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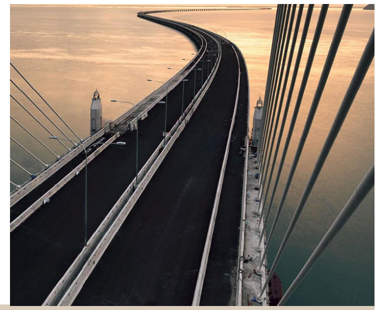
Investment Strategy



Weekly guidance from our Investment Strategy Committee — August 14, 2023

Global Macro Spotlight

Gary Schlossberg
Global Strategist

Economic resilience in the aftermath of the pandemic

No two business cycles are alike. Cycles are driven by different catalysts, and they can affect the economy broadly or in a more cascading fashion. Support for remarkably resilient economic growth in the past year has come from lingering economic stimulus — which contributed to a more than doubling of the budget deficit in the past year — and from both the Federal Reserve's (Fed's) cash injections tied to banking turbulence and the Treasury's cash drawdown during its debt-ceiling maneuvering. Economic growth also has been supported, until recently, by unusually low inflation-adjusted interest rates, despite the Fed's aggressive rate increases.

But the hallmark of this cycle has been the pandemic. The shock of the pandemic triggered in 2020 the steepest economic declines since the 1930s Great Depression, then supported growth through subsequent adjustments that tilted the odds toward a soft landing from an economic recession in the coming year. Catch-up hiring propelled income and spending growth and has been the most visible of the post-pandemic supports. Monthly job gains have averaged over 280,000 in the past year, far greater than the average 194,000 during the pre-pandemic jobs recovery in 2011 – 2019.

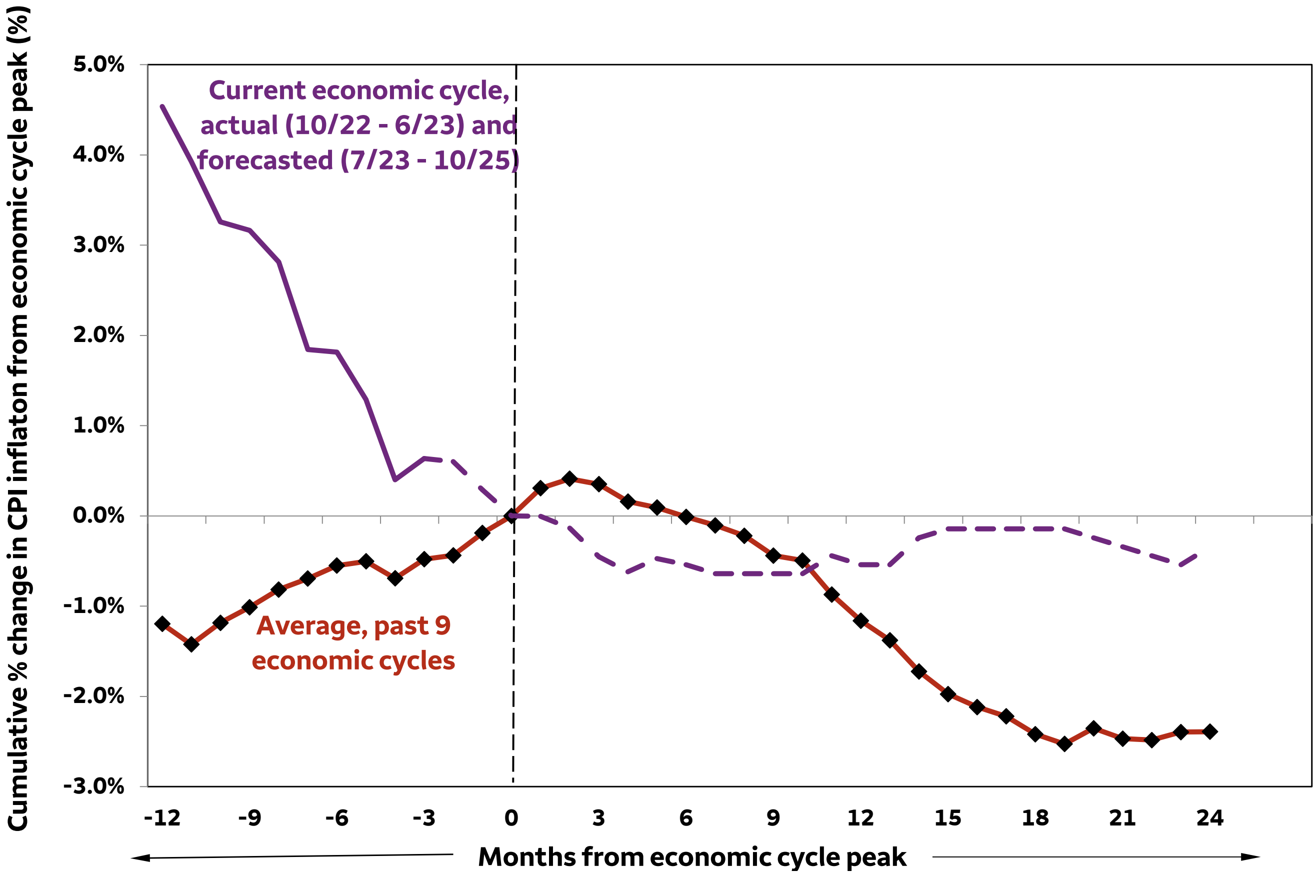
Solid job and income growth unleashed pent-up demand for autos, travel, entertainment, and other services bottled up during the pandemic. Spending growth on all services — nearly two-thirds of consumer demand — has decelerated to 2.5% over the past year, but still is well above its pre-pandemic average (1.8%). Pandemic-related fiscal stimulus — including freezing loan payments on $1.8 trillion in student debt — has added to consumer-spending growth by creating excess cash balances and by adding to household cash flow.

