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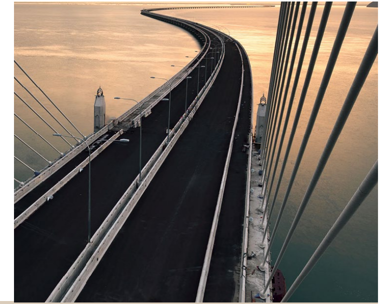

Investment Strategy

Weekly guidance from our Investment Strategy Committee **September 11, 2023**

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- If left unchecked, portfolios can drift away from target-risk levels, posing implications for investors.
- Determining and adhering to a risk tolerance level that aligns with goals and time horizon can help lead to long-term financial success.

Equities: Small caps stuck in neutral 4

- Despite talk of a soft landing, economically sensitive small-cap companies continue to struggle on both an absolute and relative basis.
- Investors should use the recent rally to trim exposure to smaller-capitalization companies in favor of higher-quality, larger-cap U.S. companies, which have shown an ability to grow earnings despite a cooling economy.

Fixed Income: U.S. corporate debt levels – A reason for concern? 5

- Concerns about the size of U.S. corporate debt, currently near $12.7 trillion, have been increasing over the past few years.
- However, economic researchers have found that the amount of debt growth is more important than the absolute level of debt when assessing the risks to the broader economy.

Real Assets: U.S. crude inventories show signs of tight supply 6

- U.S. crude oil inventories declined by 10.6 million barrels during the week ending on August 25, marking the third consecutive week of inventory draws.
- Despite a weakening macro environment, crude oil fundamentals are positive and driving supply tightness along with higher prices.

Alternatives: Private capital fundraising continues to slow 7

- We expect fundraising to remain subdued in the coming months, as investors gain more clarity on the future path of the macro environment.
- We are constructive on secondaries and distressed strategies, which have tended to thrive during economic slowdowns.

Current tactical guidance 8

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Asset Allocation Strategy Spotlight

Michael Taylor, CFA
Investment Strategy Analyst

Reassessing risk tolerance

In a recent report, we highlighted an emerging trend of U.S. retirees investing a higher portion of their savings in stocks compared to just a decade ago.[1] This inclination has been supported by several factors, including life expectancy and Federal Reserve (Fed) intervention during periods of financial calamities. We also noted repercussions associated with a greater exposure to stocks.

This trend of greater equity exposure among older investors poses risks. More broadly, if left unchecked, portfolios can drift away from target risk levels to higher risk exposures than intended. Below we discuss the importance of aligning a portfolio's risk exposure with an investor's risk tolerance.

Identifying tolerance for risk

One important consideration when choosing an asset allocation strategy is risk tolerance. An investor's tolerance for risk largely depends on investment goals and time horizon. Investment goals may range from generating income to growing assets — or a blend of the two. Time horizons can be short, intermediate, or long. For today's retirees, as the average time spent in retirement continues to grow, living longer often requires an investment strategy that helps mitigate the risk of outliving their nest egg. This presents an incentive to increase equity exposure consistent with a longer time horizon, while trimming bond holdings.

Yet, this tendency poses risks. If the market were to experience a significant drawdown, retirees needing cash for an unexpected medical bill or household expense may be forced to liquidate shares at discounted prices. Although some older investors may be willing to stomach choppy markets, the ability for their assets to recover after a significant market selloff may be limited.

Risk tolerance can range from conservative to aggressive or somewhere in between. Conservative investors have a lower tolerance for risk and tend to prefer assets with less potential for volatility, such as bonds. Conversely, investors with a more aggressive risk tolerance typically are willing to assume more portfolio volatility to attain higher returns as they work toward their investment goals. Identifying a suitable risk exposure for a portfolio is a key ingredient in selecting an appropriate mix of assets. Asking how easily an investor panics when volatility roils markets can be an effective way to determine the level of risk an investor is willing to take.

Time horizon and risk tolerance

Time horizon often influences an investor's ability and willingness to take on risk. Financial markets can be volatile on a short-term basis, and some investors may be unable to tolerate sizable portfolio drawdowns — even if those losses are only on paper. In our view, investors with short time horizons may benefit from more conservative allocations, while investors with long time horizons often are willing to take on more risk. Over shorter periods, higher-risk assets, such as equities (see red and orange striped bar in Chart 1), can experience wide price swings. Diversified asset allocations (purple bar) generally have seen less volatility. While high-quality fixed-income assets (red and white striped bar) historically have exhibited low volatility, they may not provide sufficient return for meeting long-term goals.

