**WELLS FARGO**
**Investment Institute**

# Investment Strategy

**Weekly guidance from our Investment Strategy Committee** **July 17, 2023**


## Alternatives Spotlight: Housing market is adjusting to new interest rate regime........ 2

- Housing market signals remain mixed. New-home construction remains active, yet affordability reached a multi-decade low amid the rising cost of financing.
- We remain cautious on residential real estate markets as low affordability levels may be a signal that markets remain overpriced, despite the current lack of supply.

## Equities: Earnings likely contracted for third straight quarter ........ 4

- We believe the corporate earnings recession likely continued in the second quarter of 2023, as revenues stalled and margins contracted.
- Should earnings continue to contract in 2023, we favor focusing on high-quality, larger-cap companies that have strong balance sheets and cash flow to weather an uncertain economic environment.

## Fixed Income: Lengthy yield curve inversion ........ 5

- The Federal Reserve appears ready to hike rates again in late July which we believe should help keep the yield curve inverted over the coming months.
- We continue to favor both short and long maturities as yield curve inversion remains persistent.

## Real Assets: Office delinquency rates are rising ........ 6

- Delinquency rates for office-backed commercial properties increased to 4.5% in June, the highest delinquency rate since 2018.
- Higher interest rates, tighter financial conditions, and lower demand for office space continue to be strong headwinds for office real estate investment trusts.

## Current tactical guidance ........ 7



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# Alternatives Spotlight

**Mark Steffen, CFA, CAIA**
Global Alternative Investment Strategist

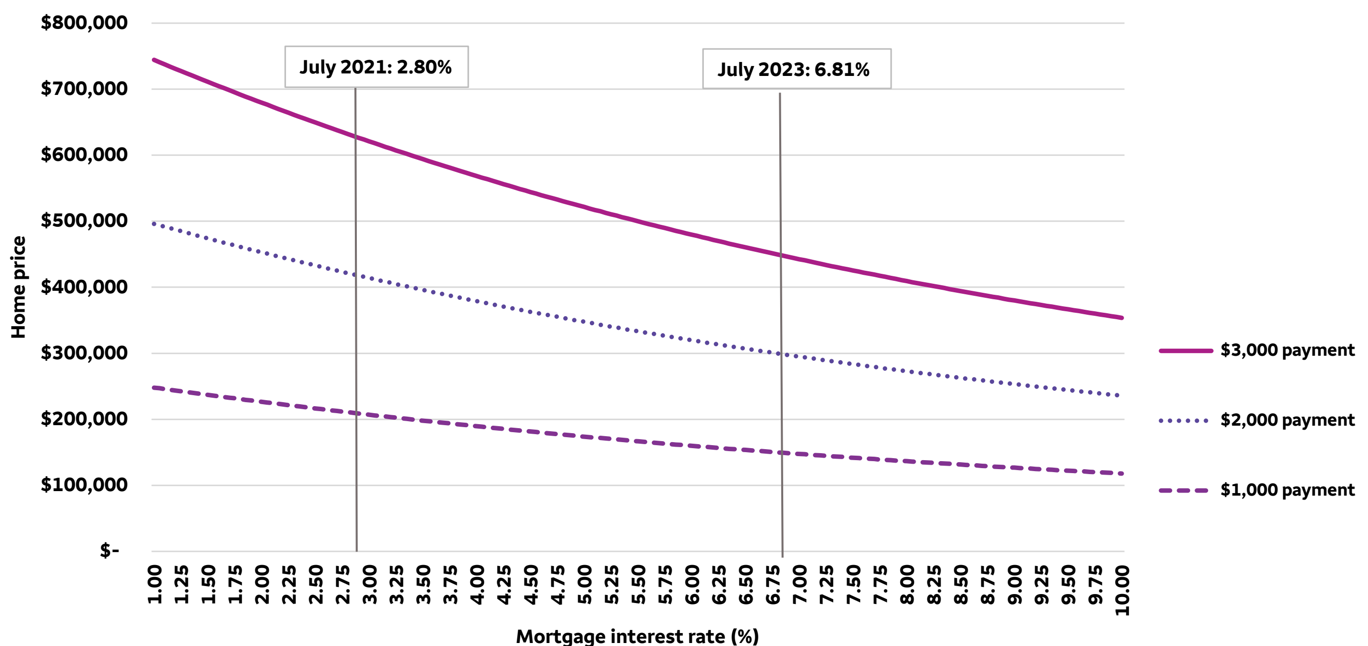
## Housing market is adjusting to new interest rate regime

Private Real Estate investments span several property types, including office, retail, industrial, and single- and multi-family residential. Within the single-family residential sector, indicators remain mixed, as new-home construction remains active and homebuilder sentiment is improving, yet housing affordability reached a multi-decade low amid the rising cost of financing. These mixed signals have many investors believing that valuations may have bottomed, yet we believe investors should remain cautious on residential markets until more signs of a recovery emerge.