But the pandemic's most profound impact in this economic cycle is tied to double-barrel support from an unusually early break in inflation, which typically peaks when the economy does, or early in a recession. First, the decline in inflation has supported gains in real incomes, or purchasing power, fueling consumer-led economic growth. Second, declining inflation has restrained increases in market-based, longer-term interest rates, which has shortened and cushioned the slowdown in housing and other credit-sensitive sectors.

From tailwinds to headwinds?

We expect pandemic-related, and most other, supports to go into reverse during the balance of 2023 and into 2024, strengthening the case for a growth slowdown and validating recent declines in corporate profits. Financial conditions already have tightened enough to sustain an accelerated rise in corporate bankruptcies that began early last year — triggered by recent declines in the money supply, banks' tightened credit standards, and inflation-adjusted interest rates now beginning to bite into economic activity.

Chart 1. Early, steep disinflation in this economic cycle is unusual compared to the past nine cycles



Source: Based on U.S. Labor Department data. Data as of July 12, 2023.

Job gains and wage growth, though still strong, have begun to soften around the edges as labor supply slowly rebalances with demand. Gains in services spending are beginning to slow, too. And inflation's outlook, after its steepest unwind in over 40 years, has been clouded by uncertainties over energy, food, and shelter prices. Slower or interrupted progress against inflation would delay improvement in real incomes and increase the risk of more rate increases by the Federal Reserve. The October resumption of student loan payments and the threat of a government shutdown over an impasse in the fiscal 2024 budget negotiations also have the potential to speed the unwind of post-pandemic supports.

Forecasting its timing and depth may be as difficult as forecasting the recession itself. The direction of economic growth (and earnings momentum tied to it) may be as important to stocks and bonds as the distinction among growth, stagnation, and decline. Recessions often have been the culmination of cascading declines across the economy. Catalysts typically have been rising inflation, higher interest rates, tightening credit conditions, and policy miscues. These changes historically have hit economically and interest-sensitive housing, postponable "big-ticket" consumer spending, manufacturing, and commercial real estate, before rippling through the rest of the economy.

That cascading process has been underway for more than a year, slowed by supports that, we believe, will fade as the effects of the pandemic subside and the economy faces fresh challenges. The more challenging economic environment is at the heart of our recommendation to stay the course, for now by focusing on high-quality, liquid large-cap stocks and by splitting fixed-income investments between short- and long-term securities.

Equities

Sameer Samana, CFA
Senior Global Market Strategist

Equities markets hit a speed bump

The equity market's recent stall has been due, in our view, to a sharp rise in long-term interest rates, concerns about a slowing economy and lingering inflation, and lackluster earnings. The rise in rates began due to improving sentiment and better-than-expected economic data and has accelerated due to a credit rating downgrade by Fitch and projections for much larger budget deficits and Treasury debt issuance. Higher rates historically have tended to exert downward pressure on equity valuations, as they represent a better alternative to equities than lower rates.