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1. See WFII "More retirees are allocating savings to equities," August 21, 2023.

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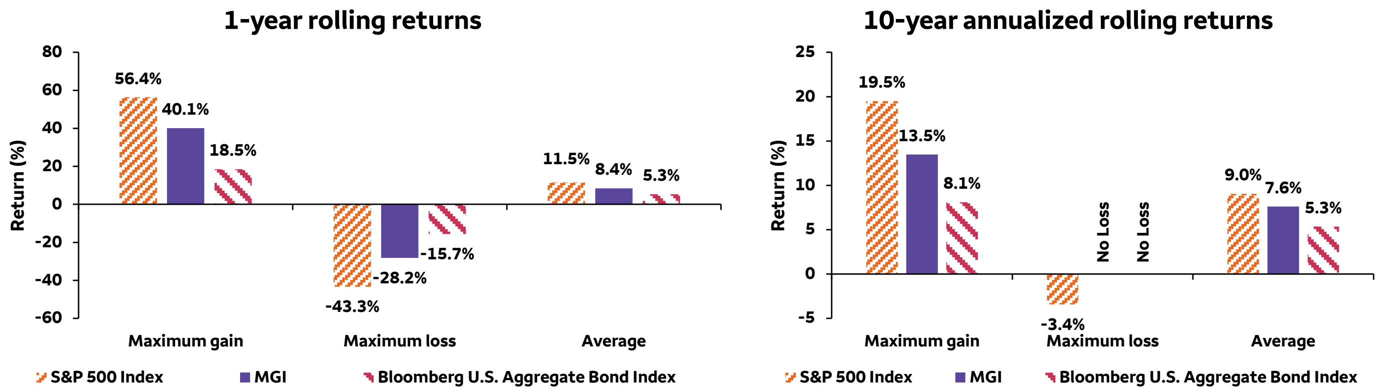
Chart 1. Annualized rolling 1-year and 10-year returns for stocks, diversified portfolios, and bonds



Sources: Morningstar Direct and Wells Fargo Investment Institute. Data from January 1, 1990 to August 31, 2023. MGI = Moderate Growth and Income Liquid allocation. Performance results for MGI are for illustrative purposes only and are calculated using blended index returns. The allocation is dynamic and changes as needed with adjustments to the strategic allocation. Index returns do not represent investment performance or the results of actual trading. Index returns reflect general market results, assume the reinvestment of dividends and other distributions, and do not reflect deduction for fees, expenses, or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results**. See end of report for composition of the allocations, risks, and definitions of indexes.
Note: Over a 10-year rolling period, neither the MGI Liquid allocation nor the Bloomberg U.S. Aggregate Bond Index showed a loss. In fact, their minimum rolling returns were positive, 2.9% and 0.7% respectively, on an annualized basis.

Looking out to a 10-year horizon, and using historical data, the potential for loss is diminished as market cycles evolve, and short-term losses can become long-term gains. Equities historically have offered greater potential reward but have come with higher risk. Bonds have historically offered lower potential returns, but typically with less risk. A diversified asset allocation historically has captured much of the upside in equities without generating a loss over any 10-year rolling period since 1990 (see chart), offering smoother returns.

The bottom line

Determining (and adhering to) a risk tolerance that aligns with investment goals and time horizon can help lead to long-term financial success. If an investor's time horizon is short, and periods of equity market volatility seem unnerving, a conservative asset allocation may be the soundest approach. If an investor's time horizon is long, and the ability and willingness to take on risk are greater, the portfolio's asset allocation can lean more toward growth assets like equities.

For investors whose risk tolerance and time horizon fall somewhere in between (like many investors, including those already in retirement), a balance between growth assets and income-producing assets may be prudent. For retirees or those approaching retirement, a detailed retirement plan should reflect one's life expectancy along with unique financial goals such as building a legacy for family members or a charitable cause. We recommend reviewing a portfolio's asset allocation with an investment professional periodically to make sure it aligns with investment goals, time horizon, and risk tolerance.

