Global Investment Strategy Team

☑ Guidance changes

☑ Forecast change

☑ Allocation changes

Adjusting our targets and equity sector guidance

Guidance changes

- **Global equities:** We are downgrading the Energy sector from favorable to neutral and upgrading the Industrials sector from neutral to favorable. The recent rebound in oil prices to near our 2023 year-end target offers an opportunity to rotate exposure from Energy into the Industrials sector, where we foresee fiscal spending tailwinds into 2024 and likely beyond.

Forecast changes

- **Global economy:** Our expectations for firming inflation in the second half of 2023 and sustained weakening trends in the U.S. economy lead us to revise our U.S. economic forecasts to predict somewhat higher 2023 inflation and to shift the bottom of the economic cycle to early 2024. This change also implies higher 2024 unemployment. These U.S. changes lift developed market and global inflation slightly and marginally lower economic growth. We continue to expect a strong growth recovery and lower inflation in the back half of 2024.

- **Global fixed income:** We are raising our 2023 year-end target ranges for the federal funds target rate and the 10-year and 30-year U.S. Treasury yield. Our 2024 year-end target ranges remain unchanged.

Allocation changes

- We favor a modest reallocation from the Energy equity sector to the Industrials sector.

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Table 1. WFII 2023 and 2024 year-end revised forecasts and market targets

	Average percent change from the same period a year ago, unless otherwise noted			
Global economy	**New year-end 2023 targets**	**Previous year-end 2023 targets**	**New year-end 2024 targets**	**Previous year-end 2024 targets**
U.S. GDP growth	**2.2%**	1.1%	**0.7%**	1.5%
U.S. CPI Inflation[1]	**3.6%**	2.9%	**2.5%**	2.8%
U.S. unemployment rate[2]	**3.9%**	4.4%	**5.6%**	4.9%
Global GDP growth[3]	**2.4%**	2.3%	**2.3%**	2.4%
Global inflation[3]	4.4%	4.4%	3.3%	3.3%
Developed market GDP growth[4]	**1.5%**	1.2%	**0.8%**	1.2%
Developed market inflation[4]	**3.6%**	3.7%	**2.4%**	2.5%

NOTE: GDP = gross domestic product; CPI = Consumer Price Index. The U.S. full-year 2024 GDP growth forecast of 0.7% is an annual average, which includes an annualized 5.1% rate during the economic recovery that we project for the second half of 2024.
1. December-to-December change
2. 3-month average, as of the fourth quarter
3. Weighted average of developed country and emerging-market forecasts
4. Weighted average of U.S. and other developed-country forecasts

Fixed Income targets	**New year-end 2023 targets**	**Previous year-end 2023 targets**	**New year-end 2024 targets**	**Previous year-end 2024 targets**
10-year U.S. Treasury yield	**4.00% – 4.50%**	3.50% – 4.00%	3.75% – 4.25%	3.75% – 4.25%
30-year U.S. Treasury yield	**4.00% – 4.50%**	3.50% – 4.00%	4.00% – 4.50%	4.00% – 4.50%
Federal funds rate	**5.50% – 5.75%**	5.25% – 5.50%	3.75% – 4.00%	3.75% – 4.00%

Source: Wells Fargo Investment Institute, August 15, 2023. Bold type indicates changes. **Forecasts, targets, and estimates are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.**

Summary

Extrapolating the strength in the labor market and consumer spending has led some to forecast that the U.S. economy can avoid a recession. That's possible, but parts of the economy already are in recession, and the spending and employment trends are weaker. Ultimately, we believe the economy will struggle to avoid a recession. To be sure, small cracks in consumer spending and labor market appear modest, taken individually. Combined, however, these modest negatives multiply the stress on household finances and, in our view, have raised the risk significantly that the consumer becomes the economy's final sector to fall into contraction, just as in past recessions.

Our forecast changes anticipate upside inflation surprises and correspondingly higher interest rates than we previously expected and recognize an accelerated deterioration in household finances heading into year-end 2023. But the bottom of our recession forecast now appears likely in early 2024, still to be followed by renewed growth for the rest of 2024 and into 2025.

