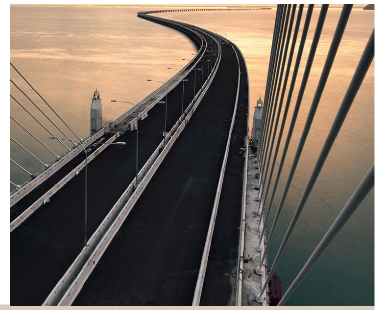
WELLS FARGO
Investment Institute



Investment Strategy

Weekly guidance from our Investment Strategy Committee **July 24, 2023**

Real Assets Spotlight

John LaForge
Head of Real Asset Strategy

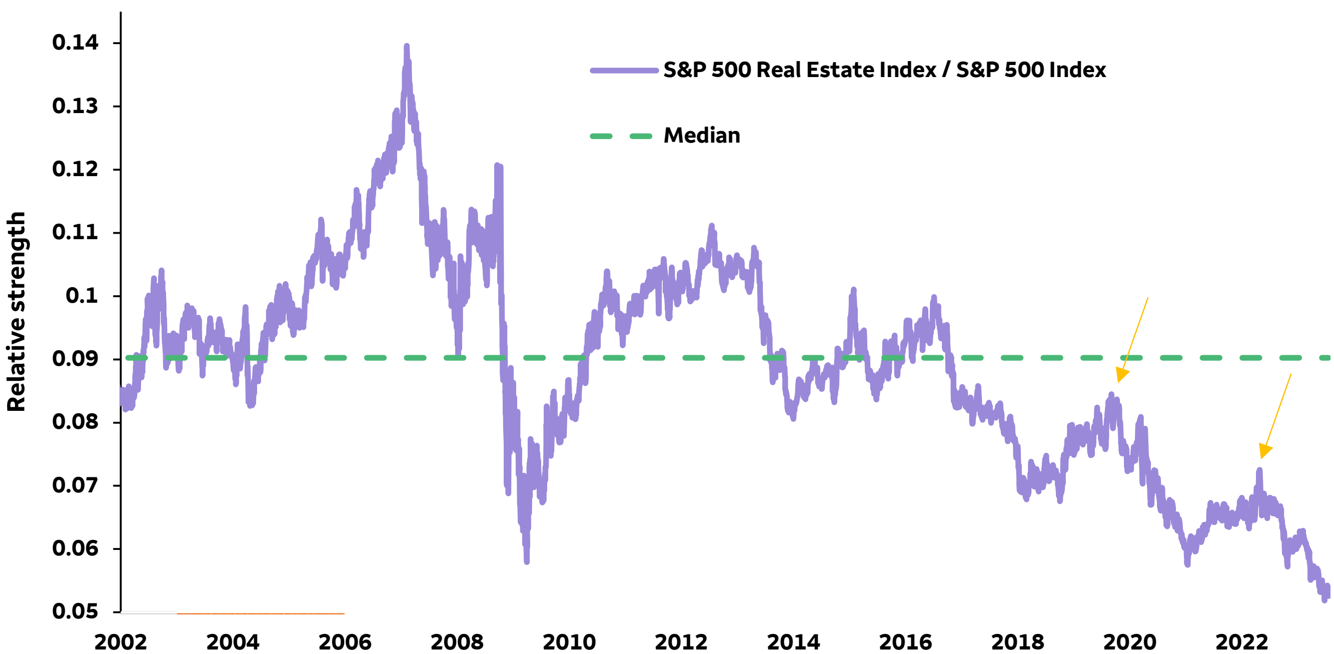
Mason Mendez
Investment Strategy Analyst

REIT values better, but we're not buying

Real estate investment trusts (REITs) have had rough go of it for the past year. It has been so bad, in fact, that the S&P 500 Real Estate sector hit new relative strength lows versus the S&P 500 last week (relative strength is measured by S&P 500 Real Estate Index price / S&P 500 Index price). Yes, a low lower than even March of 2009. The blue line in Chart 1 emphasizes this point.

Chart 1 highlights another interesting pattern too — that REIT relative strength since the 2008 – 2009 Global Financial Crisis has been moving in two-year cycles. REITs have been showing positive relative strength for two years, followed by roughly two years of weak relative strength. If this pattern continues, it suggests REITs could remain weak versus other S&P 500 sectors into 2024.

