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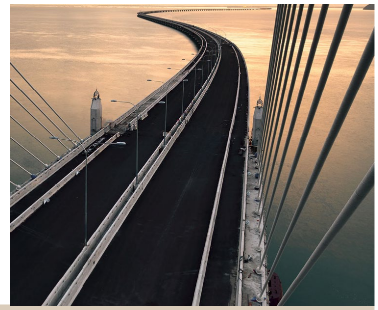

Weekly guidance from our Investment Strategy Committee **September 18, 2023**

Alternatives Spotlight

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Global Portfolio and Investment Strategist

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Private capital improves accessibility

The landscape of alternative investments continues to evolve. Traditionally, private equity, private debt, and many private real estate strategies were only available in closed-end drawdown fund structures that required capital commitments of at least 10 years — money would be invested over the first several years and distributed throughout the life of the fund. In addition, these funds had very high requirements in terms of investor net worth and offered limited or no liquidity options.

While many more liquid hedge fund strategies migrated to the mutual fund universe, the significant limitations on the use of private, illiquid assets prevented many private capital strategies from being offered this way. The advent of a hybrid structure, often termed perpetual or evergreen funds, allow for greater use of illiquid investments while offering many advantages that allow for easier implementation in investors' portfolios. These benefits include:

- **Increased liquidity and transparency to investors.** Perpetual products typically conduct monthly or quarterly valuations of underlying assets and allow investors to commit and redeem capital on a similar frequency. As a result, investors may feel more certainty with the timing of the cash flows they will receive.
- **A lower investment minimum.** These perpetual funds are typically designed for investors with a lower asset qualification.
- **Ease of implementation in an asset allocation.** Capital is immediately invested during the month or quarter committed and remains invested until the investor chooses to sell. As a result, investors can implement and maintain their target allocations, potentially without continually investing across multiple fund vintages (as is required by traditional drawdown funds).

Table 1. Comparison of perpetual structure and drawdown structure

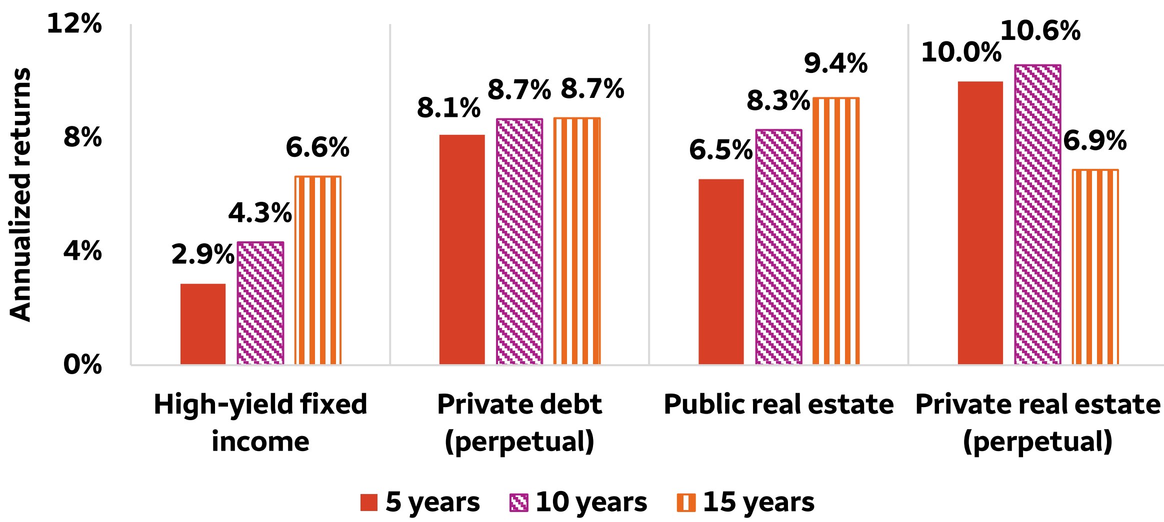
	Liquidity	Fund life	Investment minimum	Fees	Capital commitment	Redemption frequency	Example strategy
Perpetual structure	Semi-liquid	Perpetual	Generally lower	Potentially lower	Generally monthly investments allowed	Generally monthly to quarterly, with redemption limits	Core private real estate, direct lending
Drawdown structure	Illiquid	Strategy dependent, generally 5-15 years	Generally higher	Similar or higher	Capital calls over the first 3-5 years	Generally, no redemption allowed. Capital is distributed at fund's discretion	Most private capital strategies

Source: Wells Fargo Investment Institute. As of September 13, 2023.

