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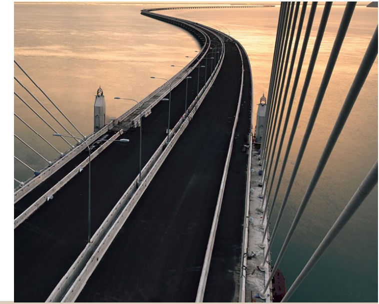

Investment Strategy

Weekly guidance from our Investment Strategy Committee — August 7, 2023

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- Last week, a major rating agency, Fitch, downgraded the long-term credit rating of the U.S. to AA+ from AAA.
- We see the immediate market impact of the Fitch downgrade as modest; however, we believe fiscal issues at some point may require increasing government revenue, reducing spending, or implementing some combination of the two.

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- Americans' savings rates jumped during the pandemic but has now declined to low levels.
- We expect U.S. retail sales to decelerate through second-half 2023 due to multiple headwinds facing consumers.

Fixed Income: Fed rate hike cycle continues 5

- The Federal Reserve (Fed) rate-hike cycle is likely to continue as the Fed works to bring inflation down to its target 2.0% level. Our 2023 year-end rate targets are currently under review.
- Short-term investment-grade securities continue to offer investors an attractive yield opportunity.

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- A number of real estate investment trust (REIT) sub-industries that provided strong total returns in 2022 were among the weaker-performing REIT sub-industries in the first half of 2023.
- Data center REITs have likely benefited from artificial intelligence, in our view, and residential REITs have likely benefited from a strong U.S. labor market and healthy operating conditions.

Alternatives: Uncertainties remain for private real estate 7

- We remain cautious in the office sector and in the broader private real estate market.
- The office sector is going through a transformation to adapt to corporations' evolving office needs, while at the same time facing headwinds from the current elevated cost of capital and a slowing economy.

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Fixed Income Spotlight

Brian Rehling, CFA
Head of Global Fixed Income Strategy

What the U.S. debt downgrade may mean for investors

Last week, Fitch, one of three major rating agencies, downgraded the long-term credit rating of the U.S. to AA+ from AAA. The Fitch downgrade was initiated, in its words, due to "expected fiscal deterioration over the next three years, a high and growing government debt burden, and the erosion of governance … that has manifested in repeated debt limit standoffs and last-minute resolutions."[1]

This is not the first time the U.S. has seen its credit rating downgraded. In 2011, Standard & Poor's (S&P) downgraded the U.S. credit rating to AA+, a rating it continues to maintain. Moody's Investors Service (Moody's) continues to rate the U.S. at AAA.

The S&P downgrade in 2011 had a material market impact, resulting in significant stock market declines and falling Treasury yields. The initial market reaction to the Fitch downgrade has been less volatile — with both stocks and bonds falling in prices modestly. Despite the modest impact at this point, the debt and deficit trends which led to the downgrade should be taken seriously by investors.

- Interest costs to service the outstanding debt are rising, and higher interest rates are accelerating this trend. As debt service costs become more difficult to sustain, investors typically demand to be compensated with higher yields to offset the added risk. Debt service costs currently stand near 14% of tax revenues, a level that historically has prompted investors and Congress itself to demand increased fiscal discipline by policy makers.[2]
- The U.S. Treasury is currently ramping up new issuance, and markets are expecting $1 trillion worth of Treasury issuance this quarter. The flood of new Treasury supply likely will remove at least some liquidity from markets at a time when the Federal Reserve (Fed) continues to reduce its balance sheet.[3] Over time, the increasing federal debt issuance could lead to a greater portion of private investment spending and consumption being diverted to Treasury debt, shrinking the pool of capital available for private investment. This would likely result in lower economic output, lower incomes, lower investment of capital, and lower investment returns.
- Also of concern to investors is the decreasing flexibility policymakers may have to respond to future economic shocks and unexpected events. Both the Great Recession of 2008 – 2009 and the COVID pandemic highlighted the flexibility policymakers had to buffer significant economic shocks. Increasing debt and a bond market that may begin to impose fiscal discipline would restrict policymakers' ability to respond to unexpected future events. As a result, future shocks may have a more significant negative economic impact, as lawmakers might lack flexibility to deal with them fiscally.

