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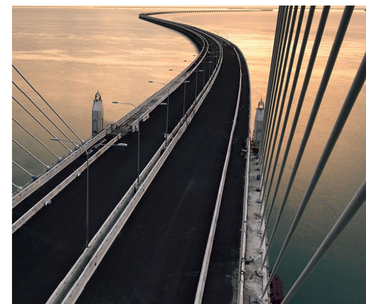

Investment Strategy

Weekly guidance from our Investment Strategy Committee **September 25, 2023**

Global Equity Spotlight: Peak China pessimism? 2

- A number of policy, macro, and geopolitical headwinds have buffeted China and resulted in an exodus of investors and severe underperformance of China stocks over the past couple years.
- We expect that recessions are still likely to develop in the U.S. and abroad, we urge investors to stay patient and focus on quality in portfolios. We remain unfavorable on Emerging Market (EM) Equities.

Fixed Income: Fed continues to reduce its balance sheet 4

- The Federal Reserve (Fed) continues to reduce its balance sheet, which ultimately impacts market liquidity.
- While difficult to predict, reduced market liquidity can make the market more susceptible to unexpected shocks.

Real Assets: Higher gasoline prices could stick around in 2023 5

- West Texas Intermediate (WTI) crude oil prices climbed above $90 per barrel, pushing gasoline prices up to $3.81 per gallon, as of September 18.
- President Biden acknowledged the spike in prices, but we believe there is not much the U.S. government can do to potentially provide relief to U.S. consumers.

Alternatives: Private infrastructure growth fuels secondary market 6

- A substantial increase in allocations to private infrastructure from institutional investors has led to high levels of fundraising over the past decade.
- We believe current conditions in the secondary infrastructure market may have the potential to deliver outsized returns relative to its level of risk for qualified investors.

Current tactical guidance 7

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Global Equity Spotlight

"Start where you are. Use what you have. Do what you can." — Arthur Ashe

Austin Pickle, CFA
Investment Strategy Analyst

Peak China pessimism?

A number of policy, macro, and geopolitical headwinds have buffeted China and resulted in an exodus of investors and severe underperformance of China stocks over the past couple years. At nearly 30%, China is the single-largest country weight in our EM Equities benchmark — the MSCI Emerging Markets Index. Needless to say, our view on China heavily influences our rating on EM Equities overall. We have held an unfavorable rating on EM Equities for nearly two years. Is now the time to take that tilt off the table? Let's discuss.

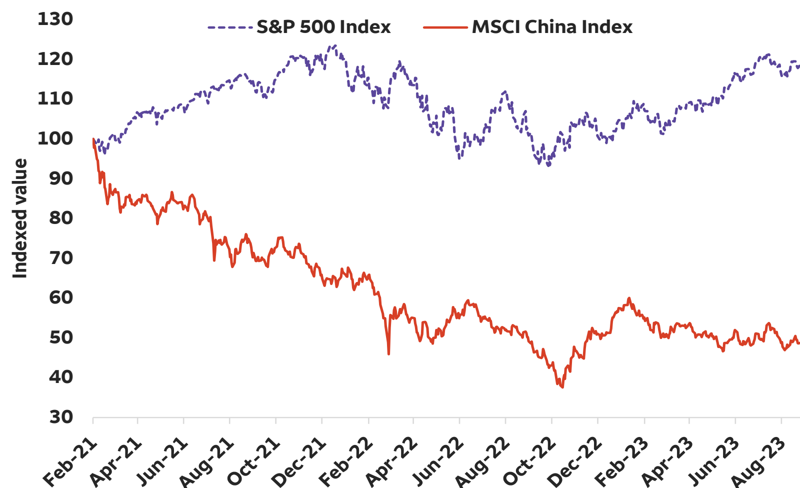
Macro

China is facing a number of well-known structural headwinds, not least of which is slowing growth brought on by the planned shift to a consumer-led economy, as well as the potential emergence of a middle-income trap. (A middle-income trap occurs when wage gains — and often debt levels — undermine an export-led economy's global competitiveness before it can transition to consumer-led growth.) Additionally, policy errors — including regulatory uncertainties in technology and other highly visible parts of the economy — as well as labor disruptions tied to an abrupt slowdown in growth have conspired to keep consumer and business sentiment depressed.

Yet, lately, there have been some encouraging near-term developments. August saw China industrial production and retail sales growth jump above expectations. This follows efforts by the government to support a recovery, including cutting the cost of borrowing, reducing the stamp duty on stock transactions, and lowering down payment requirements for homes (and other policies to encourage home buying).

