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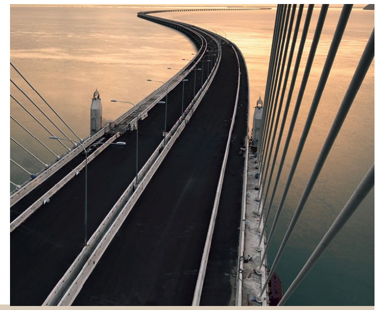
**Investment Institute**

# Investment Strategy



**Weekly guidance from our Investment Strategy Committee** **July 31, 2023**

# Global Equity Spotlight

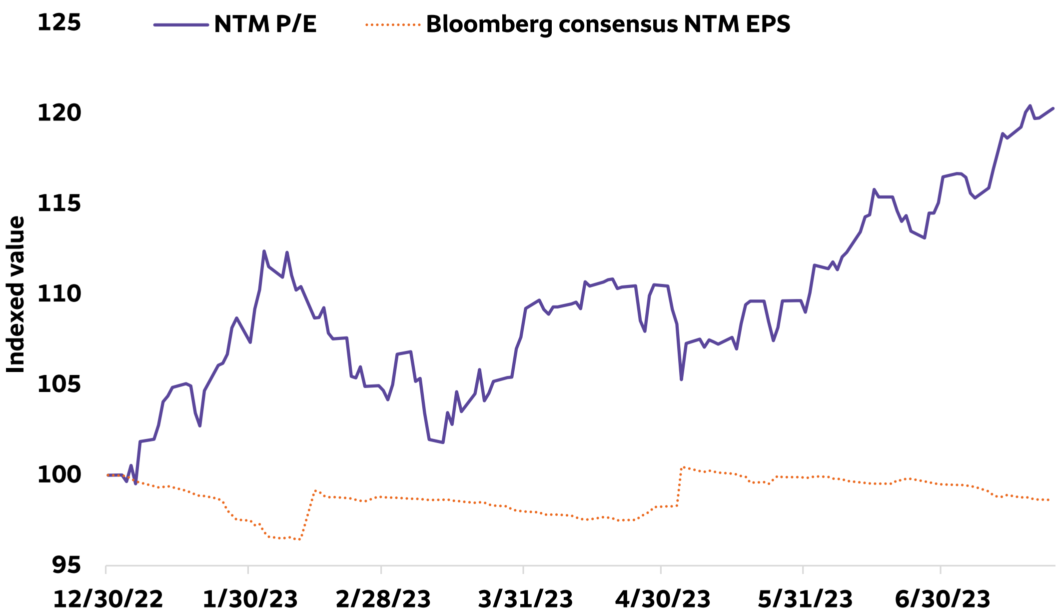
**Chris Haverland, CFA**
Global Equity Strategist

## Curb your enthusiasm

After hitting a cycle low of 3577 on October 12, 2023, the S&P 500 Index has surged more than 20% as of this writing. While this does fit the simple definition of a bull market, we are hesitant to use that label until the index at least reaches new highs.

Year-to-date performance also has been strong, driven by flat-to-lower long-term rates, improving inflation conditions, expectations for a Federal Reserve (Fed) pause, and optimism over artificial intelligence. What is absent from that list is earnings growth — a key component of equity market returns. As Chart 1 illustrates, the 2023 rally has been driven entirely by price-to-earnings (P/E) multiple expansion, the magnitude of which has only been seen in prior early-cycle recoveries in 2009 and 2020. Sentiment can be a strong driving force for returns in the short-term. However, sustainable market rallies eventually require support from rising corporate profits.