By most measures, existing home prices have declined modestly in many areas of the U.S. over the past year as long-term mortgage rates increased over 4.0% in the past two years. Areas experiencing the largest declines have been those that realized the greatest appreciation during the pandemic era rise, mostly in the coastal and sunbelt regions. While prices have declined in the past year, the average home price nationally remains around 30% higher than pre-pandemic levels.

Yet affordability remains a challenge for housing, as the growth in financing costs has significantly outpaced the modest drop in home prices nationwide. The rise in mortgage rates has led to a dramatic decline in affordability, as the typical home now costs an estimated 25% more per month to own versus renting. As highlighted in Chart 1, the increase in the average 30-year fixed rate mortgage from July 2021 (2.8%) to July 2023 (6.8%) has a significant impact on the home price each buyer can afford. For example, a buyer in July 2021 who can afford a $2,000 monthly payment could purchase a $422,000 home, but today that same monthly payment will only buy a $300,000 home.

**Chart 1. Impact of higher interest rates on housing affordability**




Source: Redfin and Wells Fargo Investment Institute. Assumes a 20% down payment, 30-year mortgage, 1.25% property tax rate, 0.5% homeowners' insurance rate, and no HOA dues.

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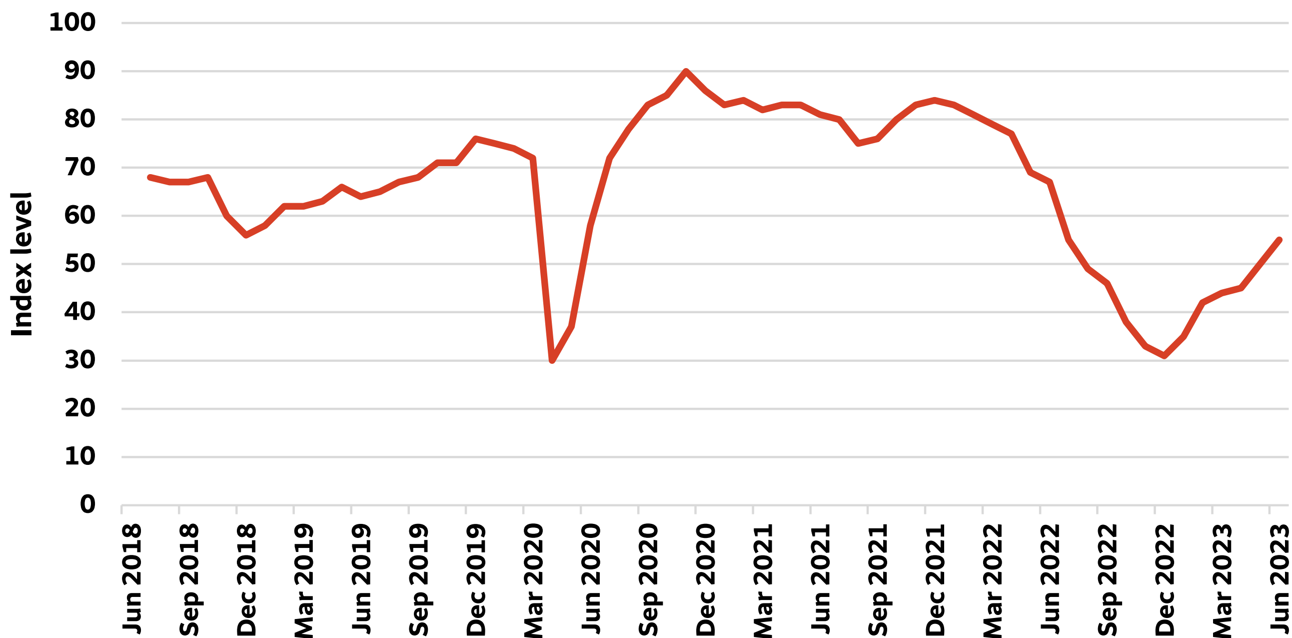
What's more, high borrowing costs are causing many potential buyers to stay in their current homes, where they are locked into low-rate mortgages. This trend — would-be sellers opting to stay on the sidelines — has led to a significant reduction in the inventory of existing homes for sale and reduced the number of potential buyers in the marketplace. According to real estate firm Redfin, approximately 82% of current mortgaged homeowners have interest rates below 5%, 62% below 4%, and 24% below 3%. The number of homes for sale declined from approximately 2.2 million in May 2019 to just 1.4 million in May 2023, a decline of 36%. While these dynamics affect both supply and demand for existing houses, the result has been a narrower market for potential buyers, which may lead to bidding wars in many areas and provide further support to home prices.