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Equities

Sameer Samana, CFA
Senior Global Market Strategist

Small caps stuck in neutral

History suggests that the smaller the size of a company, the more sensitive it may be to economic and credit conditions, in both directions. Specifically, small-capitalization companies have tended to underperform during recessionary periods and then outperform during the subsequent economic recovery, much as they did in the 2020–2021 period (see chart below). It is for this reason that we find the small-cap Russell 2000 Index's absolute and relative performance since late 2021 so interesting.

The fact that it remains well off its absolute high and is back down close to the relative lows hit during the worst days of the pandemic-related selloff in 2020 shows that, despite all the talk this year about better-than-expected economic data and the possibility of a soft landing, small-capitalization U.S. equities continue to struggle. If anything, the underperformance has accelerated recently due to the regional bank crisis in the spring, which further tightened credit and financial conditions for small businesses and likely will result in a host of new regulations for small- and mid-size banks.

While we expect small caps to eventually have their day in the sun (probably during the next economic upturn), we believe it is much too soon to add exposure to these companies. The fall historically has tended to be a seasonally weak period for equities, and lingering inflation threatens to push the Fed to raise rates to higher levels and keep them longer, which increases the risk of a policy mistake and adds to the uncertainty that markets face. In our view, the recent rally should be viewed as an opportunity to trim exposure, in favor of higher-quality, larger-capitalization U.S. companies, which have shown an ability to generate earnings during an economic slowdown.

Small-cap struggles continue

Source: Bloomberg. Data from September 5, 2021 through September 5, 2023. Small Caps represented by the Russell 2000 Index. SMAVG (50) = 50-day simple moving average. SMAVG (200) = 200-day simple moving average. The Russell 2000 index is a measure of small-cap stocks in the U.S. market. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Fixed Income

Luis Alvarado
Global Fixed Income Strategist

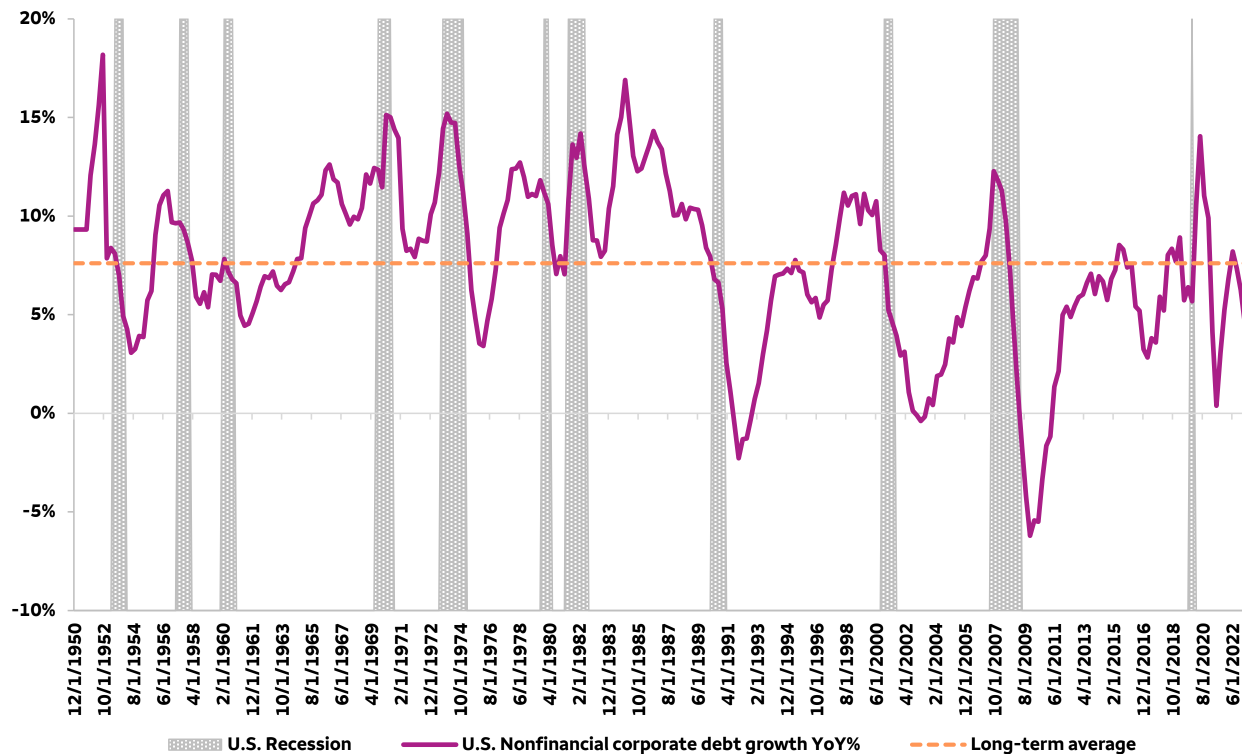
U.S. corporate debt levels – A reason for concern?

