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Investment Institute

TIMELY GUIDANCE

Institute Alert

Timely guidance that may affect your investment strategy — June 13, 2023

Global Investment Strategy Team

☑ Guidance change

☑ Forecast change

☑ Allocation change

Updating guidance ahead of a likely volatile season

Guidance changes

- **Global fixed income:** We are downgrading from neutral to unfavorable three fixed-income sectors that could be vulnerable to intensifying strains in the credit markets. These downgrades are for Leveraged Loans, Commercial Mortgage-Backed Securities, and High Yield Municipal securities.
- **Global equities:** We are downgrading the Information Technology sector from favorable to neutral and upgrading the Materials sector from neutral to favorable.
- **Alternative investments:** We are upgrading the private capital sub-strategy of Distressed/Special Situations from neutral to favorable.

Forecast changes

- **Real Assets:** We are adjusting crude oil and gold targets to account for our expectations for more limited crude oil and general commodity price upside in 2023 and 2024, as well as more limited gains for gold in 2024.

Allocation changes

- We favor a modest reallocation from the Information Technology equity sector to the Materials sector.

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Table 1. Revised 2023 and 2024 commodity targets

Real assets	New year-end 2024 targets	Previous year-end 2024 targets	New year-end 2023 targets	Previous year-end 2023 targets
WTI crude oil	**$90-$110**	$100-$120	**$80-$90**	$85-$95
Brent crude oil	**$95-$115**	$105-$125	**$85-$95**	$90-$100
Gold	**$2300-$2400**	$2400-$2500	$2100-$2200	$2100-$2200
Bloomberg Commodity Index	**255-275**	275-295	**235-255**	250-270

Source: Wells Fargo Investment Institute, June 13, 2023. WTI = West Texas Intermediate. An index is unmanaged and not available for direct investment. Entries in bold indicate changes as of this report. **Forecasts, targets, and estimates are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.**

Summary

One of the most apparent challenges in the coming year is an abrupt tightening of financial liquidity, brought on by deteriorating credit quality, renewed banking sector strains, and stubbornly high inflation. The economy sidestepped a credit crunch in March and April, but recent declines in the money supply and persistent credit tightening are increasing financial stress, threatening housing as well as consumer and business borrowing. Our guidance — to remain defensive in portfolio positioning — has remained consistent through the bear market that began in 2022. We reinforced that guidance in April by turning more defensive. However, tightening credit conditions lead us to some additional adjustments, which we describe in this report.

Downgrading three fixed-income sectors from neutral to unfavorable

Leveraged Loans from neutral to unfavorable: Although the Leveraged Loans sector has managed to deliver relative strong performance year-to-date (similar to high-yield bond performance), we believe this performance advantage may begin to reverse if, as we expect, an economic recession begins later in 2023.[1] Interest rate coverage ratios and balance sheet cash remain robust but have declined ahead of a potential earnings recession. Furthermore, we believe additional headwinds likely will surface in the upcoming months as credit conditions tighten further and capital cost remains elevated.

At this time, distressed loan volume continues to trend higher, and default rates over the next 12-months are also expected to climb. Overall sentiment from institutional investors hasn't necessarily changed yet, but outflows from retail investors have been evident over the past 12-months. We believe there is an opportunity to move to an unfavorable stance on Leveraged Loans while we emphasize our preference to remain defensive in fixed income and to move up in credit quality.

Commercial Mortgage-Backed Securities from neutral to unfavorable: On March 2, 2023, we downgraded Commercial Mortgage-Backed Securities (CMBS) from favorable to neutral, largely on the view that credit spreads seemed likely to remain range-bound. However, shortly after our guidance change, a regional banking crisis since March 8 caused spreads to widen by almost 40 basis points (a basis point is 1/100 of a percent) as of May 31, 2023.

1. As of May 12, 2023

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The prospects of a recession in the second half of the year continue to grow, and this increases risks for leased space. We believe credit spreads have an upward bias, especially while interest rates remain elevated, or even rise further. Another near-term problem for the market is the asset-liability mismatch in floating rate deals. This could cause an increase in delinquency rates, especially at a time where liquidity could dry up in the space. Consequently, we are downgrading CMBS.