On the economic and inflation front, the labor market has been cooling and consumer spending has been slowing; unfortunately, oil prices have crept higher, wage growth has stayed stubbornly high, and companies have been doing their best to increase prices. We expect that this combination will keep the Fed vigilant about a reacceleration in inflation data and will keep monetary policy tighter for longer than markets expect.

Lastly, equity markets rallied into earnings season and investors, who had paid lofty valuations for the market's high-growth leaders, were left wanting for better results. Many of these companies' stocks have already started to pull back, and their large weightings will be one more drag on overall equity performance in the seasonally weak months of August and September. Given these factors, we expect the S&P 500 Index (4498), which remains in a short-term uptrend as of August 10, to pull back toward key support levels at the 50-(4433) and 200-day moving average (4112). Investors should stay defensively positioned and wait for a better risk-reward tradeoff.

S&P 500 Index relative to 50-day and 200-day moving averages

Source: Bloomberg. Data as of August 10, 2023. **Data 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.

Fixed Income

Luis Alvarado
Global Investment Strategist

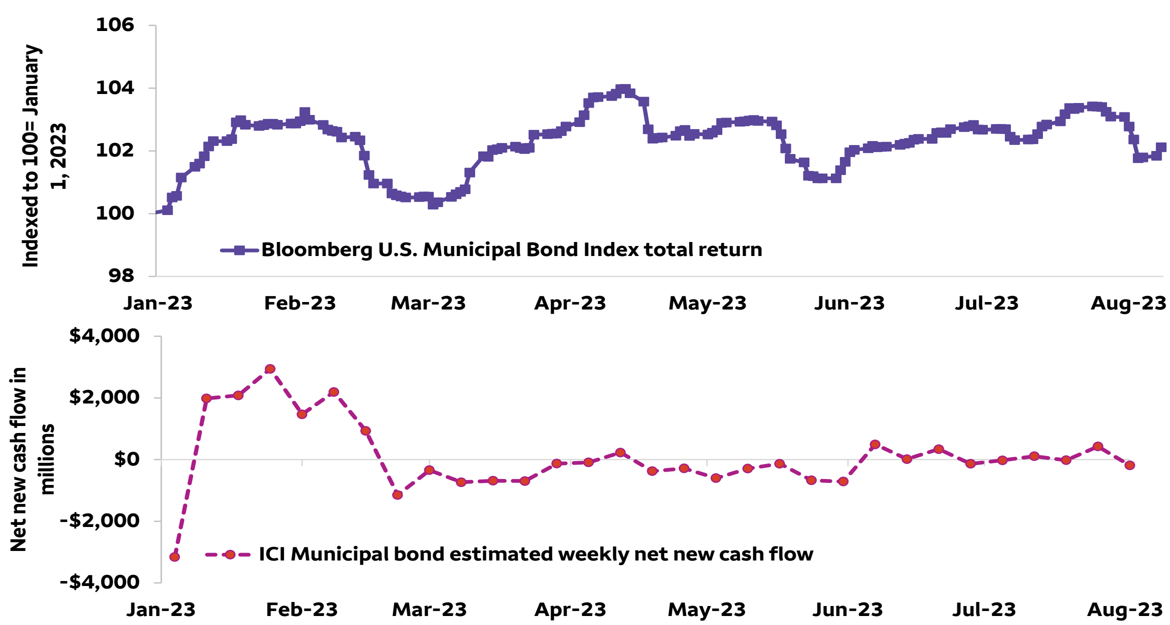
Municipal bonds — Value can still be found

The U.S. municipal bond market has continued to see positive performance year-to-date[1] (+2.12%), and we expect this trend to be sustained through year-end despite concerns over a potential recession. We maintain a favorable view of municipal bonds, even though municipal-to-Treasury yield ratios (MTYR) in the long-end of the curve have been declining over the past year. The lower MTYR are signaling that municipal bonds appear to be somewhat expensive when compared to their long-term averages.

Also, municipal yields and relative values in comparison to corporate bonds are not as compelling as they were in previous months. Using the indicators that we use to monitor municipal-to-corporate crossover opportunities for investors in the highest tax bracket, we see an advantage in the 1 – 10-year part of the curve to purchasing corporate bonds over municipal bonds with similar credit ratings. Still, the technical imbalance between supply and demand in municipal bonds continues to be the stronger force. The Treasury and corporate bond markets have expanded significantly over the past several years. Meanwhile, the outstanding balance of municipal bonds has remained relatively flat.