Investors should also recognize that perpetual private capital funds have several differences as compared to mutual funds or exchange-traded funds typically seen in public markets.

- Perpetual funds are semi-liquid. To serve the best interest of all investors and avoid forced sales of illiquid assets at unfavorable times, perpetual funds typically set early redemption fees to discourage short-term investors. Moreover, there may be fund-level redemption limits and managers also have the option to completely suspend redemptions in market dislocations when redemption levels are elevated.
- Potentially improved returns relative to public investments. Over past periods, perpetual private capital funds have typically generated higher returns than similar public market investments (see table 1).

Chart 1. Historical returns of select public and private capital indexes



Sources: Bloomberg and Wells Fargo Investment Institute. 5-year, 10-year and 15-year periods end August 31, 2023. High yield fixed income is represented by Bloomberg U.S. Corporate High Yield Index. Private debt (perpetual) is represented by Cliffwater Direct Lending Index. Public real estate is represented by FTSE NAREIT All Equity REIT Index. Private real estate (perpetual) is represented by NCREIF Open End Diversified Core Equity Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** Please see the end of the report for index definitions and risk considerations.

We consider perpetual funds a viable option for qualified investors planning to build out private capital allocations. Given the lower investment minimum and similarity to public funds, investors may feel more comfortable starting with these products. Moreover, long-term private capital holdings can be established with these funds without the need to execute a yearly investment plan. Perpetual products are potentially also valuable for income-seeking investors given their historically stable yields and low volatility in returns relative to public investments.
Overall, we believe both drawdown and perpetual funds are important private capital vehicles and investors should consider additional factors, such as investment merit and manager track record, when making investment decisions.

Equities

Chris Haverland, CFA
Global Equity Strategist

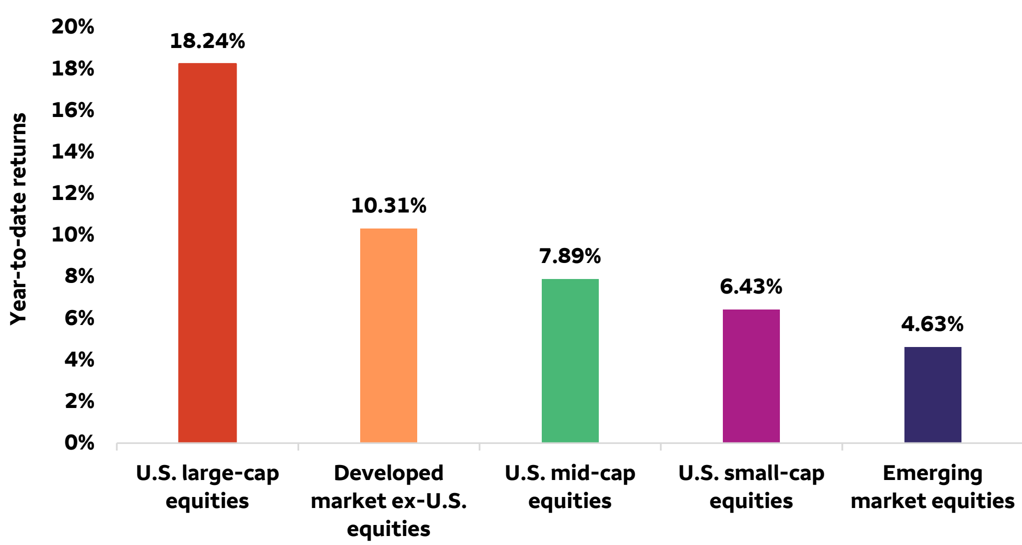
Stick with quality (for now)