High Yield Municipal Fixed Income from neutral to unfavorable: We have been neutral on High Yield (HY) Municipal Fixed Income since March 5, 2021. Over this time period, the broader investment-grade Bloomberg U.S. Municipal Bond Index has outperformed the Bloomberg U.S. Municipal Bond High Yield Index by roughly half a percentage point, through the end of May. We maintained a neutral position on HY municipal bonds, as we believed that they could offer additional income opportunities to those investors willing to bear the additional risk, especially during the low interest rate environment of 2021.

Although all municipal bond sectors suffered in 2022 as the Federal Reserve began to raise interest rates, we believed that HY municipal bonds had a good chance of recovering as we crossed into 2023. The Bloomberg U.S. Municipal Bond High Yield Index (+2.44%) managed to deliver excess positive returns against the investment-grade Bloomberg U.S. Municipal Bond Index (+1.94%) in the past six months, as of May 31, 2023.

However, at this time, we believe high-yield bonds will be more vulnerable to fundamental credit pressure and resulting price declines during an upcoming recession. We also note that non-rated bonds account for almost 70% of all HY municipal bond trading, while Puerto Rico and Tobacco represent the majority of the market and are typically the most liquid bonds within the space. Still, we believe that liquidity will be challenged in the upcoming slowdown. Therefore, we believe that a move to an unfavorable view of HY Municipal Fixed Income is appropriate.

Upgrading the Materials sector to favorable; downgrading Information Technology to neutral

Materials: Outside of the Energy sector, Materials is likely the most levered sector to the overarching trends that we expect, including higher commodity prices, China's ongoing reopening, and a flat to weaker dollar over the coming 6 to 18 months. These trends favor continued strong cash flow, and the sector scores well on other quality metrics, such as low debt ratios. Sector valuations also are attractive, and we believe the recent underperformance has provided an attractive entry point to upgrade the sector from neutral to favorable. Industrial gases remain our favored sub-industry.

Information Technology: The Information Technology sector still scores high in our analysis of quality characteristics, including relatively low debt levels, high free cash flow generation (the amount of cash remaining after expenses have been paid), and the return of cash to shareholders in the form of share repurchases. We believe these qualities should serve investors well if the economy rolls over as we expect. However, the sector's outperformance has lifted valuations to levels that we find unattractive at present. Higher-for-longer interest rates are another negative factor in our analysis. In our view, these two, relatively short-term negatives strike a rough balance with the positive longer-term quality characteristics (including the potential of artificial intelligence). We therefore downgrade our rating for this sector from favorable to neutral. It also may be worth noting that a neutral allocation is still more than 25% of the S&P 500 Index weighting (see Table 2); this represents the sector's highest market capitalization weighting since 2000 and the largest single-sector weighting in the index.

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Table 2. Revised equity sector preferences

Sector	S&P 500 weight (%)	Guidance
Communications Services	8.7%	Neutral
Consumer Discretionary	10.1%	Unfavorable
Consumer Staples	7.1%	Neutral
Energy	4.3%	Favorable
Financials	12.8%	Neutral
Health Care	14.1%	Favorable
Industrials	8.5%	Neutral
Information Technology	**26.8%**	**Neutral**
Materials	**2.5%**	**Favorable**
Real Estate	2.4%	Unfavorable
Utilities	2.7%	Neutral

Sources: Bloomberg and Wells Fargo Investment Institute, June 13, 2023. Weights as of May 22, 2023.
Notes: Entries in bold indicate changes as of this report. To reposition allocations for consistency with our guidance, add two percentage points of exposure to market weight for favorables, subtract two for unfavorables, and hold market weight for neutrals. **Forecasts, targets, and estimates are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.**

Adjusting real asset price targets for 2023 and 2024

We are adjusting our oil and broad commodity index prices modestly lower but keeping a profile for potential gains over the coming 18 months. While the lower targets acknowledge the role of weaker demand, supply constraints appear to be the dominant factors over the coming 18 months, for two reasons. First, while U.S. and European economic recessions weigh on global commodity demand, the emerging economies are the dominant global commodity consumers. These economies are likely to grow and offset the weaker U.S. and European demand through 2024. Second, we believe that supply constraints are the main drivers of the multi-year bull market we have noted in commodities since 2020.