Our overall message to investors remains the same. We remain favorable on U.S. Large Cap Equities but are selective and focus on quality — more specifically, we favor sectors that we believe have good long-term revenue generation prospects and cash flow to pay dividends. If inflation perks up again even more materially than we expect during the second half of 2023 and interest rate increases exceed current market expectations, then, in our

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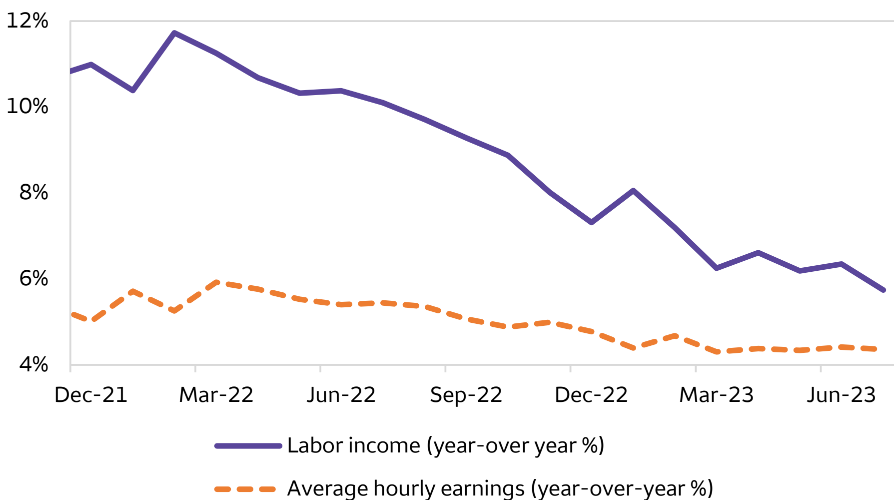
view, the technology-oriented drivers of this rally should be vulnerable to sharp pullbacks. Instead, our front-of-mind principle is to be overweight where potential reward exceeds likely risk. This approach leads us to make a change between equity sectors, lightening exposure to the Energy sector in favor of potentially greater opportunity in the Industrials sector.

Keeping the right focus on the economic outlook

What's changed recently is that our higher inflation and interest rate targets likely will aggravate the growing pressures on the consumer. As we describe in previous reports, disinflation was already likely to stall into year-end.[1] Rental inflation (25% – 30% of the Consumer Price Index) is set to track with the increases we've seen in private rent indexes since the spring. Annual average hourly wage growth has steadied at 4% (Chart 1). Fuel and food prices already are rebounding from declines earlier this year. Finally, we believe it will become more challenging for the 12-month inflation rates to decline during the rest of this year because the comparison point from 12 months earlier will reach back into the second half of 2022, when inflation was already declining.

Two key categories of economic data to watch are retail sales and labor market indicators. Job and wage growth have been steady (Chart 1). At the same time, people have rejoined the workforce, especially prime-age workers (people between 25 and 54 years old), and so the supply of workers more nearly matches the demand for help. The rebalancing allows businesses to ask fewer hours (including overtime) from workers. As hours decline more quickly than wage rates rise, total labor income grows much more slowly (Chart 1). If we adjust income growth for inflation, the purchasing power of wages grew by only 2.3% in June. As hours worked decline and inflation rises, purchasing power is very likely to shrink, not just slow.

Chart 1. Labor income is slowing faster than average hourly earnings



Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data, December 2021 through July 2023. Estimate of labor income is calculated as the product of the Bureau of Labor Statistics' (BLS) Average Hourly Earnings series and another BLS series, Average Hours Worked.

Risk appetite appears to have grown and fueled the recent equity market rallies, as retail sales have printed sequential gains. But below the surface, consumer spending has been switching from essentials to discretionary items. This signals that households are managing budget constraints by postponing essentials, to maintain the pace of discretionary spending. This is consistent with the slowing labor income shown in Chart 1. As purchasing power growth slows further, this substitution to discretionary spending seems increasingly unsustainable to us.