**Chart 1. S&P 500 Index change in price/earnings versus earnings per share**



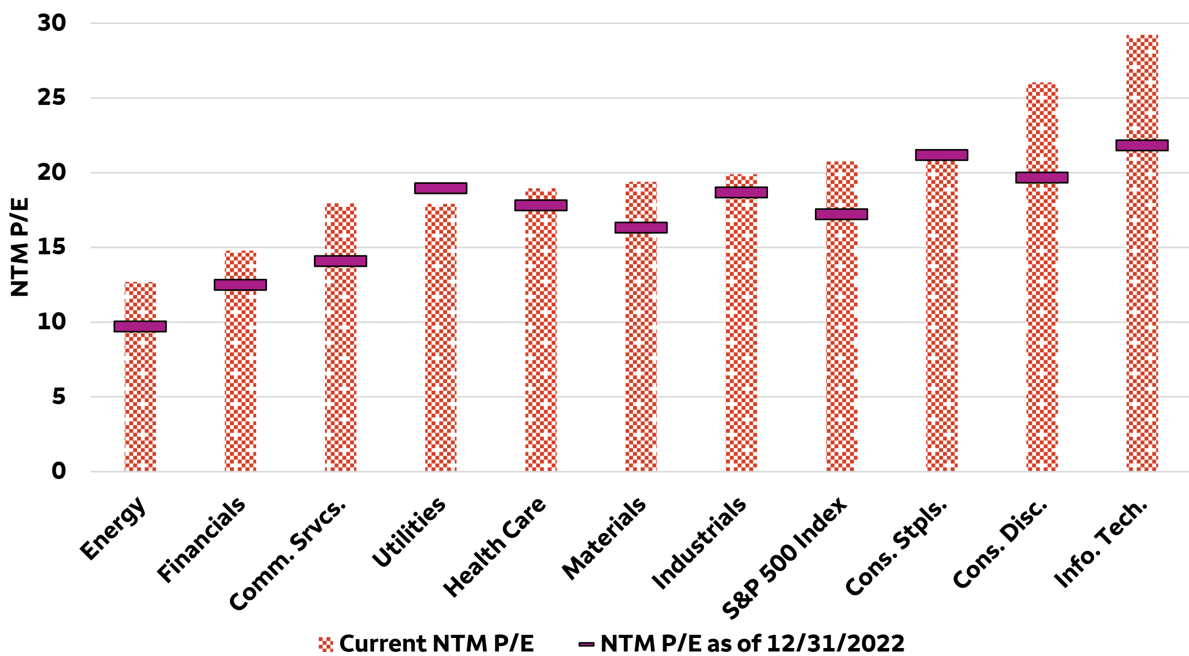

Sources: Bloomberg and Wells Fargo Investment Institute. Bloomberg consensus earnings estimates. Daily data: December 30, 2022 – July 24, 2023. Indexed to 100 as of the start date. NTM = next twelve months. P/E = price to earnings ratio. EPS = earnings per share. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** Data as of July 24, 2023.

S&P 500 Index earnings per share (EPS) declined in the fourth quarter of 2022 and in the first quarter of 2023. We are halfway through second-quarter earnings season, and it appears the index will post its third consecutive profit decline. Bloomberg consensus earnings estimates are basically unchanged through the first half of the year. They show another modest decline for the third quarter and a rebound in growth in the fourth quarter and into 2024. Bloomberg consensus projects revenues accelerating and margins expanding into what we believe will be a deteriorating economic environment. We are less optimistic and believe the current earnings recession is likely to last through 2023. Without support from earnings, it could be difficult to achieve further equity market gains in the near term.

The surge in equity prices without growth in earnings has led to above-average valuations. The S&P 500 Index is trading at roughly 21 times Bloomberg consensus next-twelve-months (NTM) earnings. Using our more conservative earnings estimate, the multiple is even higher. These levels, while not unheard of, have been typically seen in early-cycle recoveries, not late-cycle slowdowns.

While valuation alone is not a strong timing tool, it does show that the market may be priced for perfection in the near-term. Chart 2 illustrates valuations today versus the end of 2022. P/E multiples have expanded in most sectors, led by areas expected to benefit from artificial intelligence (Information Technology, Consumer Discretionary, and Communication Services). Information Technology entered 2023 reasonably valued, supporting our favorable rating at the time. We downgraded the sector in June as valuations moved to the upper end of recent ranges. Even so, the sector represents more than one-quarter of the index, giving investors sizable exposure at our current neutral rating.