To that point, Chart 1 still shows that commodity prices are well supported, even after accounting for the pressure of the global economic slowdown and the price consolidation following the extreme price gains at the start of the Russia-Ukraine war. We still foresee modest upside for commodity prices from current levels and stronger performance in 2024.

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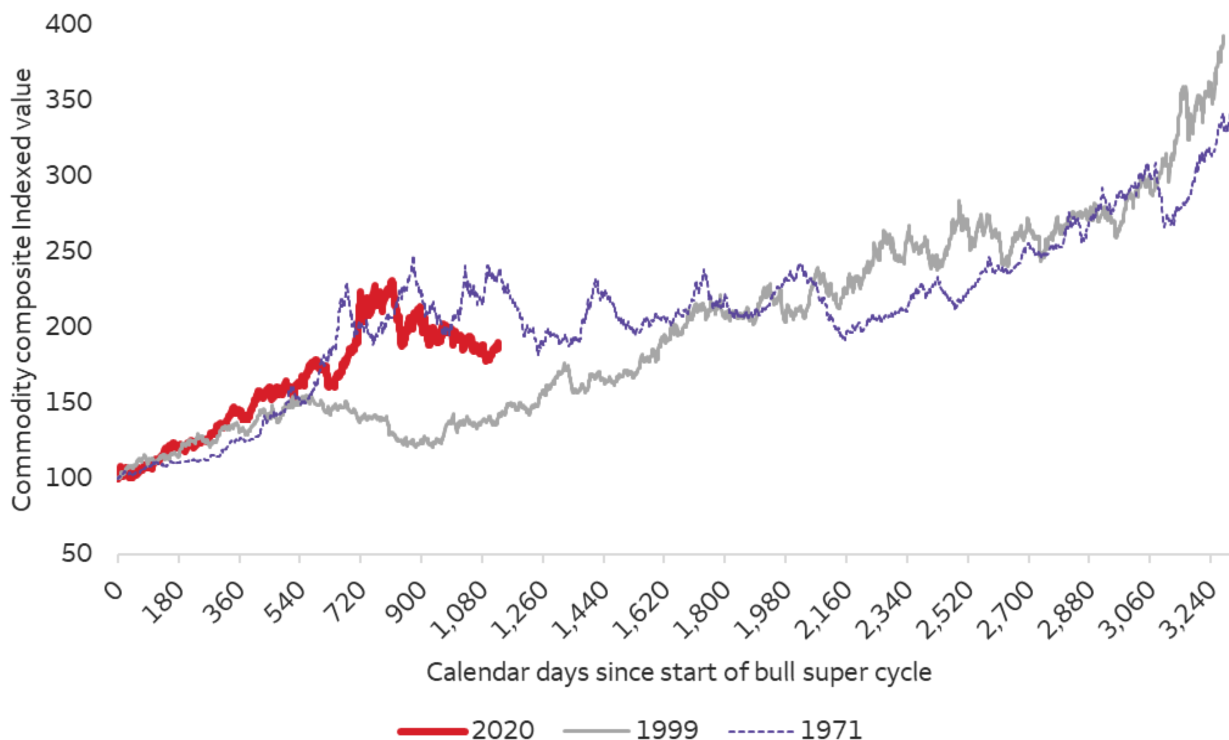
Chart 1. Modern commodity bull markets have shown periods of consolidation



Sources: Bloomberg and Wells Fargo Investment Institute. Commodity performance measured by our Commodity Composite, indexed to 100 as of the start of each bull market. Performance measured from October 4, 1971 - November 20, 1980; July 13, 1999 - July 2, 2008; and March 18, 2020 – May 30, 2023. An index is unmanaged and not available for direct investment. Super-cycle = If you look at commodity prices over the very long term (hundreds of years), it becomes evident that they tend to move in overall bull and bear cycles, some lasting decades. **Past performance is no guarantee of future results.**

We also are taking our 2024 gold price target slightly lower, proportionally to our adjustments to oil and broad commodity price targets. During a bull super-cycle[2], individual commodity price movements tend to take momentum from movements across the commodity complex. And, so, the new gold target reflects less strength than in our prior targets for all commodities. We make no change in the 2023 gold price target because we expect financial strains to continue to grow as the dominant factor supporting gold in the balance of the year.

