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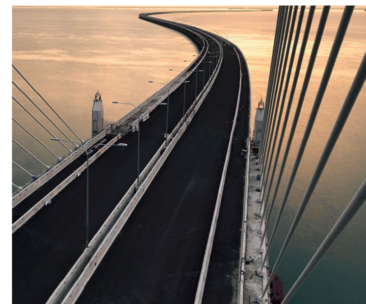
# Investment Strategy



**Weekly guidance from our Investment Strategy Committee** **August 21, 2023**


Asset Allocation Spotlight: More retirees are allocating savings to equities ........ 2

- U.S. retirees are investing a greater portion of their savings in stocks, posing significant implications for investors in their golden years.
- A higher risk tolerance may prompt some retirees to overweight equities, yet the strategy poses risks going forward, considering the ballooning budget deficit and future Federal Reserve policies.

Equities: Highlighting updated guidance: Energy down, Industrials up ...... 4

- We downgraded the Energy sector from favorable to neutral, and we upgraded the Industrials sector from neutral to favorable last week.
- The recent oil price rebound into our 2023 year-end target range offered an opportunity to rotate exposure from Energy into the Industrials sector, where we foresee fiscal spending tailwinds into 2024 and likely beyond.

Fixed Income: Our view on duration as long-term yields move higher ..... 5

- We believe it will be difficult for the 10-year U.S. Treasury yield to cross above 4.5% in the near term, given contained inflation expectations.
- We maintain a favorable view toward extending duration (a measure of a bond's interest rate sensitivity) and view 10-year U.S. Treasury yields above 4% as an opportunity to add duration exposure, as we expect yields to move lower in the first half of 2024.

Real Assets: Oil's performance has been heating up ........ 6

- West Texas Intermediate prices are up for the seventh week in a row — the longest streak of consecutive weekly gains since June 2022.
- Expectations for stronger global demand growth, coupled with aggressive OPEC supply cuts, are driving crude oil's recent outperformance.

Alternatives: Low beta for the long run ........ 7

- Low beta effect describes the higher risk-adjusted returns exhibited by low beta stocks in the long term compared to high beta stocks.
- Such an unusual return effect continues to present itself even five decades after it was originally written about.

Current tactical guidance ........ 8



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# Asset Allocation Spotlight

**Douglas Beath**
Global Investment Strategist

**Michael Taylor, CFA**
Investment Strategy Analyst

## More retirees are allocating savings to equities

U.S. retirees are investing a significantly higher portion of their savings in stocks compared to just a decade ago. According to a recent report from Vanguard, nearly half of 401(k) investors who actively manage their money and are over the age of 55 hold more than 70% of their portfolios in stocks, versus 38% in 2011. In a similar finding at Fidelity Investments, nearly four in 10 investors between the ages of 65 and 69 hold roughly two-thirds or more of their portfolios in stocks.[1]

And the higher allocation to equities is not limited to the baby boomer generation. In taxable brokerage accounts at Vanguard, one-fifth of investors 85 or older hold nearly all their money in stocks, up from 16% in 2012. The same is true of almost a quarter of those between the ages of 75 and 84.

Several factors have led investors to increase equity exposure in their golden years. These include:

- Returns — Since 1980 through July 2023, stocks (using the S&P 500 Index as a proxy) have outperformed bonds (using the Bloomberg U.S. Aggregate Bond Index as a proxy) 11.8% to 6.7% on an annualized total return basis, with stocks significantly exceeding their longer-term average of 7.2% since 1930. This trend could continue with elevated inflation in the wake of the coronavirus pandemic, and long-term expectations for price increases growing as well.
- Equity-market rebounds — Historical data indicate that stocks have often rebounded strongly and quickly from market turbulence, reinforcing the investor mentality of "buying on dips," which, in turn, supports a higher allocation to equities. In the post-World War II period, there have been 26 corrections (declines of 10% to 20%) in the S&P 500 Index, with an average duration of 125 days or approximately four months from peak to trough of each decline. What is significant to investors is how quickly stocks rebounded after the market bottomed. On average since World War II, the S&P 500 Index reclaimed the lost ground in three-and-a-half months.