**Chart 2. S&P 500 Index and sector price/earnings**




Sources: Bloomberg and Wells Fargo Investment Institute. Bloomberg consensus EPS estimates. NTM = next twelve months. P/E = price to earnings ratio. EPS = earnings per share. Data as of July 26, 2023. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

## Where do we go from here?

Higher valuations, extreme investor sentiment readings, and recent cyclical leadership suggest the equity market may be pricing in a soft economic landing scenario. We remain skeptical and believe the macroeconomic backdrop likely will continue to deteriorate in the second half of the year. Therefore, our view on equities has not changed — we favor quality in an uncertain economic and earnings environment. This strategy has worked well year-to-date, with U.S. Large Cap Equities (favorable rating) significantly outperforming lower-quality U.S. Small Cap Equities (most unfavorable) and Emerging Market Equities (unfavorable).

# Fixed Income

**Patrick Stoffel**
Municipal Analyst

## Remote work may bring challenges to large U.S. cities

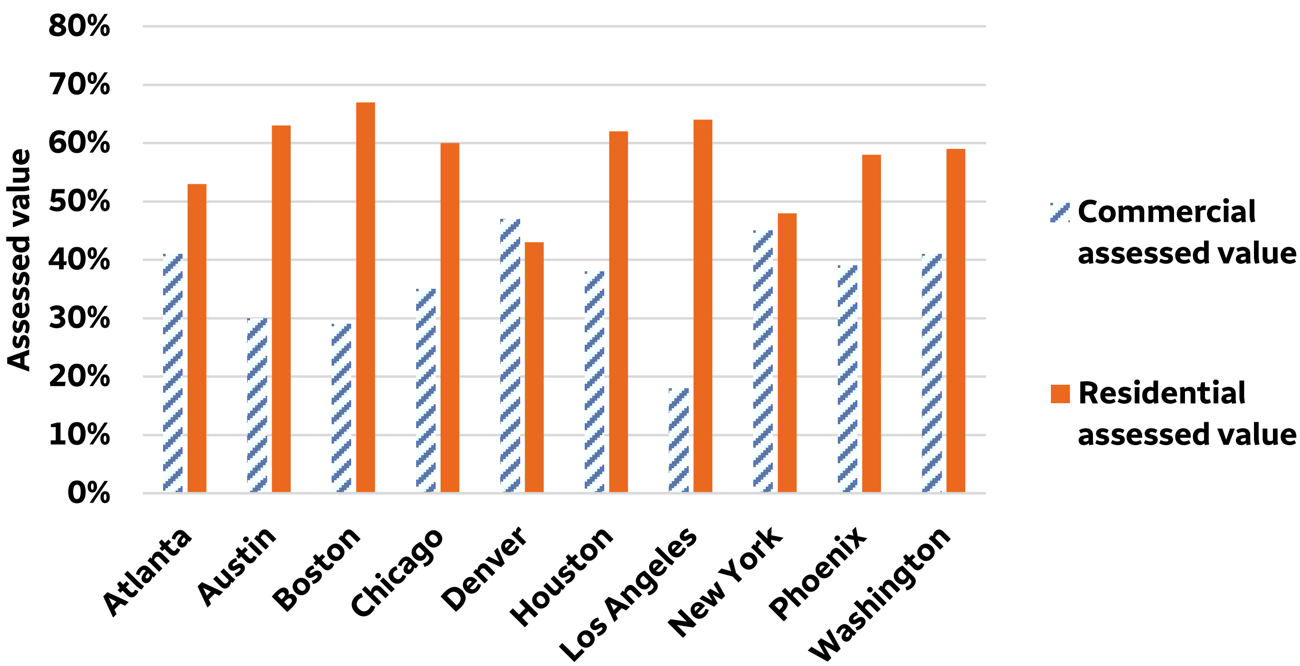
The rise in work from home since the onset of the COVID pandemic could pressure larger municipalities in the coming years. According to Standard & Poor's, days worked from home in the U.S. jumped from 5% in March 2020 to 28% in April 2023. The rise in office vacancies is likely to negatively impact building valuations, lowering commercial property tax over time.