While we believe that these and other easing measures should certainly help, we believe they lack the potency of the monetary and fiscal stimulus China has unleashed during past downturns. We suspect that Beijing will remain reluctant to turn to that level of stimulus due to its need to balance economic stimulus against the risk of adding to local government debt.

Chart 1. The MSCI China Index has dropped over 50% since its 2021 peak



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data: February 17, 2021 to September 19, 2023. Indexed to 100 as of the start date. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Markets

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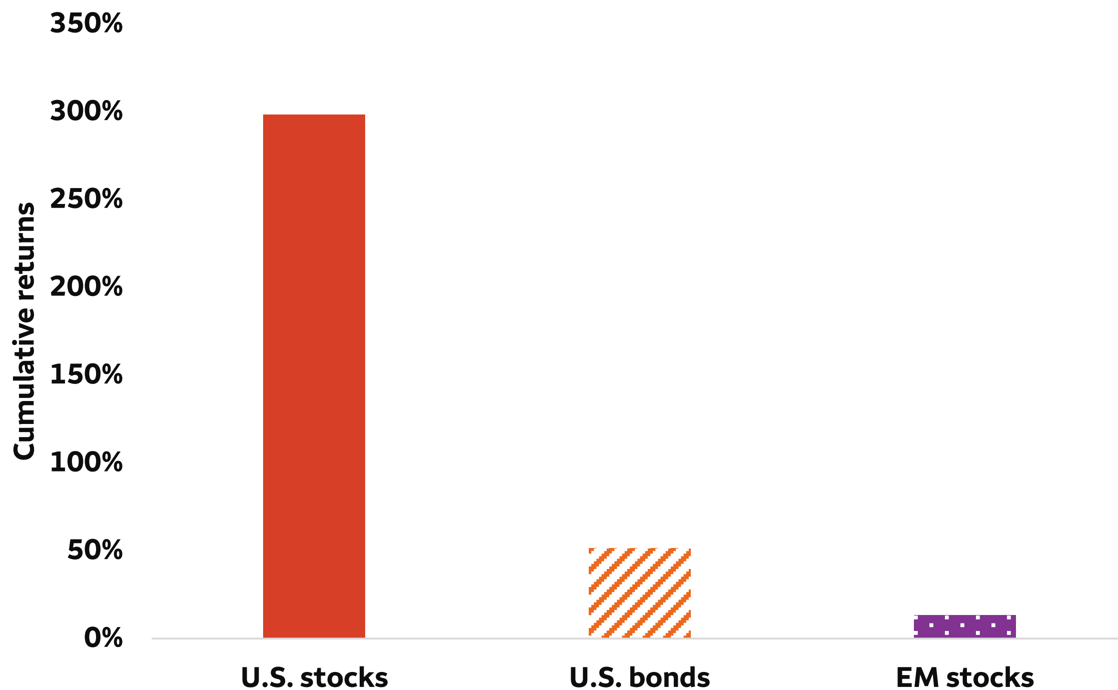
China's equity underperformance since February 2021 has been steep. In fact, the MSCI China Index is still down over 50% since its 2021 peak. For reference, the S&P 500 Index has returned a positive 18% during this time, despite experiencing a drawdown of over 20% in 2022 (see chart 1).

After such poor returns over such an extended period, there is a decent argument to make that markets have reached peak China pessimism. Yet, there are considerations that keep us from upgrading our unfavorable outlook on EM Equities — for now. Ongoing political risks from Chinese regulatory reform, increasing U.S.-China diplomatic and economic strains, and the potential for U.S. and European recessions in coming months are just a few. In this environment, we prefer to emphasize the relative quality of U.S. Large Cap Equities over the elevated risks and volatility we see in EM Equities. In fact, we believe the long-term track record of EM returns has left much to be desired (see chart 2).

Chart 2. EM equity returns have been poor over the past 16 years



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data: October 29, 2007 – September 19, 2023. U.S. stocks represented by the total return of the S&P 500 Index. EM stocks represented by the total return of the MSCI Emerging Markets Index. U.S. bonds represented by the total return of the Bloomberg U.S. Aggregate Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results**.

Yet, if events unfold as we forecast, an EM Equities upgrade may not be far off. EM Equities should underperform if, as we expect, the global economy slows into U.S. and eurozone recessions and the U.S. dollar attracts flows as a perceived risk haven. But once EM prices reflect these developments, we would look to pivot to a more favorable outlook on EM Equities, which historically have benefited from economic recoveries.