  To be clear, the duration of bear-market periods during recessions and the rebound phases have been significantly longer than market corrections. On average in the post-World War II period, the S&P 500 Index took approximately three years to recoup lost ground on a price-only basis. Even so, U.S. large-cap stocks rebounded from the bear market associated with the pandemic in just six months.
- Federal Reserve put — Investors have become accustomed to the Federal Reserve (Fed) intervening during periods of financial crisis. Examples include aggressive Fed easing after the 1987 stock-market crash, the 1994 Mexican peso devaluation, and the 1997 southeast Asian crisis. More recently, the Fed responded to the Great Financial Crisis (GFC) in 2008 – 2009 and the pandemic in 2020 by cutting short-term rates and engaging in quantitative easing, which involves buying bonds to lower long-term interest rates. Generally, investors' mentality appears to have morphed into less worry about markets crashing and more confidence that stocks will rebound from the turbulence and set new highs.
- Baby boomer generation — The majority of today's retirees are baby boomers, born between 1946 and 1964, who did not live through the Great Depression, nor were active investors during the "lost decade" of

1. "America's Retirees Are Investing More Like 30-Year-Olds," *Wall Steet Journal*, July 4, 2023.

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the 1970s when the S&P 500 Index produced a nearly flat return on a price-only basis. Thus, baby boomers have tended to exhibit a greater willingness to take financial risks.

- **Life expectancy** — From 1960 to 2015, life expectancy in the U.S. increased by almost 10 years, from 69.7 years to 79.4. It is projected to increase another 6.1 years from 2016 to 2060 to reach a record high of 85.6 years, according to a 2020 Census Bureau report.[2] The potential for a longer, healthier life in retirement is, in our view, an incentive to increase equity exposure consistent with a longer investment time horizon.

To be sure, there are risks associated with a higher exposure to equities in retirement portfolios. First, if the market were to experience a significant drawdown, retirees needing cash may be forced to liquidate shares at heavily discounted prices. This is significant, as health care costs have skyrocketed for retirees and can be unexpected in many cases. Indeed, a recent study found that a 65-year-old couple can expect to spend an average of $315,000 in medical expenses throughout retirement.[3] That estimate was up 5% from 2021 and has nearly doubled from $160,000 in 2002.

Second, the financial landscape for a continuation of the "Fed put" — or future fiscal spending in response to crises — has been significantly altered in the aftermath of the pandemic. We believe the ballooning U.S. federal budget deficit and stubbornly high inflation make it less likely that Washington will pursue another massive spending initiative or that the Fed will aggressively lower rates and reverse course by reducing its balance sheet.

## What it means for investors

In our view, the trend of higher risk tolerance of U.S. retirees that we've noted over the past 10 years will likely reinforce investor tendencies to rebalance during bouts of market volatility — to purchase stocks at more attractive prices, potentially shortening the rebound phase. However, the "buy on the dip" strategy faces uncertain risks going forward, as the growing U.S. budget deficit could pose a headwind to future Fed easing policies. In addition, higher bond yields present competition for stocks, reducing the equity risk premium from the previous 10-year period. With this in mind, we advise investors to match their asset allocation to their risk tolerance and time horizon, especially in this environment of near-term uncertainty in the markets and the opportunities elevated bond yields now offer.

2. "You Could Live to 100. The Trick is Not Running out of Money," *Barron's*, February 10, 2023.

3. "Americans can expect to pay a lot more for medical care in retirement," CNBC, May 16, 2022.