Concerns about the size of U.S. corporate debt, currently near $12.7 trillion, have been increasing over the past few years. Investors have been questioning the sustainability of these levels and how shocks to the corporate sector, especially with higher interest rates, may impact the broader economy once the credit cycle turns.

Although it is true that the nominal value of corporate debt has been increasing, so has the size of the economy. Still, the amount of U.S. nonfinancial corporate debt as a percent of gross domestic product (GDP) currently stands near 48%, already surpassing the previous high of 45% (excluding the period of the pandemic), achieved both in the mid 1990's and early 2000s.

This all-time high level of U.S. corporate debt has attracted the attention of many financial commentators who have said that this level of debt appears to be the "canary in the coal mine" of the next credit cycle bust. However, economic researchers have been tracking the increase in debt for some time and studies have found that the amount of debt growth is more important than the absolute level of debt when assessing the risks to the broader economy.[2] In fact, current U.S. corporate debt growth remains below levels that have preceded the beginning of U.S. recessions since the 1950's, and also, the current rate of growth is still below its long-term average. In our opinion, U.S. corporate debt levels are not a major concern.

U.S. corporate debt growth (2.6% year-over-year) is below the long-term average (7.6%)



Sources: Wells Fargo Investment Institute and Bloomberg. Quarterly data from December 31, 1950, to March 31, 2023.

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2. Schularick, Moritz and Taylor, Alan M., Credit Booms Gone Bust: Monetary Policy, Leverage Cycles and Financial Crises, 1870-2008 (November 2009). NBER Working Paper No. w15512. Last revised May 22, 2022.

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Real Assets

"There is a crack, a crack in everything. That's how the light gets in." — Leonard Cohen from "Anthem"