1. For example, please see our report, "Q&A: Managing through the equity rally of 2023", July 31, 2023.

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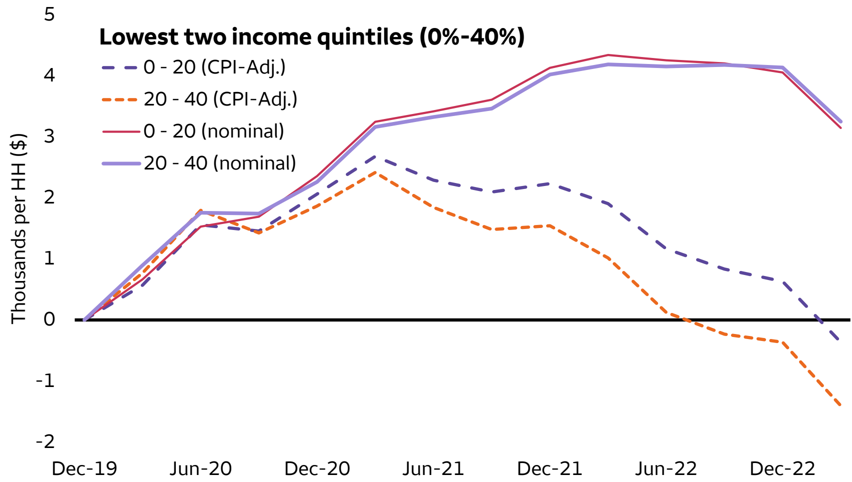
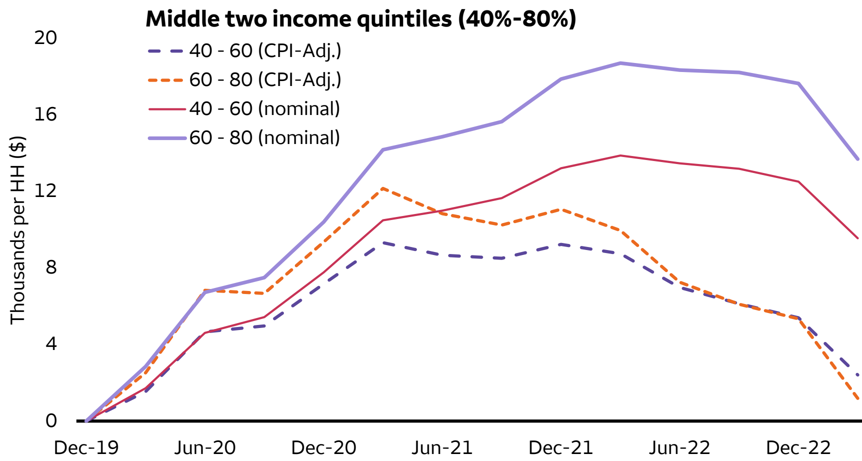
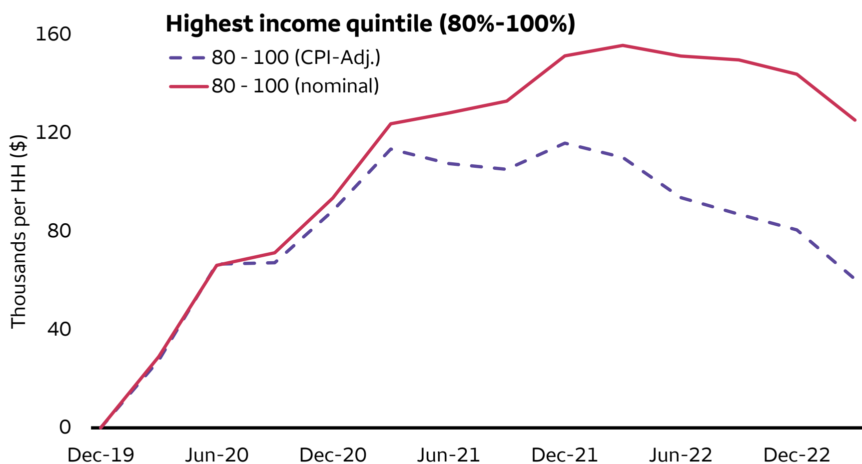
Household liquid assets (cash and other assets easily sold) also support less spending growth. Chart 2 shows that all household (HH) income quintiles are seeing slowing growth in assets. When adjusted for the level of the Consumer Price Index (CPI), the purchasing power of these assets is contracting or now flat for four of five quintiles. As income and asset growth slows for most households, the cracks in consumer spending seem set to break wider.