While affordability remains a headwind for housing markets, rising interest rates have had less of an effect on the new-home construction market than many forecasted. The number of new housing starts in the U.S. has trended upward in each of the past six months. Homebuilder sentiment has rebounded to an 11-month high, as measured by the National Association of Home Builders (NAHB)/Wells Fargo Housing Market Index (see Chart 2). The resiliency of the new home market may be in part due to the attractive incentives offered by builders as they continue to unload inventories. Rather than reducing prices, many builders are instead offering lower interest rates through their in-house financing divisions, reducing closing costs, or offering free home upgrades to entice buyers from the sidelines.

**Chart 2. Homebuilder confidence continues to rebound in 2023**




Source: Bloomberg. Data as of June 30, 2023. Index shown is the National Association of Home Builders (NAHB)/Wells Fargo Housing Market Index.

In summary, we continue to witness conflicting market signals on the health of the residential market. Although the rise in mortgage rates has led to low measures of affordability, the new-home construction market is showing signs of improving conditions. While positive signs are encouraging for private real estate investors, we remain cautious on residential real estate markets in general. While the supply of houses remains low, the impact of higher financing costs should continue to weigh on new home purchases over time. Low affordability levels may be a signal that markets remain overpriced.

Although the single-family residential property type continues to face near-term uncertainty, other property types, such as Industrials, continue to perform well given the more attractive supply and demand dynamics. We continue to maintain our neutral guidance on Private Real Estate overall, which includes core, value-add, and opportunistic sub-strategies.

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# Equities

**Chris Haverland, CFA**
Global Equity Strategist

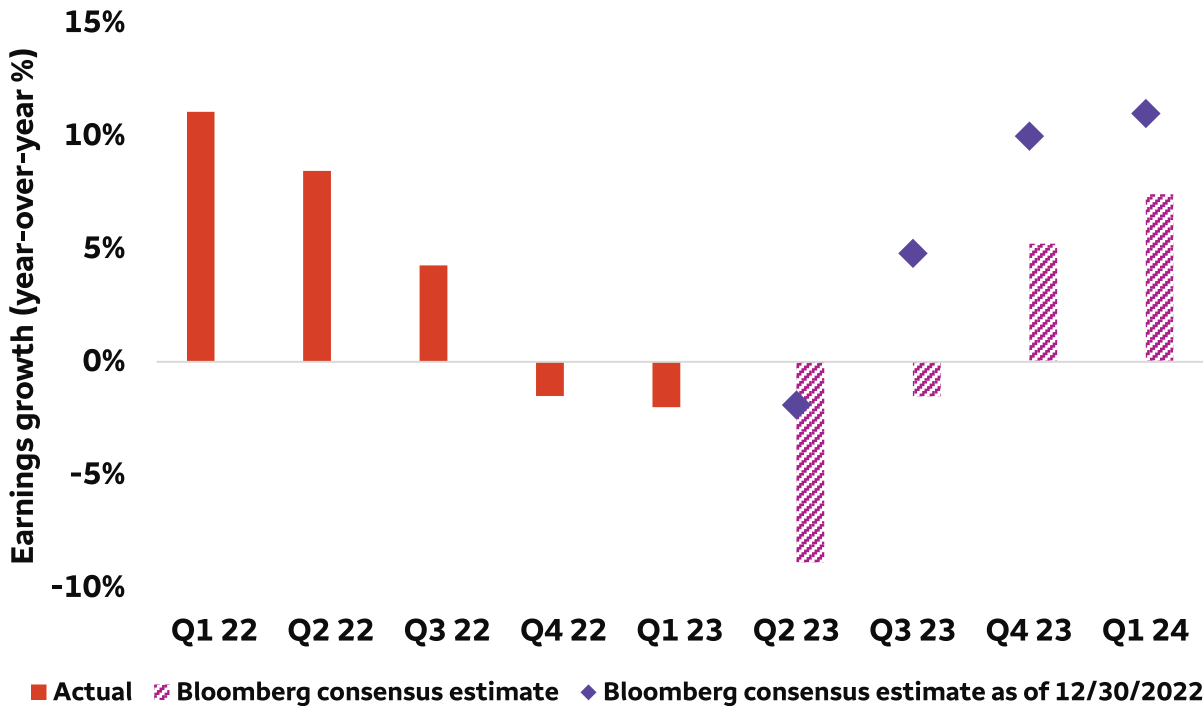
## Earnings likely contracted for third straight quarter