For now, however, we urge investors to stay patient and focus on quality in portfolios as the economic cycle rolls over. We remain unfavorable on EM Equities. We believe that for investors who find themselves with little or no exposure to EM Equities, however, the recent weakness may provide a potential opportunity to bring portfolio allocations to our recommended weights. Remember, an "unfavorable" rating does not mean a zero weighting.

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Fixed Income

Brian Rehling, CFA
Head of Global Fixed Income Strategy

Fed continues to reduce its balance sheet

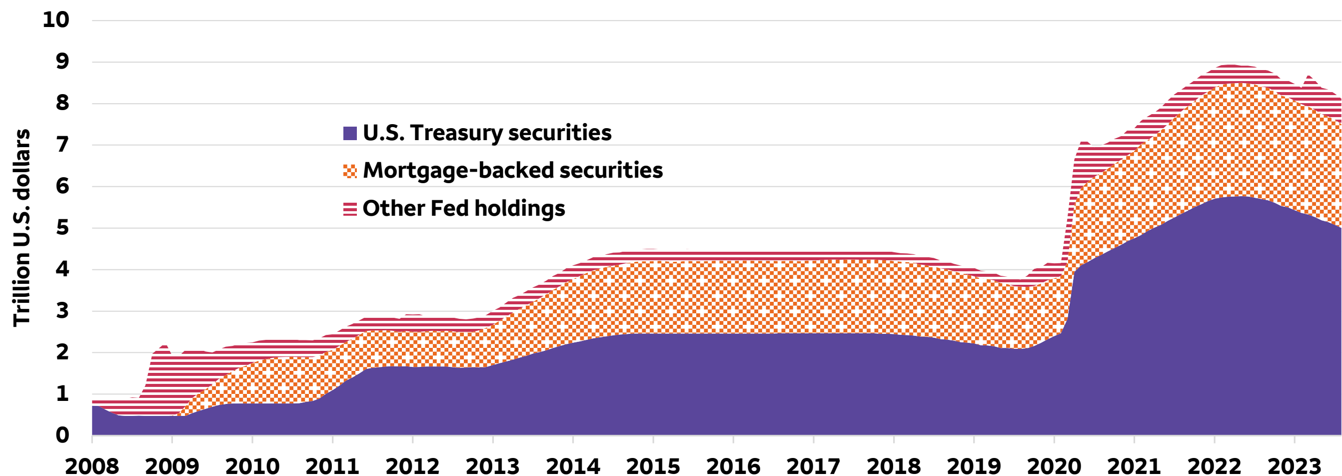
In May 2022, the Fed announced that it would begin reducing its bond holdings. At each Federal Open Market Committee (FOMC) meeting since, the Fed reiterated that it would continue to reduce its holdings of Treasury securities, agency debt, and agency mortgage-backed securities. As the Fed reduces its holdings, market liquidity has been negatively impacted.

Earlier this year, we experienced the impact of reduced liquidity as several notable banks failed and sent equity markets into a temporary tailspin. Regulators quickly injected capital and stemmed the capital flight, but continued reductions in the Fed balance sheet have made markets susceptible to event risk. While difficult to predict, the possibility of a more challenging liquidity environment in bond markets could begin to emerge at any time. The risks of a bond market liquidity event also increases as we move through an economic slowdown and a potential recession as we expect.

Fixed income plays a vital role in many investors' portfolios and is often used with the intention of reducing portfolio volatility. With this in mind, it is important for investors to understand the potential liquidity risks embedded in their fixed-income holdings. In an effort to help mitigate liquidity risks in fixed-income investments, investors can diversify portfolios, avoid overexposure to lower credit quality fixed-income classes, raise credit quality, and review individual liquidity needs with an investment professional.

If we experience a period of market stress, we believe there can also be opportunities for investors. Liquidity events may offer nimble market participants that are willing and able to withstand the volatility that occurs during these market shocks the opportunity to purchase some fixed-income securities at a notable discount to today's prices. In a period of illiquidity and risk-off, investors may consider opportunistically adding to typically less liquid fixed income sectors and asset classes, such as high yield and preferred securities.

Fed balance sheet



Source: Bloomberg. Data as of September 19, 2023.