Overall, demand for municipal debt has remained strong over the past year, while the relative low volume of municipal bond supply has provided support for municipal bond valuations amid net inflows from municipal bond funds. We see the most potential value in the 10- to 15-year part of the municipal yield curve, where investors can pick up additional yield. We also believe that municipal investors should undertake meticulous credit research or access professional management, particularly in the current environment.

Municipal bond performance steady amid fund inflows



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of August 8, 2023. ICI = Investment Company Institute. **Past performance is not a guarantee of future results**. An index is not managed and not available for direct investment.

1. As of August 8, 2023.

Real Assets

"If I waited for perfection, I would never write a word." — Margaret Atwood

Mason Mendez
Investment Strategy Analyst

John LaForge
Head of Real Asset Strategy

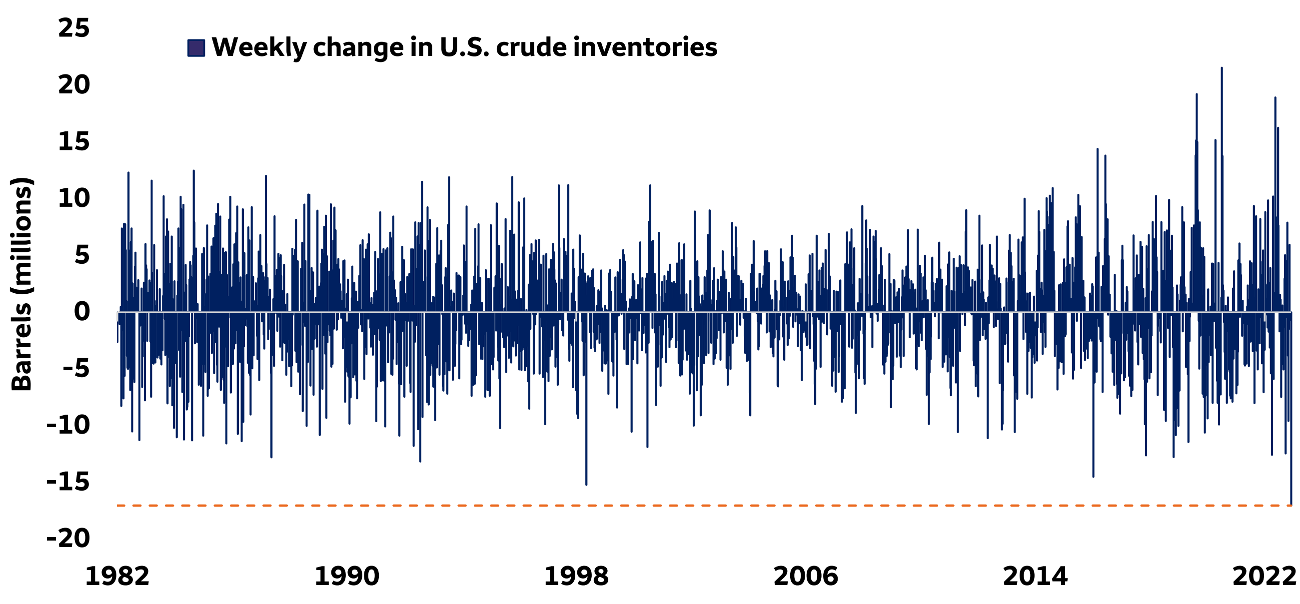
Oil higher on tightening supplies

During the last week of July, U.S. crude oil inventories experienced the largest drawdown on record. This is the latest in a series of data points signaling tightening global oil supplies. The other major trends impacting supplies are OPEC's (Organization of the Petroleum Exporting Countries) restrictive production policies, and resilient global demand growth. As of August 9, Brent (up 16.8%) and West Texas Intermediate or WTI (up 19.5%), have handily outperformed the S&P 500 Index (up 0.5%) since July 1.

Tight global supply has been our main argument all year for higher crude oil prices in 2023. As long as global supplies remain tight, we likely will remain constructive on oil prices, despite our expectations for a U.S. recession in 2024. Global crude oil demand continues to hold up, and in select parts of the globe, it is accelerating. This while OPEC, which accounts for 33% of global production according to the Energy Information Administration, recently announced its plan to continue to extend production cuts throughout 2024.