Fewer workers in office buildings could also result in reduced sales tax revenue for major business districts, with average consumer spending in large U.S. cities already down $2,000 to $5,000 per person since early 2020. The potential shortfall in revenue could force some large municipalities to alter the means of revenue generation in order to bridge any future budget gaps.

Fortunately, recent economic growth, higher real estate valuations, and federal stimulus should provide many municipalities with some financial flexibility over the near term. Some cities — specifically, those less reliant on property taxes as a large component of funding — may also be better insulated from the risk of reduced commercial property tax revenue.

Cities that develop structural budget gaps may raise the sales tax rate or shift the tax burden to residential property owners through higher tax rates, although higher property taxes are typically seen as politically unpopular. Until the full effect of remote work on municipal budgets is fully realized, we recommend clients invest in large cities rated A or higher to limit the impact potential downgrades could have on municipal portfolios.

**Composition of assessed value in 10 large U.S. cities for 2022 fiscal year: Commercial versus residential**




Source: Standard & Poor's and audited financials. Data as of September 30, 2022.

# Real Assets

**John LaForge**
Head of Real Asset Strategy

**Mason Mendez**
Investment Strategy Analyst

## Black Sea grain deal crumbles — Will food prices spike?

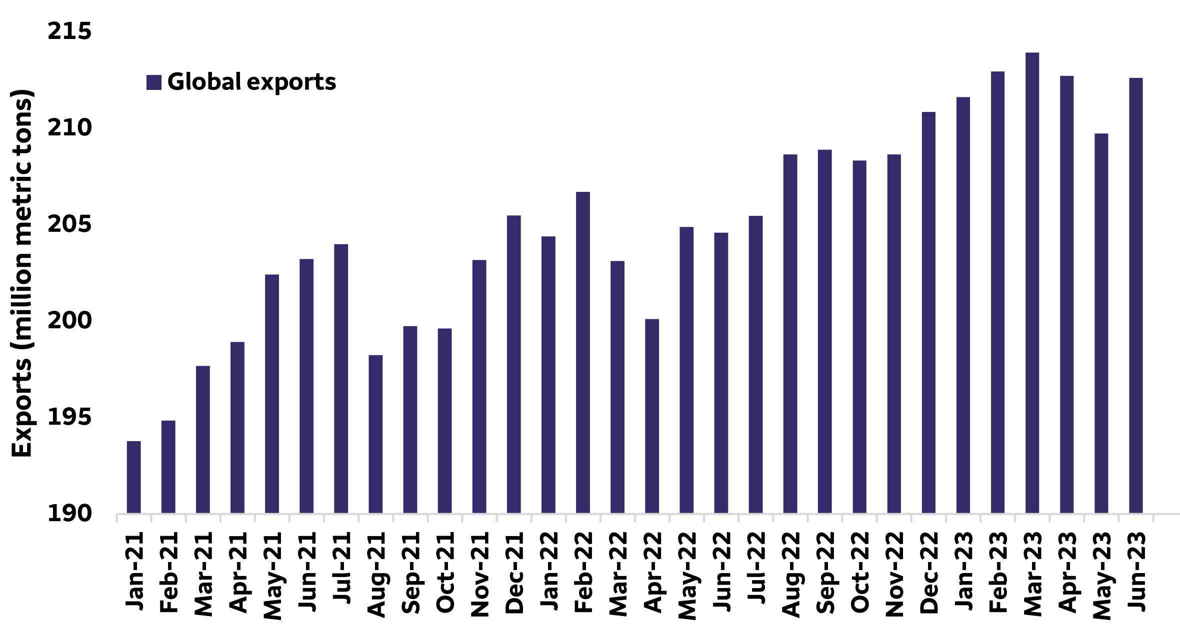
Russia's invasion of Ukraine in March 2022 initially sparked fears of supply shortages. By March 2022, global grains prices were setting record highs. Since then, though, the Food and Agriculture Organization (FAO) Food Price Index, a global benchmark for food prices, has declined 23%.