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# Equities

*"There is nothing permanent except change." — Heraclitus*

**Austin Pickle, CFA**
Investment Strategy Analyst

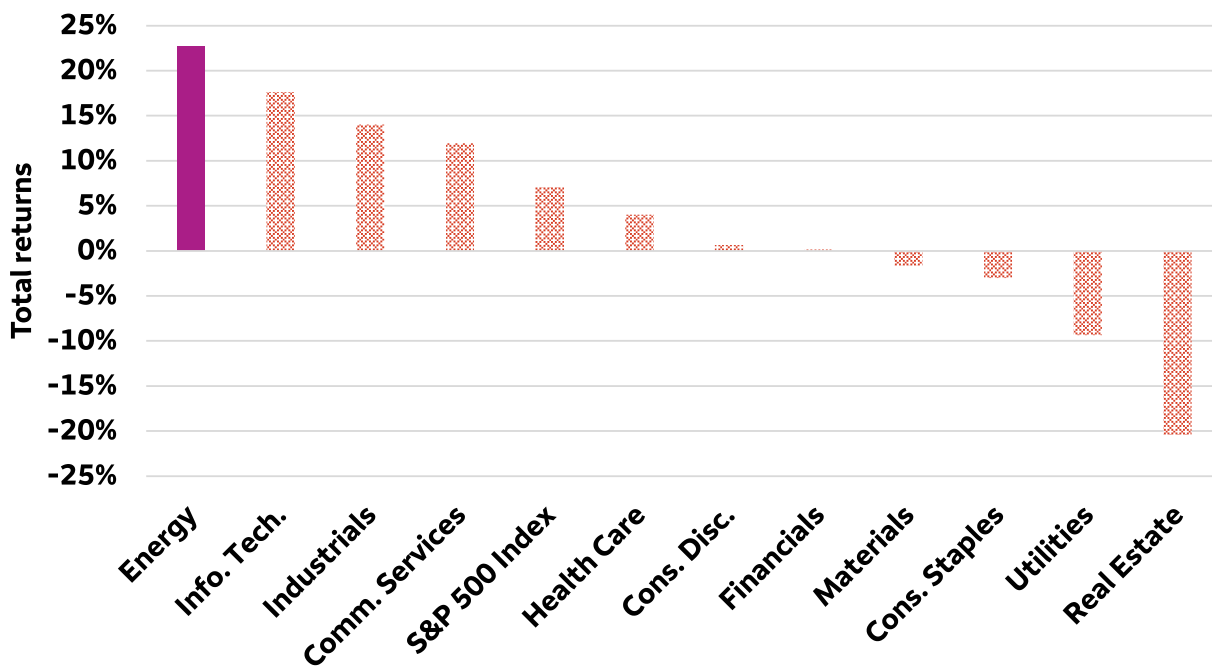
## Highlighting updated guidance: Energy down, Industrials up

On August 15, we published two sector guidance changes. We took the S&P 500 Industrials sector from neutral to favorable while downgrading the Energy sector from favorable to neutral. We recap the rationale below.

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 the Industrials sector through a recession. The economic recovery that we expect in 2024 should reinforce these positive, long-term supports, in our view. Additionally, Industrials' earnings power has impressed, we believe valuations are fair, and recent underperformance during this year's growth rally has provided, in our view, an attractive opportunity to upgrade.

In order to fund the Industrials upgrade, we favor taking profits in the Energy sector, which outperformed the S&P 500 Index — and all other sectors — between our April 28, 2022, upgrade and August 14, 2023 (see chart). Oil prices that have recently surged into our 2023 year-end target ranges suggest that there may be limited potential for further energy stock outperformance. Our call for a recession still to develop suggests plenty of downside risks to this highly cyclical sector. Attractive valuations as well as solid profits and cash flows — which are supported by continued capital discipline — offer a counterbalance to these near-term risks, supporting our neutral view. It is important to emphasize that a neutral rating corresponds with a full index-weighted allocation.

**Energy has been the top-performing sector since our upgrade last year**




Sources: Bloomberg and Wells Fargo Investment Institute. Returns are from April 28, 2022 through August 14, 2023, and are shown as total returns which include both price movement and dividends. **Past performance is no guarantee of future results.**