The latest corporate earnings recession began in the fourth quarter of 2022 with earnings per share (EPS) for the S&P 500 Index falling for the first time since 2020. This was followed by another decline in the first quarter of 2023. Second-quarter earnings season kicked off last week, and Bloomberg consensus is calling for a third consecutive drop in EPS (see chart below). Consensus estimates show another EPS decline in the third quarter before an earnings rebound in the fourth quarter.

While first-quarter earnings were better than feared, EPS estimates for the next four quarters have been revised lower. Even so, our call for a recession later this year leads us to be skeptical of the consensus forecast for EPS growth in the fourth quarter. Analysts show revenues accelerating and margins expanding into what we believe will be a deteriorating economic environment. We remain comfortable with our below-consensus 2023 EPS forecast of $205 for the S&P 500 Index.

2023 consensus estimates have been cut by more than $30 over the past year, but we believe further adjustments are warranted. We expect revisions to pick up in the coming weeks as companies provide greater clarity on their second-half outlooks. Should earnings continue to contract in 2023, we favor focusing on high-quality, larger-cap companies that have strong balance sheets and cash flow to weather an uncertain economic environment.

**S&P 500 Index EPS likely declined for the third consecutive quarter**




Sources: Bloomberg and Wells Fargo Investment Institute. Quarterly data as of July 11, 2023. Estimates are based on certain assumptions and on views of market and economic conditions which are subject to change. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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# Fixed Income

**Brian Rehling, CFA**
Head of Global Fixed Income Strategy

## Lengthy yield curve inversion

The yield curve is essentially the difference between shorter- and longer-term interest rates. The yield curve has inverted (short-term interest rates moving above longer-term rates) before each of the past seven recessions. While the yield curve can help identify stresses in the economy, it is not foolproof, as it does not pinpoint exact timing of a recession or how fast conditions may change.

While all points of the yield curve provide investors information, let's dive deeper into our preferred yield curve measure, the 10-year U.S. Treasury yield less the 1-year U.S. Treasury yield. This yield curve metric has now been inverted for one year.

**Treasury yield curve inversion (10-year minus 1-year yield) and U.S. recessions (number of weeks before start of recession)**

| Indicator | Dec 1969 | Nov 1973 | Jan 1980 | July 1981 | July 1990 | Mar 2001 | Dec 2007 | Feb 2020 |
|---|---|---|---|---|---|---|---|---|
| One week of inversion | 207 | 31 | 61 | 32 | 75 | 126 | 99 | 45 |
| Four weeks of inversion | 204 | 19 | 58 | 29 | 72 | 46 | 93 | 25 |
| Inversion of 25 basis points | 170 | 18 | 61 | 31 | 67 | 47 | 68 | 22 |

Sources: Bloomberg, Wells Fargo Investment Institute, Federal Reserve Bank of St. Louis FRED database, July 11, 2023. 25 basis points equal 0.25%.

It has been 48 weeks since the date (August 4, 2022) our preferred yield curve metric saw four weeks of inversion. In the past, a recession began as soon as 19 weeks after triggering this metric, but in 2007, it took nearly 93 weeks after triggering this metric before a recession began. While we continue to anticipate a recession in the second half of 2023, yield curve history shows that a recession that is delayed until late 2024 would still be within historical norms.

We would remind investors that the economy can continue to expand after yield curve inversion and that, likewise, risk assets can continue to perform well. However, given the powerful message an inverted yield curve has historically delivered, we believe investors should continue to be watchful, informed, and vigilant.