Now, in July 2023, food prices have moved higher again, thanks to news that Russia has exited its grain exporting deal with Ukraine, called the Black Sea Grain Initiative. While global grains prices, especially wheat, have started moving higher again, we suspect most grains prices will not surge to record highs this time. The reason is we suspect that Ukraine will still be able to export its grain via "solidarity lanes", established by the EU, which enable exports via land through neighboring countries.

Wheat has been one of the grains most susceptible to supply disruptions and price spikes during the Russia-Ukraine war, as the two countries combined account for 27% of global exports. Yet, even as war has raged on, since Russia's invasion in February 2022, global exports continued to rise, as can be seen in Chart 1. The Black Sea Grain initiative played a crucial role in releasing pent up supply in Ukraine, the solidarity lanes played an equally important role in relieving supply. According to the EU, 60% of Ukrainian grain was moved through these solidarity lanes since the start of the war, while only 40% was moved through the Black Sea.

Shortly after news of Russia's exit from the deal, the EU voiced its support, and stated it would continue utilizing solidarity lanes for Ukrainian grain. This leads us to believe that exports may still be able to hold up – despite Russia's exit from the grain deal. With that said, we will be watching the situation closely, as Russia's ongoing attacks on Ukrainian infrastructure could create additional troubles for exporters.

**Global wheat exports**




Sources: Bloomberg, USDA, and Wells Fargo Investment Institute. Monthly data is from January 2021 – June 2023. Data as of July 27, 2023.

# Alternatives

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

## Private capital correction slows

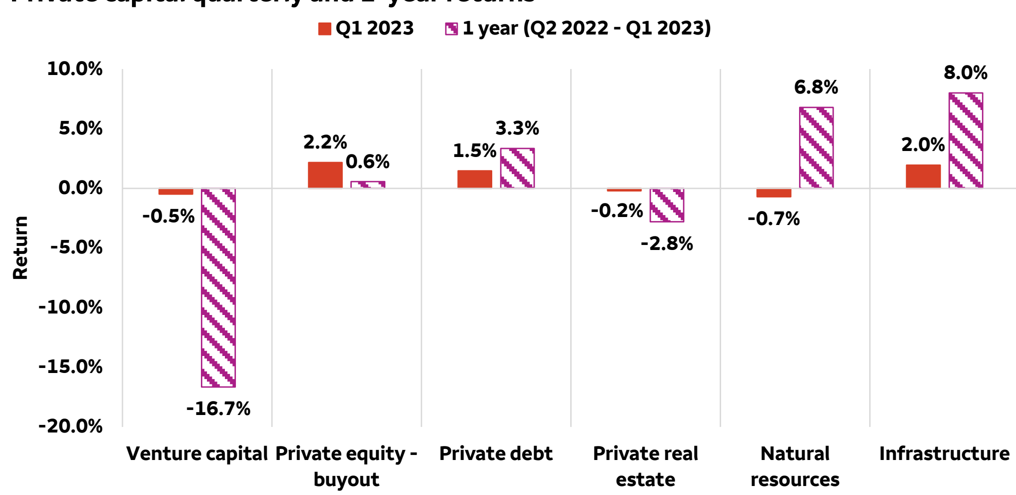
Private capital markets have continued a downward trajectory through the first quarter of 2023, based on industry benchmarks from Burgiss. However, the declines in venture capital and private real estate are muted relative to their one-year trailing returns (see chart). It has been encouraging to see continued resilient performance from private debt and infrastructure strategies.