Upgrading Private Debt – Distressed/Special Situations sub-strategy from neutral to favorable.

Given our forecast for a recession beginning in 2023 and the continued campaign by the Federal Reserve to combat inflationary pressures via additional interest rate hikes, the volume of U.S. distressed debt continues to expand (see Chart 2). We believe this growing opportunity set should bode well in the coming quarters for Private Debt – Distressed /Special Situation investing. The strategies target companies experiencing financial distress and often look for "good companies with bad balance sheets" that may have taken on too much debt financing and are unable to meet their interest obligations.

While distressed investing can take many forms, often managers build significant positions before or during the bankruptcy process and attempt to profit by either restructuring the balance sheet, merging with another entity, or liquidating the assets. In restructuring situations, managers often receive post-reorganization equity stakes to participate in the newly recapitalized firm's future growth. As such, these strategies often invest capital during

2. Super-cycle = If you look at commodity prices over the very long term (hundreds of years), it becomes evident that they tend to move in overall bull and bear cycles, some lasting decades.

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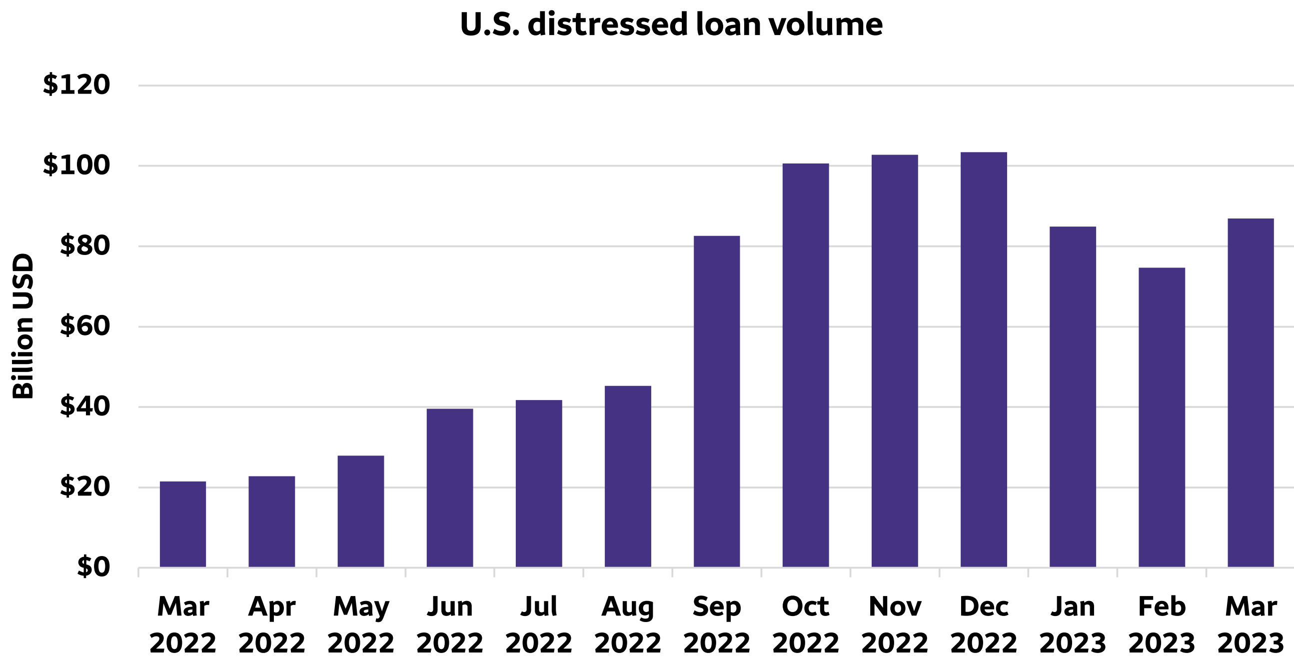
recessionary periods, when financial stress is greatest, and then can potentially benefit by holding positions in the reorganized firm while the business and economy recovers.