Chart 2. Change in liquid assets by household (HH) income quintile







Sources: Federal Reserve Board and Wells Fargo Investment Institute. Quarterly data, December 2019-March 2023.

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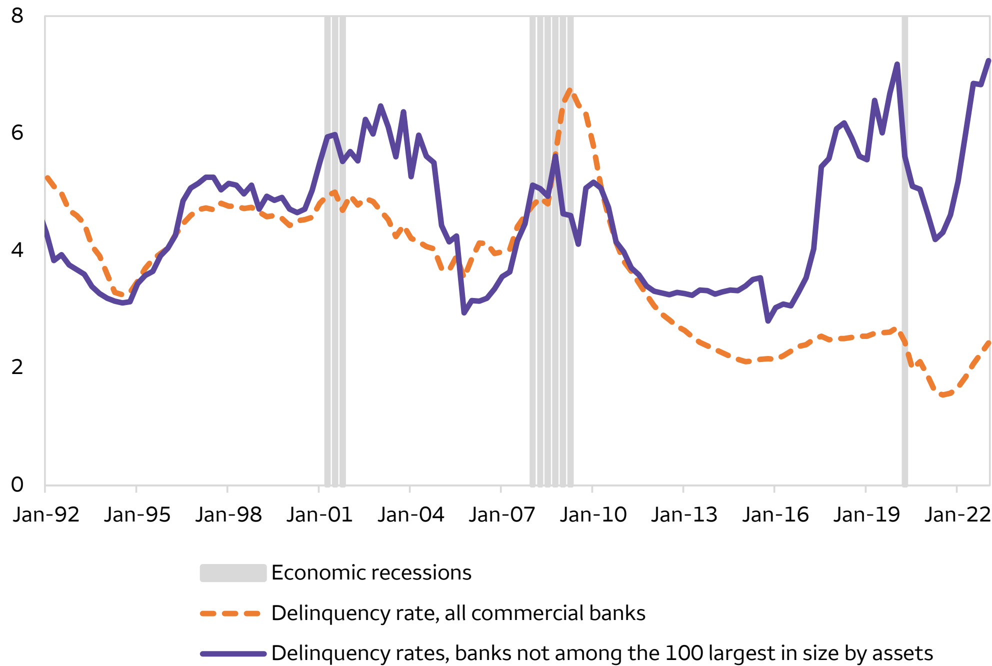
Below the top-line growth in retail spending, budget constraints have turned households to credit, which is increasingly scarce and expensive. Credit card delinquencies (see Chart 3) and auto loan delinquencies are increasing. In fact, credit card delinquencies at banks not in the top 100 in assets have increased to a record (Chart 3), which also raises stress on small- and medium-sized banks.

Chart 3. Credit card delinquencies increasing nationally, especially at smaller banks



Sources: Federal Reserve Bank of St. Louis and Wells Fargo Investment Institute. Quarterly data, January 1992-March 2023.

Interest rates on these types of credit also are at or above multi-decade highs, and recent data from the Federal Reserve Bank of New York indicate that banks are seeing increasing applications for credit cards and auto credit, and increasingly rejecting those applications.[2] Corporate bankruptcies have risen to a two-year high, a sign that credit pressures are growing for businesses, too. Extra inflation and higher interest rates in the coming months should continue to lift credit costs and limit availability for businesses and households.

The economy still has a cash cushion, but it sits mainly with high-quality companies and in the top quintile of income earners. Meanwhile, smaller companies are feeling significant financial strains and many consumers are exhausting their credit, while labor income growth has slowed sharply. These trends remain negative and are typical approaching recessions. Our outlook remains for a short, moderate recession and then recovery for most of 2024 (see table 1 footnote) and likely into 2025.