Chart 1. REITs relative strength versus the S&P 500 Index



Sources: Bloomberg and Wells Fargo Investment Institute. Daily Data is from January 2, 2002 – July 18, 2023. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** Gray areas on the chart represent recessions.

Does this pattern fit our overall REIT positioning? Yes, it does. We have been unfavorable toward REITs for more than a year now, and we do not envision altering it anytime soon. The main thesis for our unfavorable rating has not changed; REITs have historically been poor late-economic-cycle performers. And key late-cycle real estate markers are popping-off left and right, such as rising delinquencies, widening spreads on commercial mortgage-backed securities (CMBS), tightening lending standards, and decreasing demand. Fundamentals have little room to improve for a while still, in our view, with widespread global economic softness and sticky-high interest rates.

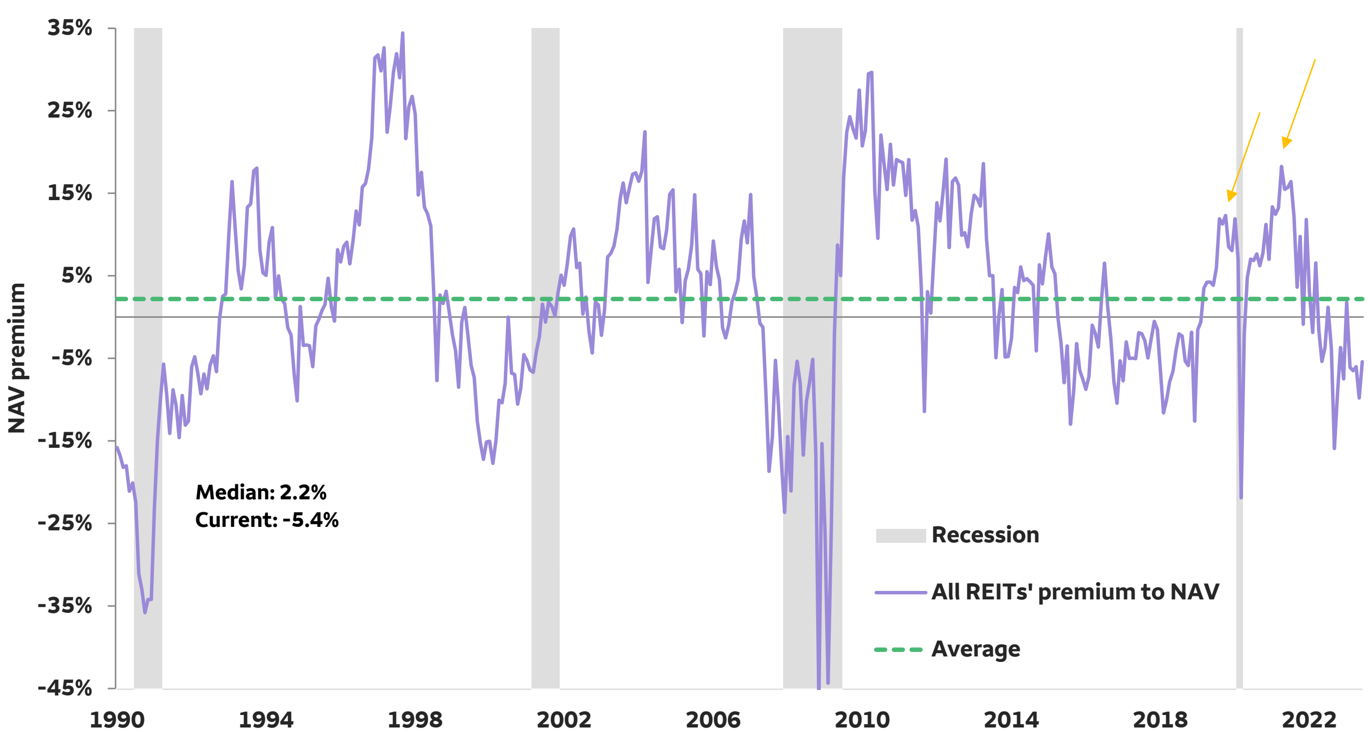
So, why does the pattern in Chart 1 exist at all? Well, there are many factors at play, some not even real estate specific, so it is hard to pin down exactly. Relative strength measures not only the asset being researched — in this case real estate; it measures the other assets too — in this case, the other sectors in the S&P 500. The pattern in Chart 1 does appear to have at least one direct tie to REITs, though — valuation, which we show using Chart 2.