While fiscal trends are concerning, it is worth highlighting that the U.S. enjoys several structural strengths. The dollar's status as the world's reserve currency remains on solid footing and gives the U.S. government significant

1. Fitch Rating Report - Fitch Downgrades the United States' Long Term Ratings to "AA+" from "AAA"; Outlook Stable, August 1, 2023.
2. Congress historically has cut spending when interest costs rise above 14% of federal revenues. For more information, please see our Investment Strategy Report, "Navigating volatility around the debt ceiling debate", May 15, 2023.
3. For more details on the potential impacts of Treasury refunding on liquidity available for financial markets, please see our latest edition of our quarterly "Policy, Politics and Portfolios" report, July 25, 2023.

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flexibility in managing its finances, and the U.S. economy is currently performing above expectations and is advanced and well-diversified.

While strong economic growth is generally the best way to grow out of fiscal deficit issues, the potential for recessionary conditions later this year or early next year further complicates the near-term fiscal outlook.

Potential implications for investors

For investors, the immediate impact of the Fitch downgrade has been modest, and we think the U.S. still has time to address spending issues and put the country on a more sustainable long-term path. Fiscal issues may at some point require increasing government revenues, reducing spending, or implementing some combination of the two.

If, however, the current U.S. fiscal challenges highlighted by the Fitch downgrade remain in place over the medium- to long-term, we anticipate that investors may be faced with higher interest rates and increased borrowing costs, especially in longer maturities. We would also expect increased volatility in equity markets, as rising interest rates compete with equities for investor attention and as policymakers lack the tools to help buffer unexpected economic events.

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Equities

Brian Postol
Equity Sector Analyst, Consumer Discretionary

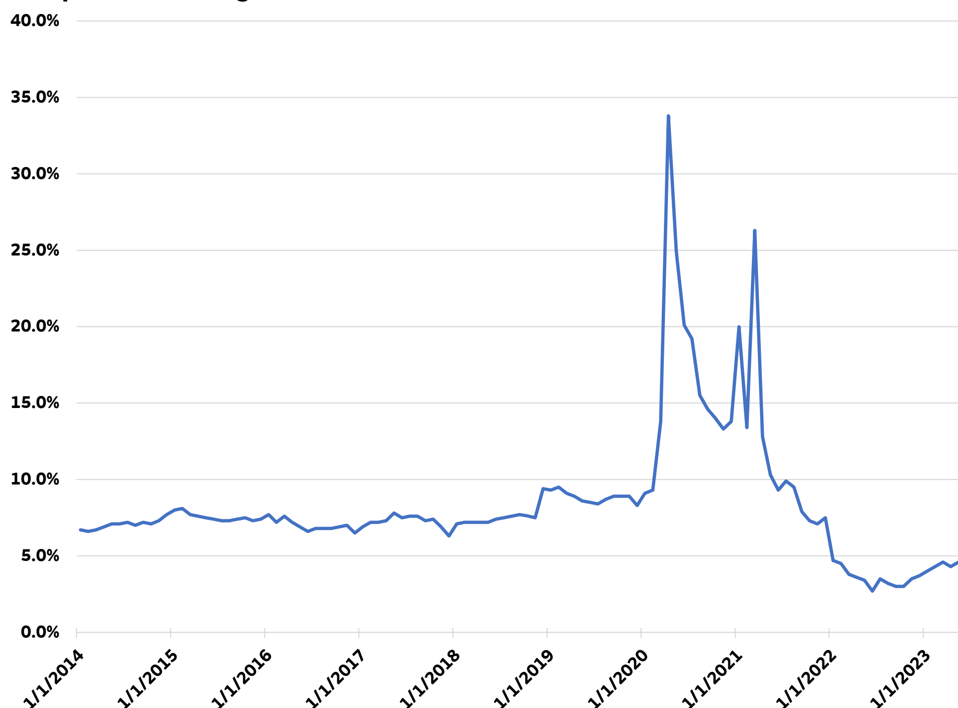
Excess savings drawdown could limit spending trends

The S&P 500 Consumer Discretionary sector has gained 34.0% year to date (through July 25), outperforming the S&P 500 Index, which was up 19.2%. For companies, the combination of improved inventory levels and tighter expense controls (excluding wages) has more than overshadowed the ongoing inflationary pressures facing consumers.