Higher terminal policy interest rates and long-term rates for this cycle

Our revised federal funds rate target for year-end 2023 anticipates that the Federal Reserve (Fed) will continue raising rates as disinflation stalls too far from the Fed's 2% goal. We now expect the Fed will increase the federal funds rate one additional time in 2023 to reach a year-end range of 5.50% – 5.75%. In addition, our outlook for a short and moderate recession into early 2024 keeps on track our expectation for Fed rate cuts next year to support the economy.

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2. See "SCE Credit Access Survey", Federal Reserve Bank of New York Center for Microeconomic Data, July 23, 2023.

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For long-term U.S. Treasury yields, a higher terminal policy rate implies higher yields to finish 2023 between 4.00% – 4.50%, an increase of one-half percentage point from our previous targets. This increase also implies that the current yield-curve inversion is unlikely to deepen further. (Yield-curve inversion means that short-term rates exceed long-term rates.) A key assumption for holding our 2024 yield targets steady is that long-term inflation expectations will remain stable. Some expectations measures have risen recently but remain well within their ranges since January 1, 2021. While inflation expectations remain well anchored in this way, we believe it will be difficult for long-term rates to meaningfully break through the 4.50% level.

Our expectations of Fed rate cuts in the second half of 2024 and an economy well on its way to recovery by this time next year anticipate that the yield curve will move back to a positive slope (short-term rates below long-term rates). Inversions historically have typically ended by the time the recession ends and the Fed is lowering rates. After a recession, the yield curve has typically experienced a bull steepening (short-term rates fall faster than long-term rates). We expect a similar dynamic in the coming recovery, implying that long-term rates should fall slightly from our year-end 2023 target level. Hence, we maintain our 2024 year-end 10-year and 30-year U.S. Treasury yield targets.

Changing some equity sector preferences

Upgrading the Industrials sector to favorable: We take this opportunity to upgrade the Industrials sector, which potentially benefits from a confluence of private and government spending tailwinds into 2024 and likely beyond. Specifically, we believe higher levels of defense and construction spending, the clean energy transition, supply chain re-shoring, data center expansion, and continued supply chain normalization should support this sector through a recession. A stronger economy in 2024 should reinforce these positive, long-term supports, in our view, and we expect broad earnings strength in the group. Industrials' earnings power has impressed us, and the sector is one of the few which has seen improved Bloomberg consensus earnings estimates throughout this year. We believe sector valuations are fair and the recent underperformance during this year's growth rally has provided an attractive opportunity to upgrade Industrials to favorable.

Downgrading the Energy sector to neutral: In order to fund the Industrials upgrade, we favor taking profits on the Energy sector. After remaining favorable for much of the last two years, as oil prices rebounded from their depressed pandemic lows, we believe now is a good time to consider taking profits. Specifically, the extreme summer heat has limited refinery operations, and key oil producers Russia and Saudi Arabia have cut production (or extended cuts). Between June 27 and July 31, the benchmark West Texas Intermediate crude oil price per barrel has risen from the mid-$60s to over $80, and powered an 8.2% sector return, the best among the S&P 500 sectors over that time period.

The rebound has also lifted oil prices close to our 2023 year-end target range, and oil demand could weaken with the U.S. economy later in the year. These factors suggest some near-term volatility for energy equity prices. This sector gained 19.70% between our April 28, 2022 upgrade and August 8, and outperformed the S&P 500 Index (6.92%) over that time. Our neutral rating reflects our view that the outlook is balanced between near-term volatility and, on the other side, continued capital discipline, solid profits, and cash flow. What's more, a neutral rating indicates exposure at the sector's full market weight in the S&P 500 Index.

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Risk considerations

Forecasts are not guaranteed and 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. **Dividends** are not guaranteed and are subject to change or elimination. The value type of investing tends to shift in and out of favor. **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.

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. The **Energy** sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio's performance.

Definitions

An index is unmanaged and not available for direct investment.

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

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.

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