Mason Mendez
Investment Strategy Analyst

John LaForge
Head of Real Asset Strategy

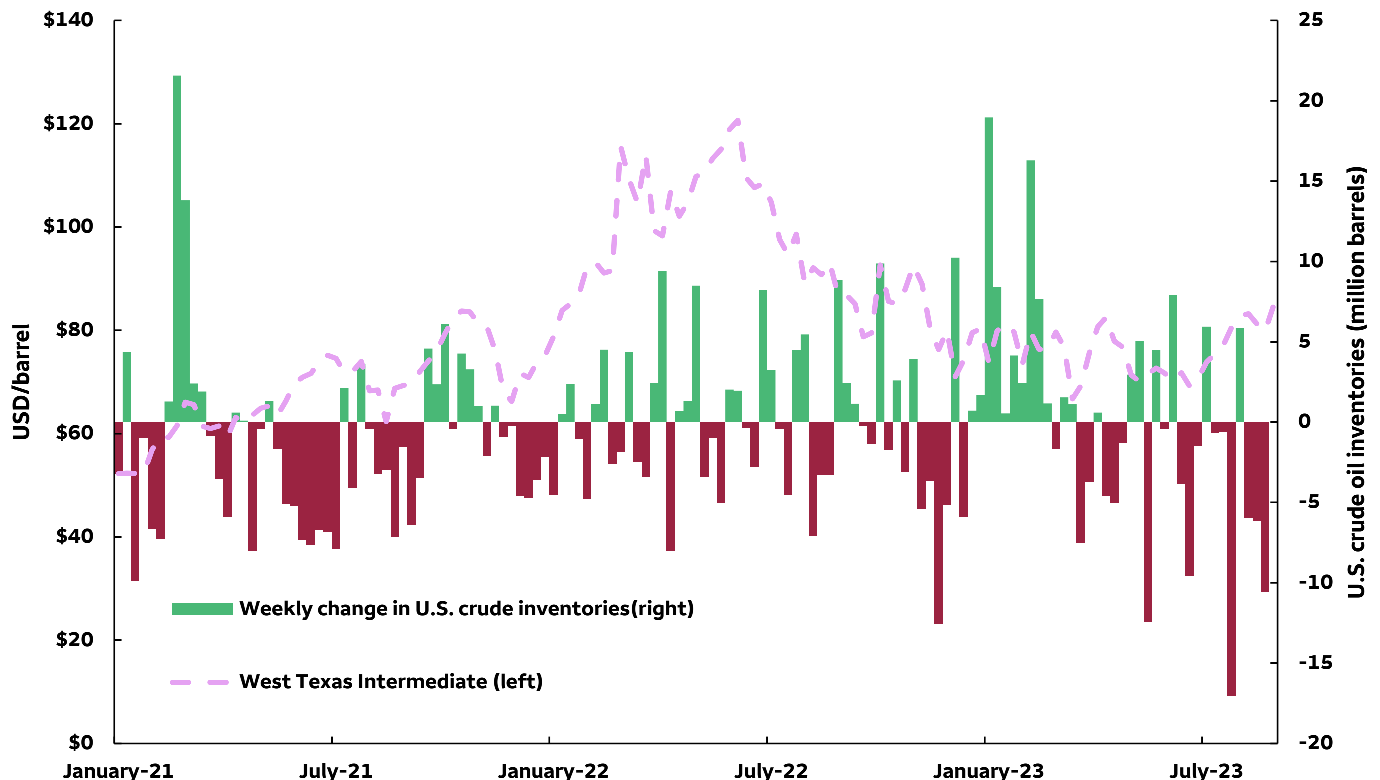
U.S. crude inventories show signs of tight supply

Despite a softening macro environment, we still see signs of a tightening oil market, as U.S. crude inventories fell to the lowest level since December 2022. While higher interest rates and a slowing economy are not constructive for oil prices, fundamentals such as falling inventories and limited supply growth have generally been positive. Both are driving a tighter market along with higher prices.

The most recent decline of 10.6 million barrels marked the third consecutive week of declines (see chart below). Notably, this series of declines occurred shortly after the largest decline on record and pushed commercial inventories to 422.94 million barrels — the lowest level since 2022. As a result, West Texas Intermediate (WTI) prices have climbed to $86, up 26% since June. This was in stark contrast to the beginning of the year, when inventory builds were frequent and price performance was fairly weak.

We suspect that we will continue to see large inventory declines throughout the rest of the year, as OPEC (Organization of the Petroleum Exporting Countries) extends its restrictive policy and global supply growth is limited. Therefore, as long as inventories continue to decline and show signs of a tightening oil market, we will likely stay constructive on crude prices. For 2023, our year-end price targets are $80 – $90 for WTI crude and $85 – $95 for Brent crude.

U.S. crude inventory builds and draws



Sources: Bloomberg, Energy Information Administration, and Wells Fargo Investment Institute. Weekly data is from January 1, 2021 – September 1, 2023.

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Alternatives

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

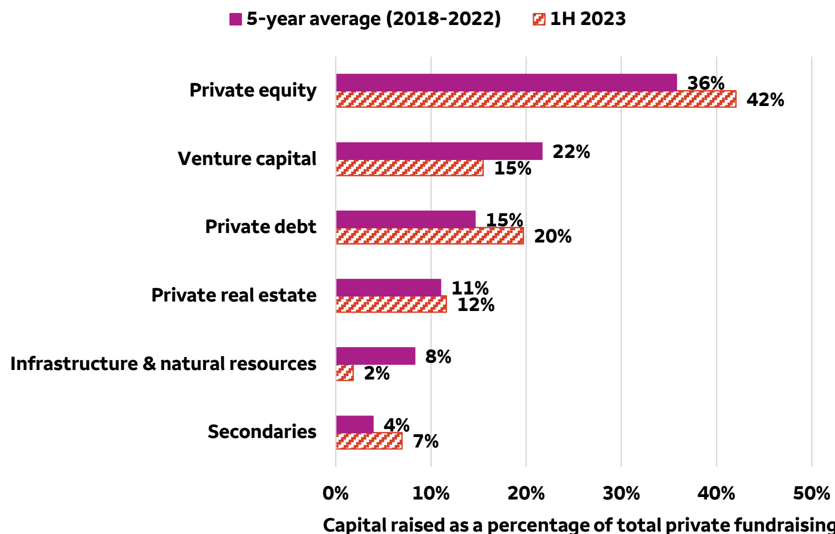
Private capital fundraising continues to slow