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# Fixed Income

**Luis Alvarado**
Global Fixed Income Strategist

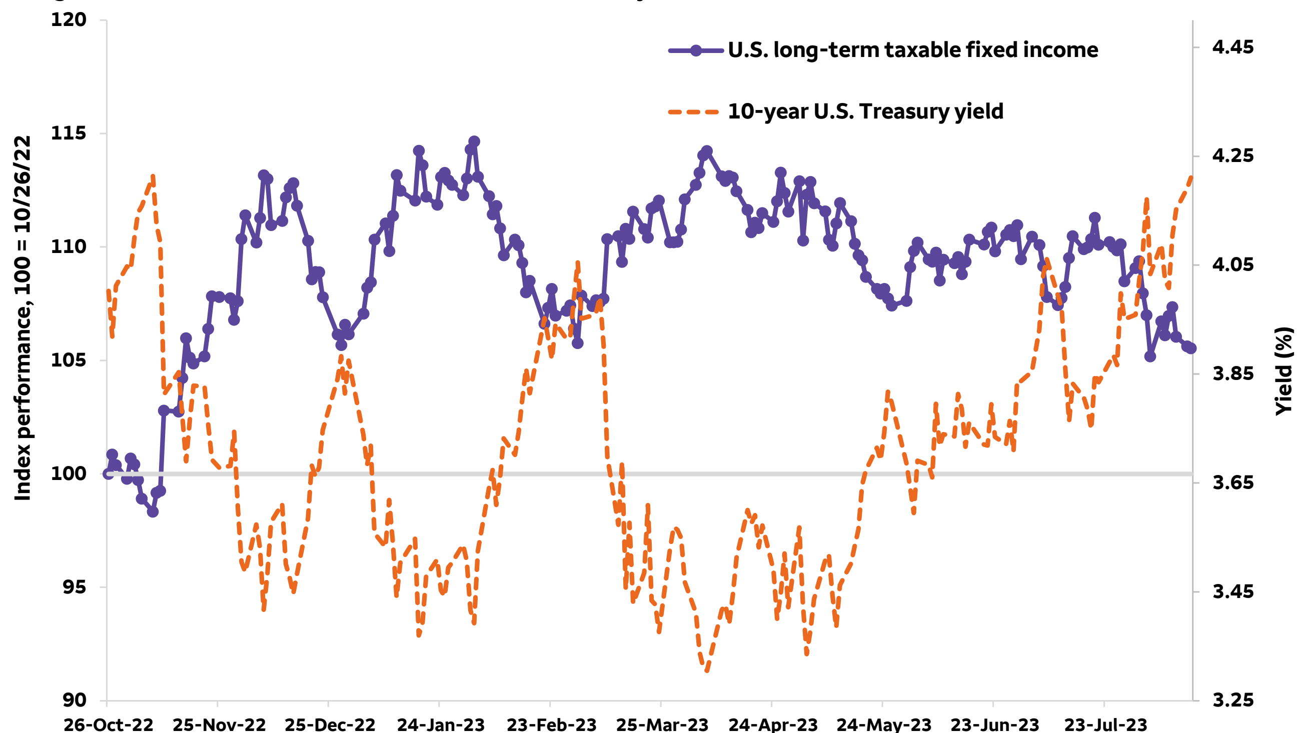
## Our view on duration as long-term yields move higher

U.S. Treasury yields have been moving higher over the past three months, influenced largely by the resilient macroeconomic outlook. Last week, we updated our year-end 2023 interest rate targets for the federal funds rate and for 10-year and 30-year U.S. Treasury yields to accommodate for a period of higher interest rates while the Fed continues to battle inflation.

Although possible, we believe it will be difficult for the 10-year U.S. Treasury yield to cross above 4.5% in the near-term, especially as most of the indicators that we follow to track inflation expectations remain contained in a trading range between 2.0% – 2.32% (as measured by Treasury Inflation-Protected Securities breakeven inflation rates as of August 15, 2023). However, we acknowledge that any signal from the Fed to continue hiking rates aggressively through year-end and into 2024 could cause the yield curve to shift even higher, but that is not our base case.

Furthermore, it is important to point out that we still expect an economic slowdown to occur between year-end 2023 and the first half of 2024, when we anticipate yields across the curve will move lower. This is why we still maintain a favorable view toward extending duration and view 10-year U.S. Treasury yields above 4% as an opportunity to add duration exposure. We believe fixed income portfolios should benefit as yields decline (prices go up) in anticipation of an economic recession and eventual rate cuts from the Fed.

**Long-term fixed income total returns benefit when yields decline**




Sources: Wells Fargo Investment Institute and Bloomberg. Daily data from October 26, 2022 to August 15, 2023. U.S. long-term taxable fixed income = Bloomberg U.S. Agg 10+ Year Index. An index is not managed and not available for direct investment. Refer to index definitions at the end of report. **Past performance is no guarantee of future results**.