The bottom line is that until we see signs of loosening global supplies, or serious demand destruction, we likely will remain constructive on global oil prices. Our year-end 2023 target ranges for WTI and Brent remain $80 to $90 per barrel, and $85-$95 per barrel, respectively.

Record drawdown in U.S. crude inventories



Sources: U.S. Energy Information Administration and Wells Fargo Investment Institute. Weekly data is from August 27,1982 – July 28, 2023.

Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

Slow and steady remains in front

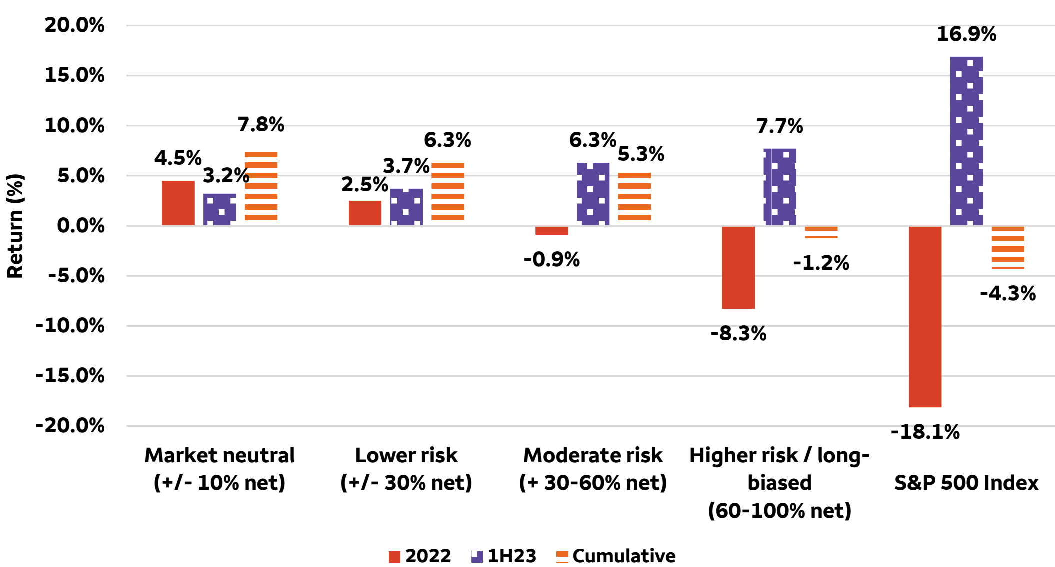
While hedge funds performed well in the market decline of 2022, their performance this year has trailed the general equity markets and has investors questioning their merits.

Long/short equity strategies, a category of hedge funds, employ both long and short positions. A long position is when the manager buys the stock, and a short position is when the manager sells a borrowed stock, a practice known as "short selling." Short sellers profit when a stock declines in value, as they attempt to purchase the stock back at a lower price in the future to repay the loan. The types of long/short strategies range from those that attempt to eliminate all exposure to stock market fluctuations by balancing their long and short exposures (in other words, market neutral), to those that use limited short selling to modestly hedge their long positions (in other words, long biased).

In general, lower-risk long/short equity strategies achieved positive returns in 2022, as well as through the first half of 2023. In contrast, higher-risk strategies declined over 8.0% (see chart below) in 2022, yet rebounded nearly 8.0% year to date through June. Over the entire span, the more consistent returns achieved by the lower-risk funds have outperformed their more volatile counterparts. As highlighted in the chart, over the past year and a half ending June 30, 2023, the cumulative performance of the more stable, lower-risk long/short equity strategies continues to exceed the general equity market by over 10% despite the dramatic rebound in 2023.

While we remain neutral on long/short equity strategies, we favor more defensive strategies that offer relatively consistent results and attempt to protect against future market declines.

Performance of four categories of long/short equity strategies versus the S&P 500 Index



Sources: Wells Fargo Investment Institute, Bloomberg, and Goldman Sachs. Data as of June 30, 2023. Universe defined as long/short equity managers that use Goldman Sachs as a prime broker. **Past performance is not a 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.

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 14, 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

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

Bloomberg U.S. Municipal Bond Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds.

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.

An index is unmanaged and not available for direct investment.

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