Through the first half of the year, the consumer remained resilient, as investor expectations for a more normalized 3% growth rate held. According to the U.S. Census Bureau, excess savings remains substantial but are now down to around $0.8 trillion (versus the $2.2 trillion pandemic peak), delaying a deeper pullback in retail sales. We expect U.S. retail sales to decelerate through the second half of 2023, mainly due to disinflation in grocery, as well as big-ticket durable categories with limited pricing power. (Think electronics, furniture, etc.) The resumption of student loan payments later this summer may add a slight headwind. Importantly, household balance sheets appear to still be on solid footing with most borrowing (mortgages, for example) locked in at low fixed rates.

Four factors drive our bearish view on upcoming retail spending trends. First, we believe inflation should continue to have a negative impact on consumer spending. Second, we believe consumers will feel the impact of lapping fiscal stimulus more in 2023 than in 2022 given the resumption of student loan payments as well as decreased Supplemental Nutrition Assistance Program (SNAP) benefits and child tax credits. Third, exhaustion of excess savings should have a smaller benefit to overall sales relative to recent quarters. Fourth, we see elevated risk that the Fed's interest rate hikes will prove more harmful to consumer spending than anticipated. Our Consumer Discretionary sub-sectors with a favorable rating are Broadline Retail; Hotels, Restaurants & Leisure; and Specialty Retail.

U.S. personal savings rate



Sources: U.S. Bureau of Economic Analysis and Wells Fargo Investment Institute. Data from January 1, 2014 – June 1, 2023.

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Fixed Income

Brian Rehling, CFA
Head of Global Fixed Income Strategy

Fed rate hike cycle continues

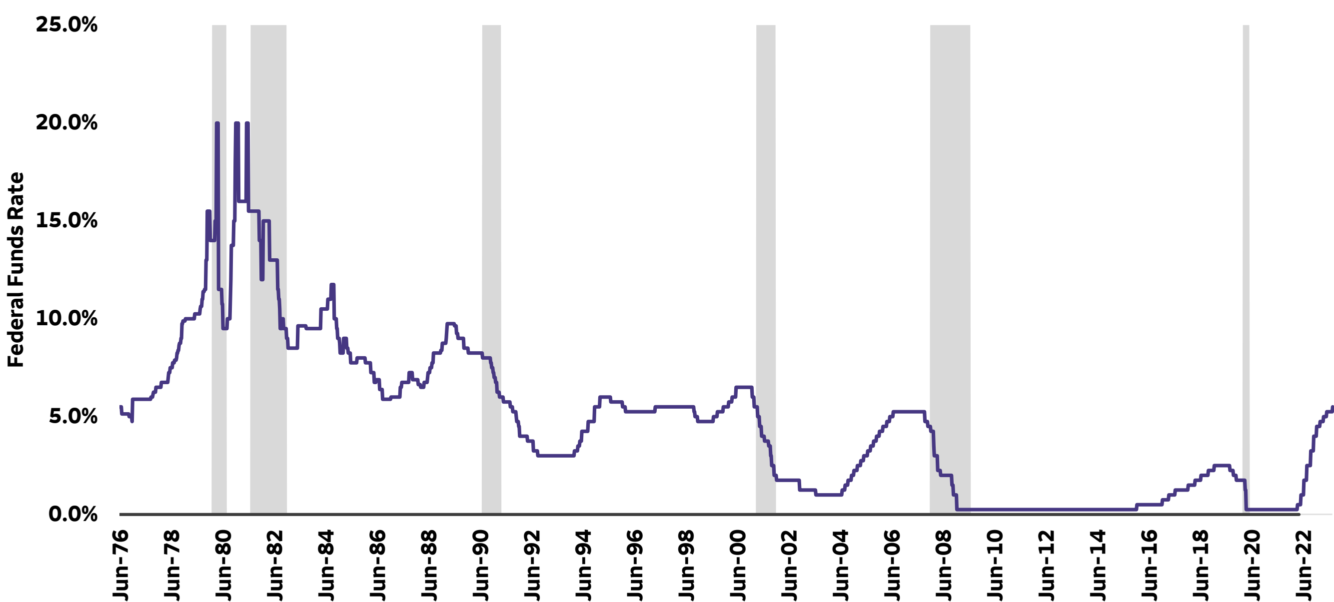
The Fed recently increased interest rates by 25 basis points (0.25%) to 5.25-5.50%. This increase was the 11th increase in the federal funds rate since the Fed started raising rates in March 2022. The Fed has now increased short-term rates by 5.25% during this rate hike cycle. We expect further Fed rate hikes later this year as it continues to work on bringing inflation down to its target 2.0% level.