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# Real Assets

*"Chance is the first step you take; luck is what comes afterward." — Amy Tan*

**Mason Mendez**
Investment Strategy Analyst

## Oil's performance has been heating up

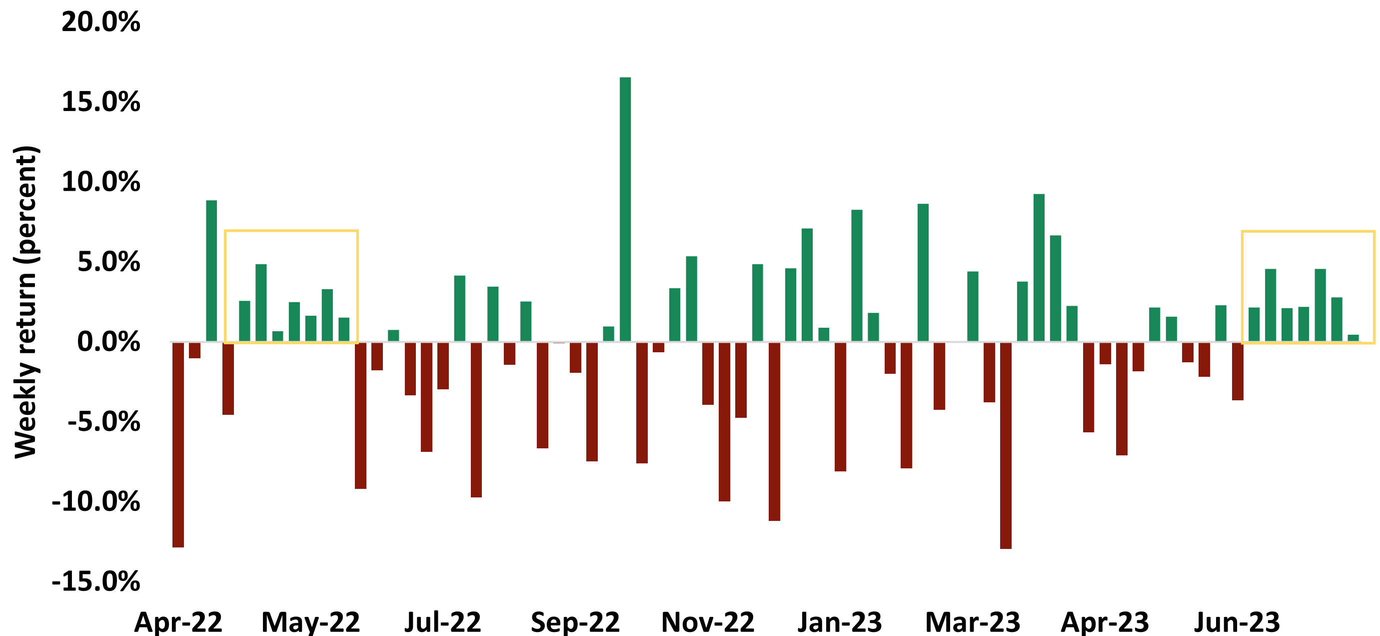
Crude oil has become a top performer so far in the second half of 2023, as West Texas Intermediate (WTI) crude extended its streak of positive returns to seven weeks — from April 30 through August 11. Over that same period, not only did WTI crude outperform the broader Bloomberg Commodity Index, but it also outperformed both U.S. equities (S&P 500 Index) and U.S. bonds (Bloomberg's U.S. Aggregate Bond Index).

Following a slow start to 2023, crude oil's performance has improved in the second half, as prices are up 23%, and WTI has posted consecutive weekly gains since June 27 (see chart). What's driving the change in performance is an improved global demand outlook, coupled with aggressive OPEC supply cuts.

Now, despite our expectations for an impending recession in the U.S., oil demand outside the U.S. is still holding up. The International Energy Agency recently raised its outlook for global demand growth and expects demand to reach a record high of 103.06 million barrels per day in the third quarter of 2023. Meanwhile, OPEC, which accounts for 33% of global production, has reduced output to the lowest level since 2021. This has led to expectations of a tighter oil market in the latter half of 2023, and as a result, market sentiment on crude prices is becoming more constructive, shifting from neutral to optimistic.[4]

We will continue to monitor the supply and demand balance as we approach the expected recession, but until we see signs of a loosening global supply balance, we will likely remain optimistic on crude oil's performance.

