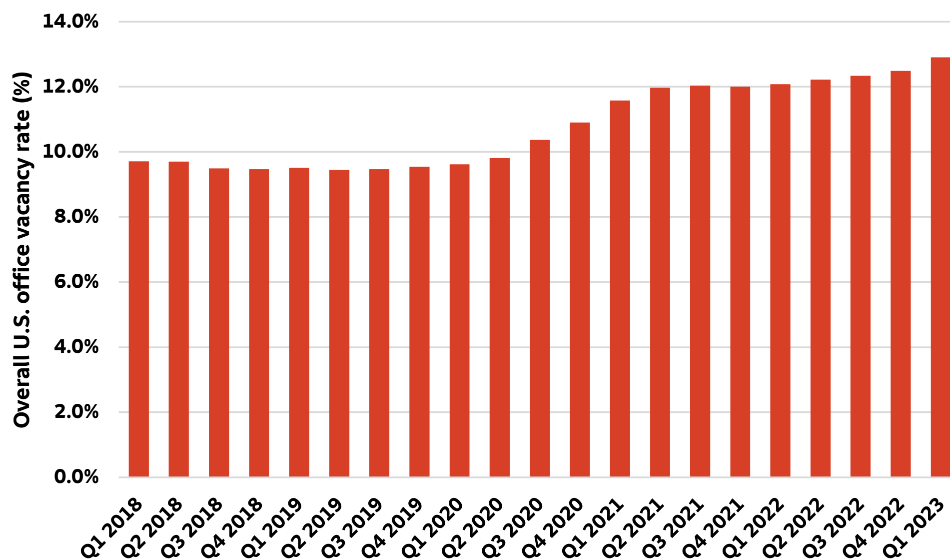
In private real estate, the office property type continues to face myriad challenges, including shifting worker preferences, a tighter lending market, and rising debt costs.

While the global pandemic is squarely in the rear-view mirror, the return-to-work trend that many expected would continue to gain momentum seems to be stalling. While some employers are persuading their workforce back into the office in the hope of fostering a more cohesive company culture, the tight labor market has kept negotiating power in the hands of employees, who have grown accustomed to work-from-home or hybrid models.

In addition to workers demanding greater flexibility, interest rates have risen significantly over the past year. Higher interest rates have increased the financing costs and aggravated the mini-banking crisis within the small and regional banks, impacting a key lender to the commercial lending market and tightening credit conditions overall.

As highlighted in the chart below, the vacancy rate for the U.S. office property type has steadily increased over the past three years and now stands at a recent high point of 12.9%. This trend may continue as companies continue to re-evaluate their long-term needs for office space as their leases expire. While the vacancy rate marches steadily upward, the fact that many companies continue to pay for under-utilized office space may mask additional underlying weakness in current tenant demand. Although the office property type continues to face several near-term headwinds, other property types such as Industrials continue to exhibit relative strength despite the rising interest rate environment. As a result, we continue to maintain our neutral guidance on private real estate overall, which includes core, value-add, and opportunistic sub-strategies.

U.S. office vacancy rate (January 2018 to March 2023)



Sources: National Association of Realtors, CoStar Group, and Wells Fargo Investment Institute. Data as of March 31, 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, June 12, 2023.

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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.

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Definitions

S&P 500 Equal Weight Index (EWI) is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market.

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