Historically, most economic expansions have not just faded away but rather have been killed off through excessively tight Fed monetary policy. While the resilience of the current economic expansion has surprised us, we remain convicted that this cycle will end just like many before it. The time and date of an eventual recession is difficult to pinpoint — the only thing more difficult than predicting a recession is predicting the timing of one.

Fed rate policy can give us some insight into the eventual end of the economic expansion. Historically, most recessions have only started after the Fed started cutting rates. While the market is susceptible to shocks, it does not mean a shock will emerge in the near term. Absent an economic shock, we don't expect Fed rate cuts to come until 2024.

We continue to favor short-term maturities. High-quality short-term fixed income securities can provide investors with an attractive yield — a yield that may continue to increase throughout this year as the Fed continues down its path of rate hikes.

Since 1977, recessions have usually followed the Fed's first rate cut



Sources: Bloomberg and Wells Fargo Investment Institute, July 31, 2023.

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Real Assets

John Sheehan, CFA
Equity Sector Analyst, Real Estate (REITs)

First-half 2023 REIT sub-industry performance dispersed

In an earlier report, we noted 2022 real estate investment trust (REIT) sub-industry performance varied widely across the various REIT sub-industries. Examining year-to-date 2023 REIT performance, we note a reversal of several REIT sector investment themes from 2022.

As the table below shows, several of the better-performing REIT sub-industries during 2022 (free-standing retail, shopping centers, and diversified) have generated relatively weaker total returns during the first half of 2023. Conversely, REIT sub-industries including data centers, industrial, apartments, and single-family homes moved from weaker-performing REIT sub-industries in 2022 to among the best-performing in the first half of 2023.

We believe there may be several factors behind the rotation of leadership in the first half of 2023. First, we believe data centers have benefited from investor interest in artificial intelligence (AI), as data centers may be viewed as a long-term beneficiary of AI. We believe several of the residential REIT sub-industries (single-family homes and apartments) are likely reacting to the relatively solid U.S. labor market and healthy operating conditions, while we think industrial REITs have benefited from continued high occupancy and growth in rental rates.

We believe infrastructure REITs were negatively impacted by investor concerns regarding the potential for larger wireless providers to reduce capital expenditures on their wireless networks. Additionally, office REITs continued to underperform most other REIT sub-industries during the first half of 2023, which we believe reflects relatively low office utilization, along with continuing debate on the long-term impact of hybrid work on office space demand.

2022 and Year-to-date 2023 REIT Sub-industry performance

	2022 total returns	YTD 2023 total returns
FTSE Nareit All Equity REITs	**-24.9%**	**3.0%**
Data centers	-28.0%	19.4%
Single-family homes	-31.9%	18.3%
Timber	-19.5%	11.2%
Apartments	-32.0%	10.1%
Self-storage	-26.7%	9.3%
Industrial	-28.6%	9.2%
Health care	-22.2%	7.8%
Specialty	-0.8%	5.6%
Lodging/resorts	-15.3%	4.6%
Regional malls	-22.9%	1.5%
Shopping centers	-12.5%	1.1%
Gaming*	N/A	-0.5%
Manufactured homes	-28.3%	-2.4%
Free-standing retail	-6.5%	-3.1%
Infrastructure	-28.6%	-10.7%
Diversified	-15.7%	-10.8%
Office	-37.6%	-16.2%