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Real Assets

John LaForge
Head of Real Asset Strategy

Mason Mendez
Investment Strategy Analyst

Higher gasoline prices could stick around in 2023

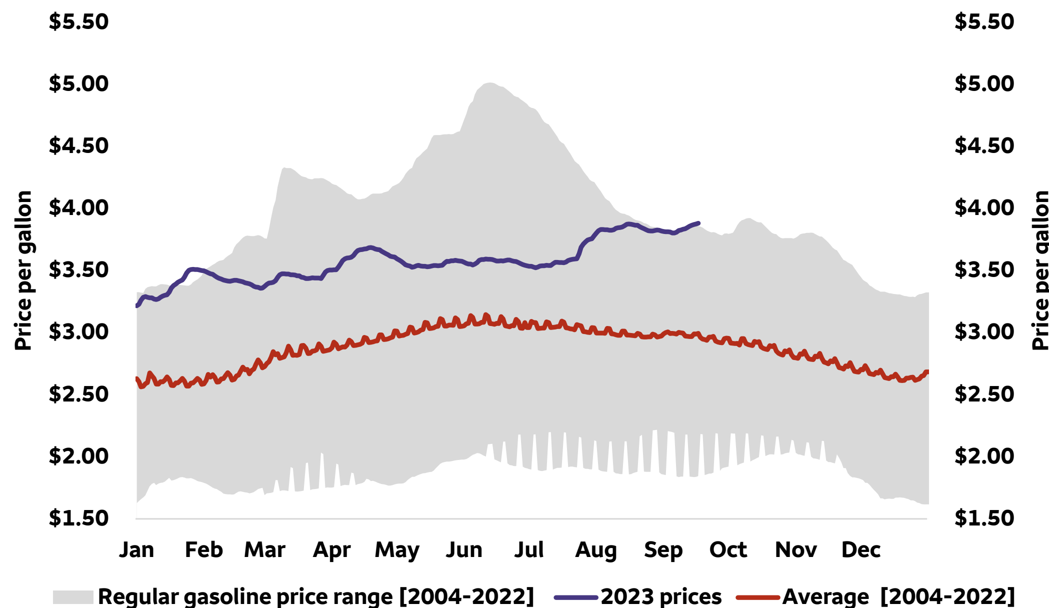
Crude oil prices have been on a tear this summer. After spending much of the springtime bouncing between $65 and $75 per barrel, WTI crude hit $90 per barrel last week. The impact was seen in U.S. gasoline prices, which hit an average of $3.81 per gallon on September 18. This was the highest price seen this late in the summer since 2004 at a time when prices would typically roll over from less seasonal demand (see chart).

As expected, such a big move in gasoline prices has caught the attention of consumers, investors, and politicians alike. The White House, especially, has been commenting more regularly on the level of gasoline prices. President Biden recently made reference to the strain that higher gasoline prices have placed on family budgets, and that he will be "laser focused on cutting energy costs, including by investing in clean energy to bolster our energy security."[1]

While some may find comfort in such pronouncements, we do not see energy prices coming down anytime soon, and we do not believe that there is much that the U.S. government can do about it. First, the rise in oil prices is global — driven by supply and demand globally — not only in the U.S. Second, the main driver of the recent move in oil prices is a lack of supply. While U.S. oil producers do have the capacity to increase supply, many producers remain hesitant as current U.S. policies incentivize renewable energy over fossil fuels. Third, we expect that investments in clean energy should not have any positive short-term impacts on energy prices. Lastly, the U.S. government will not have the Strategic Petroleum Reserve (SPR) to draw on in 2023, as it did in 2022, when it wanted to force gasoline prices lower. The SPR today sits at its lowest level since 1983.

The bottom line is that we do not see relief from high energy prices anytime soon in the U.S., and we believe there is not much the U.S. government can do about it.

Seasonality of gasoline prices



Sources: Bloomberg, American Automobile Association, and Wells Fargo Investment Institute. Daily data is from March 1, 2004 – September 18, 2023.

1. "Statement from President Joe Biden on August Consumer Price Index." White House briefing room statement. September 13, 2023.

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Alternatives

Boris Valentinov, CFA
Lead Investment Research Analyst

Private infrastructure growth fuels secondary market

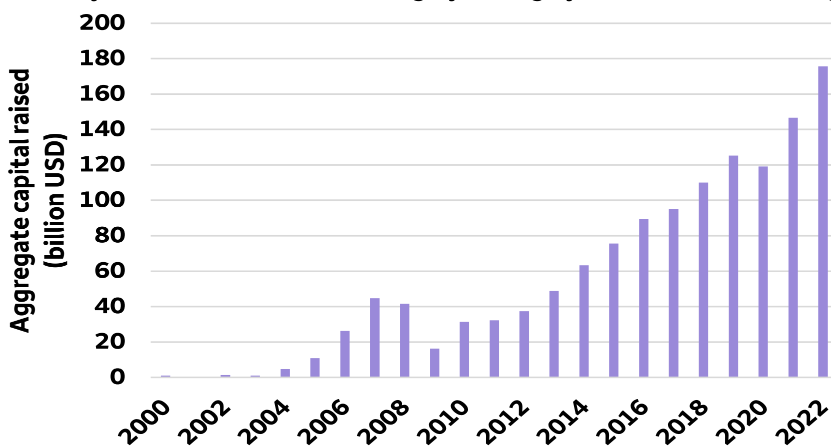
The private infrastructure primary market has experienced five-fold growth in fundraising over the past decade, driven by the sustained low interest rate environment and consistent uncorrelated outperformance relative to other asset classes. In recent years, institutional investors have increased their allocations to infrastructure, and alternatives generally.