In 2023, we have favored high-quality equities over low-quality equities. This strategy has worked well in both up-trending and down-trending market environments this year. The chart below shows clear outperformance by high-quality U.S. large-cap equities (favorable rating) in comparison to lower-quality U.S. small-cap equities (most unfavorable rating) and emerging market equities (unfavorable rating). Our work suggests that U.S. large-cap equities (represented by the S&P 500 Index) lead all other equity classes in quality characteristics such as profitability, earnings stability, and healthy balance sheets. We discuss each below:

- Profitability: Highly profitable companies have generally been industry leaders, weathering economic downturns more effectively than companies with low profitability or those that are unprofitable. Return on equity (or ROE) and profit margin are common measures of profitability and firm efficiency.
- Earnings stability: Companies that have established a proven track record of growing earnings in the past have been more likely to survive future challenges. This can be measured by examining longer-term earnings growth and variability of earnings.
- Healthy balance sheets: Lower amounts of debt can reduce the risk of financial insolvency when earnings and cash flow are negatively impacted by an economic slowdown. Companies with low leverage also have the advantage of being able to borrow at relatively low costs due to their higher credit ratings.

We believe maintaining a quality bias in portfolios is appropriate given our view that an economic recession is likely in the coming quarters. This means continuing to favor U.S. large-cap equities over U.S. small-cap equities and emerging market equities.

The higher-quality S&P 500 Index has outperformed in 2023



Sources: Bloomberg and Wells Fargo Investment Institute. As of September 11, 2023. Year-to-date returns are measured as total returns of the benchmark indexes. U.S. large-cap equities are represented by the S&P 500 Index. Developed market ex-U.S. equities are represented by the MSCI EAFE Index. U.S. mid-cap equities are represented by the Russell Midcap Index. U.S. small-cap equities are represented by the Russell 2000 Index. Emerging-market equities are represented by the MSCI Emerging Markets Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** Please see the end of the report for index definitions and risk considerations.

Fixed Income

Brian Rehling, CFA
Head of Global Fixed Income Strategy

What is next for the Fed?

The Federal Reserve (Fed) will meet next week and is expected to leave the federal funds rate unchanged. The meeting, however, is key to understanding the Fed's future actions. In addition, an important new data point will be released at the conclusion of the meeting, which will be the Fed's forward-looking summary of economic projections. The summary, also known as "the dot plots", is released four times a year and summarizes what each participant expects "appropriate monetary policy" will be going forward absent further shocks to the economy.

While the Fed is unlikely to commit to any action or non-action at future meetings, we anticipate that the summary of economic projections will suggest that another rate hike is possible before the end of the year. We look for Fed Chair Jerome Powell to stress that any future Fed moves remain data dependent.

Our expectation is for one additional rate hike this year. We look for the Fed to proceed with caution, but if inflation data does not retreat fast enough or begins to move higher once again, the Fed will have little choice. While it is likely that the rate hike cycle is near its end, we expect rates to stay higher for longer than the market currently anticipates. At some point, more rapid economic deterioration will likely force the Fed to cut rates. Timing the eventual rate cut cycle, however, is challenging.

For now, short- and long-term maturities are our current maturity preference for investment-grade fixed-income investors. Should we experience an economic shock or begin to see more rapid economic deterioration, we expect longer-term rates to fall and would use the opportunity to trim long-term bond positions and shorten duration in portfolios (duration is a measure of interest-rate sensitivity).