Chart 2 measures REIT valuations by comparing them to their underlying real estate holdings. The solid blue line shows that the average REIT today trades at a 5.4% discount to its underlying real estate holdings. Historically speaking, this is decent discount. The green dashed line highlights that on average, since 1990, REITs have traded at a premium to their underlying real estate holdings to the tune of 2.2%. We believe the reason for the premium is that investors are often willing to pay-up for professional real estate management through REIT structures. (There are other potential benefits, too.)

The point of showing Chart 2 (real estate valuations), though, is to compare it to Chart 1 (REIT performance). Notice that the REIT relative strength peaks shown in Chart 1, the ones forming roughly every two years, often match the times in Chart 2 when real estate has become relatively expensive. Then notice the trough periods in REIT relative strength also. Historically, they have often coincided with some of the cheapest real estate periods. How cheap or expensive real estate must become to trigger a change in REIT relative strength no one knows for sure, however.

Each cycle is different. Is today's 5.4% REIT discount shown in Chart 2 enough for us to change our unfavorable rating on REITs? No, it is not. But we will be watching for a reversal in relative strength in Chart 1 to signal to us that it might be time for a change.

Chart 2. Equity REITs premium to net value



Sources: Green Street Advisors and Wells Fargo Investment Institute. Monthly data is from February 1990 – July 2023. NAV = net asset value. **Past performance is no guarantee of future results.** Gray areas on the chart represent recessions. "All REITs" covers all U.S.-listed companies in Green Street's coverage universe, excluding hotels and those without a published opinion.

Equities

Sameer Samana, CFA
Senior Global Market Strategist

The going gets tougher

The market's recent rise is due to a better-than-expected combination of monetary policy, liquidity-related factors, and economic growth, along with the prospects for artificial intelligence. Unfortunately, we believe much of the good news is now discounted, as seen in higher equity prices and richer valuations, and we expect headwinds for markets will intensify in the second half of 2023.

On the monetary policy front, we believe the Federal Open Market Committee will likely hike at its late July meeting and is projecting one more increase beyond that. With respect to liquidity, the recent increase in the Federal Reserve's balance sheet is proving temporary, and it has already started to shrink again — it now sits at the lows of the year.[1] While Treasury bill issuance has not hit bank reserves as hard as anticipated, it is declining and, in our view, has further to fall.

And although the economy seems resilient, both job openings and the number of people being hired are declining, which should dampen consumption. Lastly, artificial intelligence may be a game-changer in the long run, but history suggests that it takes time for transformational technologies to translate into equity market gains, and valuations are already running well ahead of historical trends. Seasonality also becomes less favorable as we head into the fall — August and September have historically been months when equities tend to stumble. Given these factors, we would expect the S&P 500 Index, which remains in a short-term uptrend, to pull back toward key support levels at the 50- (4303) and 200-day moving average (4039). In the meantime, investors should stay disciplined and defensively positioned.

S&P 500 Index

Source: Bloomberg. Data as of July 19, 2023. **Past performance is no guarantee of future results. An Index is not managed and not available for direct investment.** SMAVG (50) = Simple moving average of prices over 50 days. SMAVG (200) = Simple moving average of prices over 200 days.