**West Texas Intermediate crude oil registers positive returns for seven weeks straight**




Source: Bloomberg, and Wells Fargo Investment Institute. Weekly return data is from April 1, 2022 - August 11, 2023. The gold boxes highlight the seven-week periods of consecutive positive weekly returns. **Past performance is no guarantee of future results**.

4. Ned Davis Research Inc. - Crowd Sentiment Poll for Crude Futures.

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# Alternatives

**Arun Kumar, CFA**
Lead Retail Research Analyst

## Low beta for the long run

A stock's beta is essentially a measure of its volatility in relation to a broad index, such as the S&P 500 Index. A beta greater than 1.0 suggests that the stock is more volatile, less than 1.0 suggests the stock is less volatile, and equal to 1.0 suggests that the stock is just as volatile as the Index.

The low-beta effect, which suggests that low beta stocks have higher risk-adjusted returns than high beta stocks, has been closely followed since notable economist Fischer Black wrote about it in the 1970s. This effect indicates anomalously higher returns for taking lower risk and lower returns for taking higher risk. Such market anomalies typically do not exist over long periods — but the low-beta effect does.

Since Fama-French academic data first became available in 1963, risk-adjusted returns of low beta and mid-low portfolios are almost twice as high as the high beta counterpart (see table). Over three years, even as the high beta portfolio generated higher returns than the low beta portfolio, those returns came with significantly high volatility. Low-beta and mid-low beta portfolios have been more efficient in the long run and as the timeframe increased compared to higher beta portfolios.

Low-beta portfolios are available to investors in the form of low-volatility exchange-traded funds and alternative investments. Such strategies historically have had additional benefits of being less sensitive to elevated interest rates, as low-beta companies tend to use little financial leverage. Their lower volatility profile enables those stocks to be held for the long term with potentially less turnover.

**Characteristics of equal-weighted portfolios of U.S. stocks ranked by historical beta**

| Long Period: Jul 1963 – Jun 2023 | Low Beta Portfolio | Mid-Low Beta Portfolio | Median Beta Portfolio | Mid-High Beta Portfolio | High Beta Portfolio |
|---|---|---|---|---|---|
| Annual Return | 13.3% | 14.8% | 14.3% | 14.2% | 11.9% |
| Standard Deviation | 14.0% | 16.2% | 18.6% | 21.8% | 28.4% |
| **Return / Risk** | **0.95** | **0.92** | **0.77** | **0.65** | **0.42** |
| Recent 3-Years: Jul 2020 - Jun 2023 | Low Beta Portfolio | Mid-Low Beta Portfolio | Median Beta Portfolio | Mid-High Beta Portfolio | High Beta Portfolio |
| Annualized Return | 6.3% | 15.0% | 18.3% | 17.4% | 12.3% |
| Standard Deviation | 20.2% | 22.1% | 25.4% | 29.3% | 36.5% |
| **Return / Risk** | **0.31** | **0.68** | **0.72** | **0.59** | **0.34** |
| Portfolio Characteristics | Low Beta Portfolio | Mid-Low Beta Portfolio | Median Beta Portfolio | Mid-High Beta Portfolio | High Beta Portfolio |
| Number of stocks | 630 | 604 | 510 | 527 | 679 |
| **Average Beta** | **0.37** | **0.86** | **1.15** | **1.52** | **2.21** |

Sources: Kenneth R. French Data Library at Dartmouth College and Wells Fargo Investment Institute, as of June 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.

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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<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, August 21, 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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### 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. 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. **Treasury Inflation-Protected Securities (TIPS)** are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond to fluctuate more than other fixed income securities. TIPS have special tax consequences, generating phantom income on the "inflation compensation" component of the principal. A holder of TIPS may be required to report this income annually although no income related to "inflation compensation" is received until maturity. 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.

Exchange Traded Funds seek investment results that, before expenses, generally correspond to the price and yield of a particular index. There is no assurance that the price and yield performance of the index can be fully matched. Exchange Traded Funds are subject to risks similar to those of stocks. Investment returns may fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost.

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.

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### 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. Aggregate 10+ Year Bond Index** is composed of the Bloomberg U.S. Government/Credit Index and the Bloomberg U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 10 years or more.

**Bloomberg Commodity Index** is comprised of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity.

**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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