Investors must possess a long-term investment horizon to consider investing in private capital funds, which typically require investment periods spanning 8 to 12 years of limited or no liquidity. While the holding period for each distressed position may vary from several months to multiple years, the fund often begins to distribute capital midway through the fund's life.

We expect interest rates to remain "higher for longer," and we view the knock-on effects of higher debt service costs as a significant headwind for many overleveraged small and middle market businesses. In addition, the elevated wage pressures and slowing consumer demand should combine to create a very challenging operating environment for these businesses. Lastly, the recent crisis in the small and regional banking industry is reinforcing credit restrictions that were developing even before the bank failures between March and May. We expect the opportunity set in the stressed and distressed credit markets to continue to grow in the quarters ahead.

Chart 2. U.S. distressed loan volume trending upward



Sources: PitchBook | LCD Research and Wells Fargo Investment Institute. Data as of March 31, 2023. U.S. distressed loan volume measured by the Morningstar LSTA U.S. Leveraged Loan Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Risk considerations

Forecasts, targets, and estimates are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.

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. **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. **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. **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. **Leveraged loans** are generally below investment grade quality ("high-yield" securities or "junk" bonds). Investing in such securities should be viewed as speculative and investors should review their ability to assume the risks associated with investments which utilize such securities. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. **Commercial Mortgage-Backed Securities (CMBS)** are a type of mortgage-backed security backed by commercial mortgages rather than residential real estate. CMBS tend to be more complex and volatile than residential mortgage-backed securities due to the unique nature of the underlying property assets. 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. Investing in **gold** or other precious metals involves special risk considerations such as severe price fluctuations and adverse economic and regulatory developments affecting the sector or industry.

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 suitable 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 U.S. Municipal Bond Index represents municipal bonds with a minimum credit rating of at least Baa, an outstanding par value of at least $3 million and a remaining maturity of at least one year. The index excludes taxable municipal bonds, bonds with floating rates, derivatives, and certificates of participation.

Bloomberg U.S. Municipal Bond High Yield Index measures the non-investment grade and non-rated U.S. dollar-denominated, fixed-rate, tax-exempt bond market within the 50 United States and four other qualifying regions (Washington DC, Puerto Rico, Guam, and the Virgin Islands).

Commodity Composite: Measures a basket of commodity prices as well as inflation. It blends the historical commodity index introduced by George F. Warren & Frank A. Pearson, former academics at Cornell, collected and published commodity price data in their book, Prices, and the producer price index for commodities (PPI-Commodities), and the National Bureau of Economic Research (NBER) Index of Spot Market Prices of 22 Commodities and the Reuters Continuous Commodity Index. The index components and weightings, from Warren and Pearson's Prices, change over time but the 11 commodity groups used from 1786-1932 are: Farm Products, Foods, Hides and Leather products, Textile Products, Fuel and Lighting, Metals and Metal Products, Building Materials, Chemicals and drugs, Spirits (stopped tracking 1890), House furnishing Goods, and Miscellaneous. The PPI-Commodities is compiled by the Bureau of Labor Statistics and shows the average price change from the previous month for commodities such as energy, coal, crude oil and the steel scrap. The NBER Index of Spot Market Prices of 22 Commodities is a measure of price movements of 22 sensitive basic commodities whose markets are presumed to be among the first to be influenced by changes in economic conditions. The Reuters Continuous Commodity Index comprises 17 commodity futures that are continuously rebalanced: cocoa, coffee, copper, corn, cotton, crude oil, gold, heating oil, live cattle, Live hogs, natural gas, orange juice, platinum, silver, soybeans, sugar no. 11, and wheat. The Commodity Composite connects the aforementioned components at the following years: Warren and Pearson- Prices: 1720-1932, BLS PPI-Commodities: 1933-1946, NBER: 1946-1956, Reuters Continuous Commodity Index: 1956-Current.

Morningstar LSTA U.S. Leveraged Loan Index is designed to measure the performance of the U.S. leveraged loan 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 U.S. stock market.

An index is unmanaged and not available for direct investment.

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