As an indicator of investor appetite, private capital fundraising was down 30% in second quarter, relative to a year ago. The drop was not uniform among strategies. For example, venture capital and infrastructure witnessed the most noticeable declines in capital raised. However, private debt and secondaries had more resilient fundraising, and they gained more shares in total private capital raised (see chart).

- For venture capital, declining valuation and diminished exit opportunities reduced investors' appetite. Valuation was marked down in 15% of deals so far this year — the highest level seen since 2013. The absence of many $1 billion-plus mega-fundraisings contributed the significant fundraising decline.
- Private debt is on track to raise over $200 billion for the fourth consecutive year. Direct lenders continued to fill the void left by banks by providing bespoke lending solutions. Private lenders' track record in offering the potential for high income with a low loss rate has also drawn strong interest from institutional and retail investors alike.
- Secondaries: Slow exit activities have limited fund managers' ability to return capital to investors. As a result, investors have turned to the secondary market for liquidity. Many fund managers also favor secondary continuation funds, which offer extended time to further grow companies and wait for a more opportune exit environment.

We expect fundraising to remain subdued in the coming months, as investors gain more clarity on the future paths of monetary policy, inflation, and economic growth. For private capital, we emphasize the importance of investing throughout the economic cycle, as the supply-demand imbalance in a down market may lead to top-performing funds over the long-term. We are also more constructive on secondaries and distressed strategies that have tended to thrive during economic slowdowns.

Percent of capital raised by private asset classes in first half 2023



Sources: Pitchbook and Wells Fargo. As of September 1, 2023. Private capital strategies are based on Pitchbook's definition.

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, September 11, 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. 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

Moderate Growth & Income Liquid: 2% Bloomberg U.S. Treasury Bill (1–3 Month) Index, 30% Bloomberg U.S. Aggregate Bond Index, 6% Bloomberg U.S. Corporate High Yield Bond Index, 5% JPMorgan EMBI Global Index, 24% S&P 500 Index, 10% Russell Midcap Index, 6% Russell 2000 Index, 8% MSCI EAFE Index, 5% MSCI Emerging Markets Index, 4% Bloomberg Commodity Index.

Bloomberg Commodity Index is a broadly diversified index of commodity futures on 20 physical commodities, subdivided into energy, U.S. agriculture, livestock, precious metals, and industrial metals sectors. Commodity weights are derived in a manner that attempts to fairly represent the importance of a diversified group of commodities to the world economy.

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. Corporate High Yield Bond Index covers the U.S.-dollar-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB= or below. Included issues must have at least one year until final maturity.

Bloomberg U.S. Treasury Bill (1-3 Month) Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. In addition, the securities must be denominated in U.S. dollars and must be fixed rate and non-convertible.

JPMorgan EMBI Global Index is a U.S.-dollar-denominated, investible, market-cap-weighted index representing a broad universe of emerging market sovereign and quasi-sovereign debt. While products in the asset class have become more diverse, focusing on both local currency and corporate issuance, there is currently no widely accepted aggregate index reflecting the broader opportunity set available, although the asset class is evolving. By using the same index provider as the one used in the developed market bonds asset class, there is consistent categorization of countries among developed international bonds (ex. U.S.) and emerging market bonds.

MSCI EAFE Index (Europe, Australasia, Far East) Index is a free-float-adjusted market-capitalization-weighted index designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

MSCI Emerging Markets Index is a free-float-adjusted market-capitalization-weighted index designed to measure equity market performance of emerging markets.

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Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. The Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

Russell Midcap Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index.

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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