1. Bloomberg. Federal Reserve weekly balance sheet data as of July 19, 2023.

Fixed Income

Luis Alvarado
Global Fixed Income Strategist

Reaffirming opportunities in RMBS

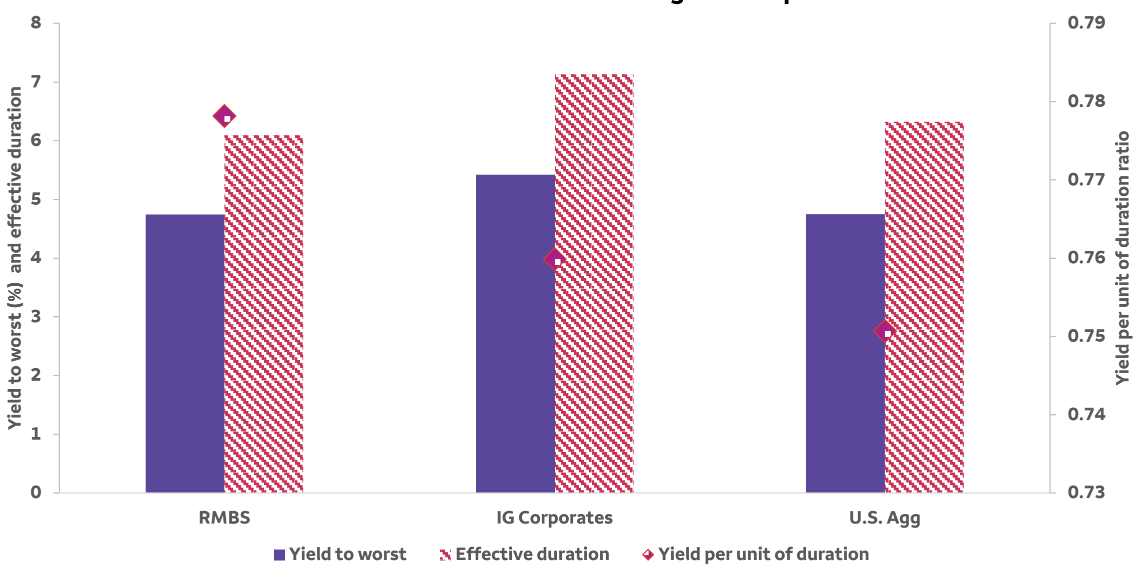
On March 2, we upgraded residential mortgage-backed securities (RMBS) from unfavorable to neutral. As was the case then, this sector is still offering yields that are relatively more attractive (see chart below) than those of investment-grade corporate bonds (also with a neutral rating), when considering the spread level over Treasury yields (reflective of market participants' view of risk).

We believe that the RMBS sector is well-positioned to provide risk-adjusted excess return in the second half of 2023, particularly as we expect Treasury yields to trade in a tight range over the next six months. Additionally, RMBS has historically offered higher credit quality and better liquidity than other sectors when an economic slowdown ensues. For now, we feel comfortable maintaining a neutral positioning on RMBS, but our bias is to the upside.

We believe that supply in the agency RMBS market will slow this year in comparison with the past few years. We expect that demand will remain mixed, with U.S. banks and foreign investors remaining on the sidelines but with opportunities emerging for money managers to step in and absorb supply (marginal buyer). Currently, prepayment risk also remains relatively low since higher mortgage rates have slowed the traditional refinancing activity. So, we have no major concerns about prepayment and reinvestment risks offsetting still-attractive RMBS valuations (see chart).

Finally, although we expect RMBS owned by the Federal Reserve (Fed) to continue to roll off its balance sheet, this has been occurring slowly. The Fed is not meeting the cap (set at $35 billion), and in recent press conferences, Fed Chair Jerome Powell has mentioned that RMBS outright sales are not likely.

RMBS valuations are attractive relative to investment-grade corporates



Source: Bloomberg and Wells Fargo Investment Institute as July 18, 2023. The yield to worst is calculated by making worst-case scenario assumptions by calculating returns that would be received if provisions, including prepayment, call, or sinking fund are used by the issuer. Effective duration is a measure of interest rate risk when valuing bonds with embedded options. Yield per unit of duration is expressed by yield-to-worst divided by the effective duration. Indexes represented are the Bloomberg U.S. Mortgage-Backed Securities (RMBS) Index, Bloomberg U.S. Corporate Bond Index and Bloomberg U.S. Aggregate Bond Index. An index is not available for direct investment. See index definitions on the back. **Past performance is no guarantee of future results.**