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# Real Assets

*"You can, you should, and if you're brave enough to start, you will." – Stephen King, author*

**John LaForge**
Head of Real Asset Strategy

**Mason Mendez**
Investment Strategy Analyst

## Office delinquency rates are rising

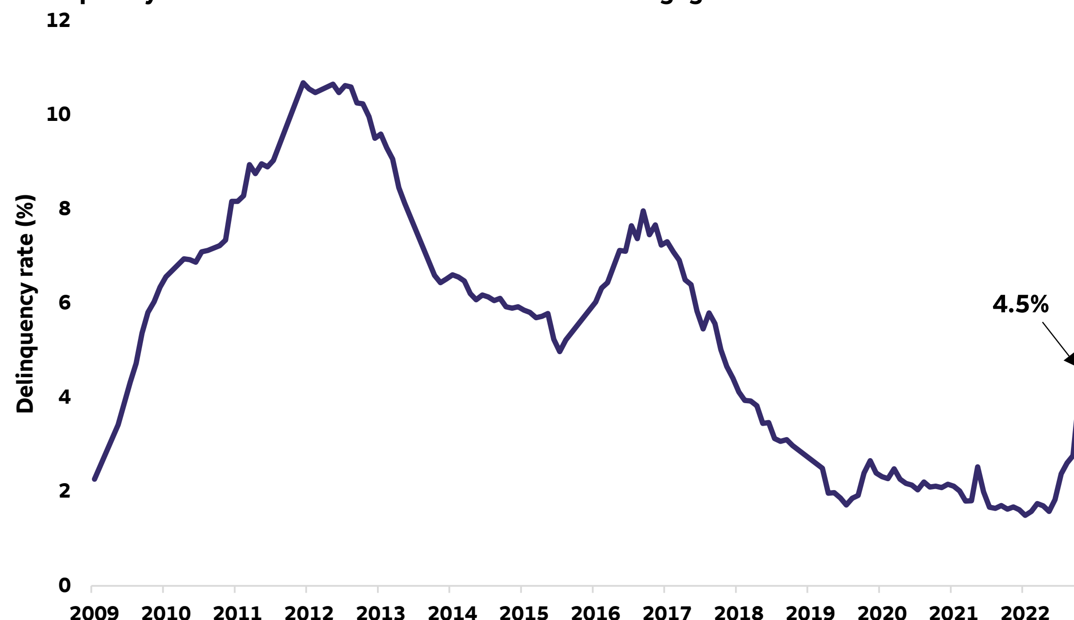
The office sub-sector of the NAREIT All Equity REITs Index continues to underperform in 2023, down 13% year-to-date through June 30, 2023. We have been unfavorable on office REITs since 2019, and we suspect that we may stay unfavorable for some time still. Tight financial conditions and historically low occupancies are continuing to push delinquency rates higher and higher — they now sit at levels last seen in 2018.

Delinquency rates for commercial mortgage-backed securities (CMBS) backed by office properties rose to 4.5% in June, the highest delinquency rate since 2018 (see chart below). The rise in delinquencies can be directly tied to tight financial conditions and low demand for office space.

- Tight financial conditions: In response to high inflation in 2021 and 2022, the Federal Reserve (Fed) began raising interest rates rapidly in late 2022. Lending conditions have significantly tightened in response, with higher interest payments, pressuring landlords especially. Given the Fed's repeated rhetoric to keep interest rates "higher for longer," we do not foresee easier financial conditions for office property owners in the coming six months.
- Low demand for office space: One way to roughly gauge the demand for office space is through occupancy rates — a ratio of units currently being leased compared to the total available units. Largely due to the pandemic, office occupancy rates dropped from 93% in 2019 to 88% as of first quarter 2023. We do not see relief for property owners anytime soon here either, as the rise of hybrid work schedules continues to gain traction.

Overall, we believe that office real estate investment trusts (REITs) will remain relative underperformers for some time still. This is in large part due to office property delinquency rates, which continue to march higher.

**Delinquency rates for office commercial-backed mortgage securities**




Sources: Trepp and Wells Fargo Investment Institute. Monthly data is from August 2009 – June 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<br>High Yield Taxable Fixed Income | Cash Alternatives<br>Developed Market Ex-U.S. Fixed Income<br>Emerging Market Fixed Income | U.S. Taxable Investment Grade Fixed Income | U.S. Long Term Taxable Fixed Income<br>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<br>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<br>Hedge Funds—Equity Hedge<br>Private Equity<br>Private Debt | Hedge Funds—Relative Value<br>Hedge Funds—Macro | |

Source: Wells Fargo Investment Institute, July 17, 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

Forecasts and targets are based on certain assumptions and on 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. **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. **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.

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

FTSE NAREIT All Equity REITs Index, a subset of the All REITs Index, is designed to track the performance of REITs representing equity interests in (as opposed to mortgages on) properties. It represents all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets, other than mortgages secured by real property that also meet minimum size and liquidity criteria.

National Association of Home Builders (NAHB)/Wells Fargo Housing Market Index is based on a monthly survey of NAHB members designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months as well as the traffic of prospective buyers of new homes. A rating above 50 indicates more builders view conditions as good than poor. The data is seasonally adjusted.

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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