This has led to notable expansion in secondary infrastructure investment opportunities, as the total addressable market has continued to grow and both limited partners and infrastructure sponsors have sought more regular liquidity. Other factors that have contributed to growth in the secondary infrastructure market are the secular trend of active portfolio management among global private fund investors and the proliferation of continuation funds, as underlying assets outlive finite fund structures.

In contrast to the market size growth and increasing supply of deals, buyer demand in the secondary infrastructure space has been limited by information disadvantages, restricted manager access, and lack of scale. In our view, this imbalance of supply and demand can result in potential opportunities for qualified investors to acquire high-quality infrastructure assets in mature, seasoned fund holdings at attractive valuations.

In addition to buyer-favorable conditions, we believe accessing infrastructure through the secondary market has the potential to offer several other advantages — elimination of blind pool risk, a shorter time frame to harvest investments, and higher current yield. There are also challenges — difficulty in obtaining information to value individual assets, lack of transparency from fund sponsors, and limited partners' reluctance to publicly dispose of their commitment. Overcoming such hurdles requires extensive manager expertise, a strong industry network, as well as the ability to transact quickly, confidentially, and in all sizes. If executed well, a secondary infrastructure strategy may have the potential for qualified investors, in our view, to deliver outsized returns relative to its level of risk.

Primary infrastructure fundraising by vintage year from 2000 through 2022



Sources: Preqin and Wells Fargo Investment Institute. Data as of September 20, 2023. Vintage year=year at which the portfolio investment held its first closing. **Past performance is not a guarantee of future results.**

Secondary investments are interests in existing private equity funds that are acquired in privately negotiated transactions after the end of the private equity fund's fundraising period. Typically these funds have portfolios of existing investments as well as capital available for new investments. 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 25, 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

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. **Preferreds securities** have special risks associated with investing. Preferred securities are subject to interest rate and credit risks. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. **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. 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.

Secondary investments – the purchase of existing partnership interests in private fund vehicles. At the most fundamental level, secondary transactions involve the sale and transfer of an existing limited partnership interest in a private equity fund, or a portfolio of funds, from one investor to another. As a result, sellers receive liquidity for their stake in the investment and are released from any unfunded portion of their capital commitment. The buyer agrees to pay a predetermined price for the interest, often at a discount to Net Asset Value (NAV). By so doing, the buyer agrees to take on future funding obligations in exchange for future distributions from the investment. The most basic – and common – type of secondary transaction involves the sale of a limited partnership interest in a single private equity fund. However, transaction characteristics can take on more complex structures involving portfolios of funds, general partnership interests, direct investments and structured or deferred payment arrangements.

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

WFII guidance definitions

Most favorable: WFII's highest conviction guidance that indicates a strong desire to overweight an asset class (or sector) within a portfolio. It also communicates that, over a tactical time frame, WFII views the asset class (or sector) as offering investors a very attractive risk/reward opportunity.

Favorable: Guidance that indicates a desire to overweight an asset class within a portfolio. It also communicates that, over a tactical time frame, WFII views the asset class (or sector) as providing investors with an attractive risk/ reward opportunity.

Neutral: Guidance that indicates a desire to maintain an asset class near the long-term (strategic) allocation guidance within a portfolio. It also communicates that, over a tactical time frame, WFII views the asset class (or sector) as providing investors with an acceptable risk/reward opportunity.

Unfavorable: This WFII guidance level indicates a desire to underweight an asset class (or sector) within a portfolio. It also communicates that, over a tactical time frame, WFII does not view the asset class (or sector) as providing investors with an attractive risk/reward opportunity.

Most unfavorable: WFII's highest conviction guidance indicating a strong belief in underweighting an asset class within a portfolio. This also communicates that, over a tactical time frame, WFII views the asset class (or sector) as offering investors a very unattractive risk/reward opportunity.

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MSCI China Index captures large and mid-cap representation across China H shares, B shares, Red Chips and P Chips. With 140 constituents, the index covers about 85% of the China equity universe.

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

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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