Alternatives

Brian Lane
Lead Analyst, Private Credit

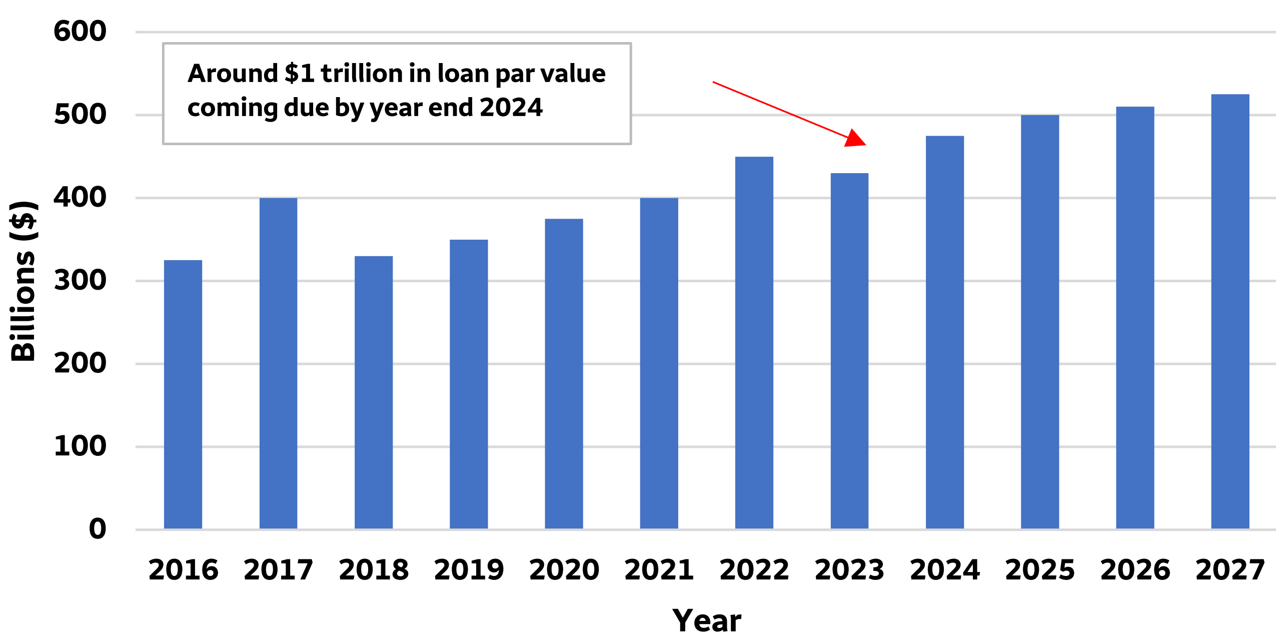
Wall of worry

The commercial real estate market is facing a wall of loan maturities that could present both a problem and an investment opportunity. By year-end 2024, almost $1 trillion in aggregate commercial real estate loans will be maturing, and by year end 2027, the number rises to roughly $2.5 trillion by most estimates.

Property owners are facing higher vacancy, reduced net operating income, falling prices, and rising capitalization rates. While valuations have started to decline in most property types, there is likely more downside to come. Some large commercial property owners have already handed back the keys to banks for individual holdings.

The challenge we see for many owners will be finding reasonable financing in today's tight credit market to refinance these loans. The lending market is tight. Banks are hesitant or unwilling to risk extending themselves further in the market, and corporate mortgage-backed security primary issuance is also down significantly from prior years. We believe many property owners will be forced to find solutions from private capital providers. This could present an opportunity for private real estate debt managers. We expect that private investors will be needed to provide debt financing and that sponsors may be forced to infuse equity to protect holdings and rightsize property deals. Discounted first-mortgage loan sales could also begin to occur where equity value is in question.

Commercial real estate loan maturities



Source: Morgan Stanley REIT/CRE/CMBS North America research publication. December 2022.
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, July 24, 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

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. **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. In addition to the risks associated with investment in debt securities, investments in **mortgage-backed and residential mortgage-backed securities** will be subject to prepayment, extension and call risks. Changes in prepayments may significantly affect yield, average life and expected maturity. Extension risk is the risk that rising interest rates will slow the rate at which mortgages are prepaid. Call risk is the risk that If called prior to maturity, similar yielding investments may not be available for the Fund to purchase. These risks may be heightened for longer maturity and duration securities. **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.. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

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.

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

An index is unmanaged and not available for direct investment.

Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Bloomberg U.S. Corporate Bond Index includes publicly issued U.S. corporate and Yankee debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

Bloomberg U.S. Government/MBS Index measures the performance of investment grade fixed-rate mortgage-backed pass-through securities of GNMA, FNMA and FHLMC.

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 Real Estate Index comprises those companies included in the S&P 500 that are classified as members of the GICS Real Estate sector.

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