Real Assets

"The finest steel has to go through the hottest fire." – Richard M. Nixon

Mason Mendez
Investment Strategy Analyst

John LaForge
Head of Real Asset Strategy

Metal prices rising on Chinese property stimulus

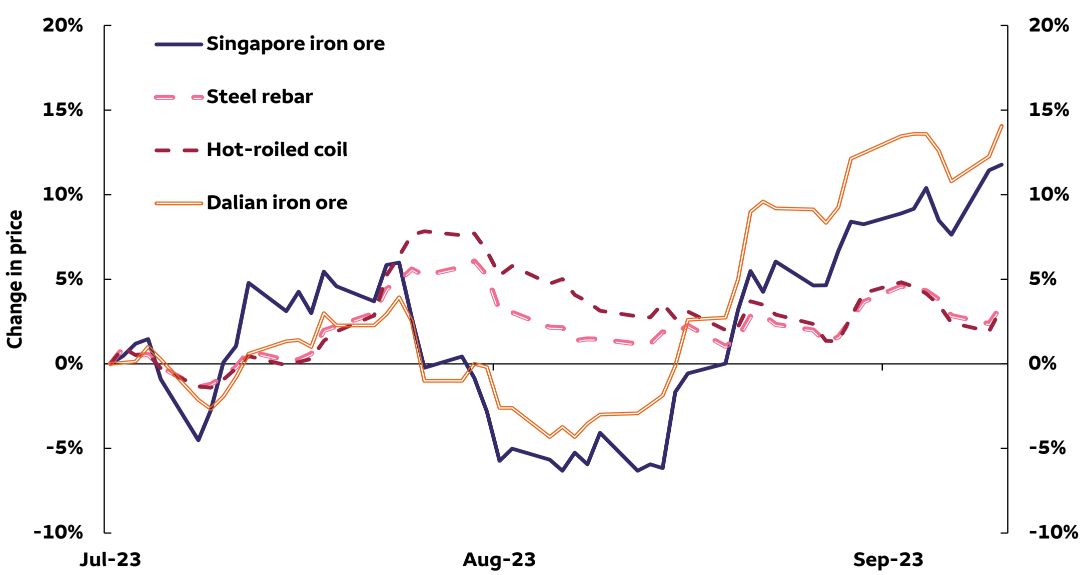
China is the world's largest consumer of steel, and roughly 30% of it is consumed by China's domestic property sector. Throughout much of the past few months there have been stories upon stories describing China's depressed property sector. So, it would be logical to expect steel and other metal prices to be falling, yet the opposite has happened. As an example, the most actively traded contract for iron ore, a key input in steel production, is up 14% since July 3, and steel prices are up 3% (see chart below).

Behind the higher metal prices are new stimulus measures aimed at boosting demand in China's property sector. A few of these measures are the government's plans to cut mortgage rates and to reduce the minimum down payments for first- and second-time homebuyers — supporting demand for construction and metals. All in all, these recent stimulus measures have some investors feeling more optimistic.

We, on the other hand, are not as optimistic on China's property market. We believe that the government's new stimulus measures will be enough to buoy China's property sector in the short term, but not enough to return it to growth in the medium term. Firstly, property developers and local governments continue to struggle with large amounts of debt, as well as a declining yuan. Secondly, on the consumer side, we believe it will take more stimulus to incentivize new home sales as consumer confidence surveys show extreme pessimism as housing affordability remains low, and youth unemployment (youth defined as ages 16 –24) is hitting record highs.[1]

The bottom line is that we remain neutral on industrial metals versus other commodity groups, as China, the largest global buyer of metals, continues to face growth headwinds in its property sector.

Chinese metal prices



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data is from July 3, 2023 – September 12, 2023. **Past performance is no guarantee of future results.**

1. Monthly surveyed urban youth unemployment rate in China June 2021 – 2023. Statista. Data as of August 22, 2023.

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 18, 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. Corporate High Yield Index covers the universe of fixed-rate, noninvestment-grade debt.

Cliffwater Direct Lending Index measures the asset-weighted performance of the underlying assets of Business Development Companies (BDCs), including both exchange-traded and unlisted BDCs.

FTSE NAREIT All Equity REIT Index is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs. Constituents of the index include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property.

MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada.

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

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NCREIF Open End Diversified Core Equity Index is capitalization-weighted and measures the performance of lower risk private real estate investment strategies utilizing low leverage and generally represented by equity ownership positions in stable U.S. operating properties diversified across regions and property types.

Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 90% of the total market capitalization of the Russell 3000 Index.

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.

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.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market.

An index is unmanaged and not available for direct investment.

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