Overall, we observed the following performance drivers:

- Private equity: Over the past year, private equity valuations have moved lower, owing to slower earnings growth and deteriorated public prices. As a result, both buyout and venture capital strategies experienced negative returns during much of 2022. Further, the slowdown in the initial public offering (IPO) market limited exit opportunities for mature venture capital funds, whereas buyout strategies started to see a price recovery during the fourth quarter of 2022.
- Private debt: Higher interest rates were a contributor to private debt's returns, as loans are periodically reset to current rates. In addition, while there are upticks in default rates, defaults remained well below past highs.
- Real assets: Private real estate prices trended downward over the past five quarters, due to higher interest rates, a weakening economy, public market corrections, and deteriorating conditions in the office sector. In contrast, infrastructure has posted 12 consecutive positive quarterly returns, reinforcing its defensive attributes.

We continue to emphasize diversification across vintage year and investment style in private capital. While the recent stock market rally has provided hope that the recession fears may be overblown, we remain cautious in light of a slowing economy and mounting pressures from higher rates.

### Private capital quarterly and 1-year returns




Sources: Burgiss and Wells Fargo Investment Institute. Preliminary 1-quarter and 1-year internal rate of return as of July 21, 2023. **Past performance is no guarantee of future results.** 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. Venture capital = Burgiss Venture Capital Index. Private equity buyout = Burgiss Private Equity Buyout Index. Private debt = Burgiss Private Debt Index. Private real estate = Burgiss Private Real Estate Index. Natural resources = Burgiss Natural Resources Index. Infrastructure = Burgiss Infrastructure Index.

# Current tactical guidance

### Cash Alternatives and Fixed Income

| Most Unfavorable | Unfavorable | Neutral | Favorable | Most Favorable |
|---|---|---|---|---|
| | U.S. Intermediate Term Taxable Fixed Income<br><br>High Yield Taxable Fixed Income | Cash Alternatives<br><br>Developed Market Ex-U.S. Fixed Income<br><br>Emerging Market Fixed Income | U.S. Taxable Investment Grade Fixed Income | U.S. Long Term Taxable Fixed Income<br><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><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><br>Hedge Funds—Equity Hedge<br><br>Private Equity<br><br>Private Debt | Hedge Funds—Relative Value<br><br>Hedge Funds—Macro | |

Source: Wells Fargo Investment Institute, July 31, 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 disclosures.

### 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

Food and Agriculture Organization (FAO) Food Price Index measures the monthly change in international prices of a basket of food commodities. It consists of the average of five commodity group price indices weighted by the average export shares of each of the groups.

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 Communication Services Index comprises those companies included in the S&P 500 that are classified as members of the GICS® communication services sector.

S&P 500 Consumer Discretionary Index comprises those companies included in the S&P 500 that are classified as members of the GICS® consumer discretionary sector.

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.

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

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

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

S&P 500 Information Technology Index comprises those companies included in the S&P 500 that are classified as members of the GICS® information technology sector.

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

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

An index is unmanaged and not available for direct investment.

Burgiss Venture Capital Index – The index provides pooled return for private capital funds sourced by Burgiss that are classified as Venture capital.

Burgiss Private Equity Buyout Index – The index provides pooled return for private capital funds sourced by Burgiss that are classified as Buyout.

Burgiss Private Debt Index – The index provides pooled return for private capital funds sourced by Burgiss that are classified as Private debt.

Burgiss Private Real Estate Index – The index provides pooled return for private capital funds sourced by Burgiss that are classified as Real estate.

Burgiss Natural Resources Index – The index provides pooled return for private capital funds sourced by Burgiss that are classified as Natural resources.

Burgiss Infrastructure Index – The index provides pooled return for private capital funds sourced by Burgiss that are classified as Infrastructure.

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