Source: Nareit and Wells Fargo Investment Institute; data as of June 30, 2023. *Gaming sub-industry established in 2023. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Alternatives

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

Uncertainties remain for private real estate

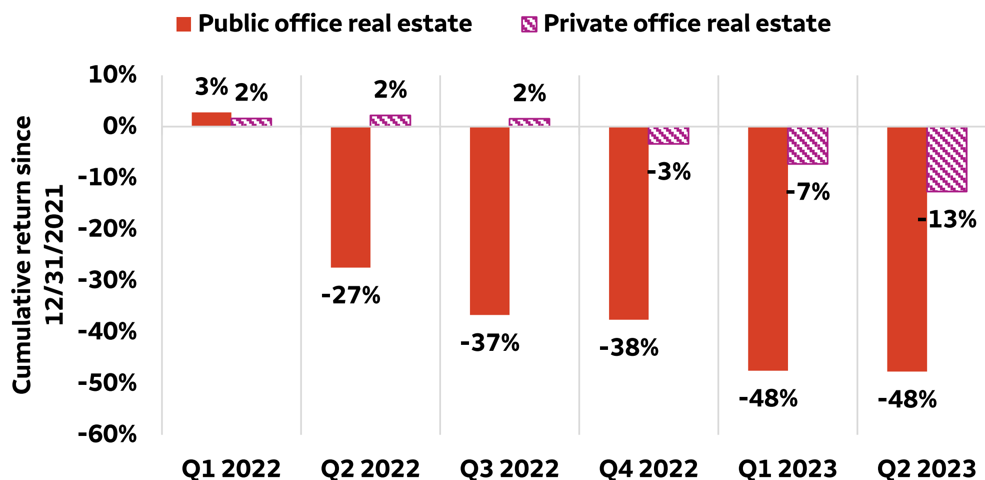
After a down year in 2022, public real estate pricing is showing signs of life, which at times has served as a leading indicator to private market returns. However, the office sector, which accounts for more than 20% weight of the private NCREIF Property Index, has continued its downtrend in price. More importantly, the cumulative return difference between private and public markets has widened to 35% since the end of 2021 (see chart below). This discrepancy has led us to anticipate further price deterioration in the private real estate market.

We believe the trends below are also relevant performance drivers:

- Hybrid work: Although more return-to-office plans have been announced across industries this year, hybrid work remains prevalent, especially in the U.S. Together with high interest rates and a slowing economy, this workstyle change has contributed to elevated vacancy rates and lagging leasing demand.
- Performance dispersion: Certain office segments, such as older and lower quality offices, have been particularly impacted and seen the most decline in prices and demand. These properties may eventually be transitioned to other property types.
- Investor interest. Owing to state-of-the-art technology, sustainability, and amenity features, new offices are most sought after. However, low investment appetite has limited the inventory of new developments and further intensified supply-demand imbalance.

We remain cautious in the office sector and in the broader private real estate market. We prefer investors remain patient for more confirmation of an improving environment before increasing their allocation to private real estate. The office sector is going through a transformation to adapt to corporations' evolving office needs, while at the same time facing headwinds from the current elevated cost of capital and a slowing economy.

Cumulative return of public and private office real estate since 12/31/2021



Sources: NAREIT, NCREIF, Wells Fargo Investment Institute. As of July 31, 2023. Public office real estate is represented by FTSE NAREIT equity office index; Private office real estate is represented by NCREIF property office index. An index is unmanaged and not available for direct investment. **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.

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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, August 7, 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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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.

NAREIT equity office index is a free-float adjusted, market capitalization-weighted index of U.S. equity real estate investment trusts (REITs). Constituents of the index include all tax-qualified REITs with more than 50 percent of total assets in qualifying office real estate assets.

NCREIF Property Index is a composite total return for private commercial real estate properties held for investment purposes only.

NCREIF property office index provides returns for institutional grade office real estate held in a fiduciary environment in the United States.

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

An index is unmanaged and not available for direct investment.

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