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Investment Strategy

Weekly guidance from our Investment Strategy Committee **October 2, 2023**

Global Macro Spotlight: Congress dodges the shutdown, for now 2

- Financial markets initially may welcome an 11th-hour continuing resolution to keep the U.S. government open until mid-November. However, as the short clock to mid-November ticks down, the prospect that Congress has postponed but not avoided a shutdown leaves intact the economy's underlying vulnerabilities and potential equity and bond market volatility.
- We encourage investors to stay aligned with our more defensive portfolio guidance, positioning for an economy approaching an anticipated recession.

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- While the importance of a reliable broadband connection was highlighted during the pandemic, many flaws within the infrastructure were highlighted as well.
- We favor the broadband providers within the service footprints receiving the largest amount of funding, as we believe they appear well positioned to expand their network and subscriber base.

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- Municipal bonds have historically seen negative performance during September and October, followed by a rebound in November and December.
- A pullback in the market could potentially offer a more attractive entry point heading into the fourth quarter, when technicals have traditionally been more favorable.

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- Despite a challenging comparison quarter, real estate investment trust (REITs) were able to generate reasonable growth in funds from operations (FFO) per share and same-store net operating income.
- Given current economic conditions, we recommend investors interested in REITs focus on the data center, industrial, self-storage, and residential REIT sub-industries.

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- Middle market buyout deal volumes have grown relative to the larger buyout deals, as deal financing through private direct lenders has remained accessible to the middle markets.
- In the past year, middle market buyout funds have outperformed large buyout funds by over 5.0%.

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Global Macro Spotlight

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Congress dodges the shutdown, for now

Congress averted a government shutdown with an 11th-hour continuing resolution, which extends current spending levels for 45 days, into mid-November. Financial market consensus has been expecting a shutdown for weeks, so the last-minute agreement is likely to cheer many investors as October's trading begins.

Nevertheless, we believe a more realistic appraisal is more sobering. First, we are skeptical that Congress can so quickly hammer out compromises on the 12 spending bills by November 17, despite progress with Senate and House versions addressing the majority of them. Second, and to this point, the fact that the continuing resolution excluded funding for Ukraine and border security provisions signals the persistent and deep divisions — not only between but within the two parties. Both parties have experienced frustration from the intransigence of a few of their members in recent years. Third, House Speaker Kevin McCarthy defied the Freedom Caucus of his party by counting on Democratic votes to pass the bill, challenging that faction's threat to unseat him as Speaker if he were to pass legislation without their support. Speaker McCarthy may choose to use this strategy again. However, If the leadership challenge succeeds, it is unclear how Congress can secure this important leadership position while also negotiating the spending bills.

For these reasons, we believe that the shutdown that the markets have been expecting is still very much in play for 2023. Moreover, by delaying the hard decisions, Congress puts its discussions even closer to the January and April deadlines to approve a budget or face 1% spending reductions to discretionary spending. (This provision was part of the debt ceiling agreement signed into law on June 3, 2023.)[1]

For perspective, any shutdown would leave untouched the 65% of mandatory, or entitlements, spending — including Social Security, Medicare, and Medicaid. And only that portion of discretionary spending deemed nonessential would be affected by a shutdown. Unfortunately, that would include the government's data mills, making it far more difficult to monitor the economy — notably for the Federal Reserve (Fed) — at a crucial juncture in monetary policy.

Essential services would continue, including defense and border protection, in-hospital care, air traffic control, law enforcement, and power grid control. However, the economy would bear the full impact of the shutdown on discretionary spending — over 26% of the budget this past fiscal year — because payments for essential, appropriated services would be made only after those bills have been approved. And if the past is any guide, absenteeism among stretched, essential-service employees could impair those services remaining open.

What a shutdown later in the year could mean for investors

Government and private estimates of lost real gross domestic product (GDP) center around 0.2% of GDP, typically recouped soon after a reopening.[2] The economic damage in past shutdowns has come from the ripple effect of lost

1. If by January 1, 2024 Congress has not passed all 12 appropriations bills or a full-year continuing resolution, then the Fiscal Responsibility Act (FRA) of 2023 requires a 1% cut to spending caps (relative to fiscal year 2023 levels). If Congress meets neither of those same two conditions by April 30, 2024, then the 1% spending cut comes into effect. Source: "China, Government Shutdown, & 2024 Presidential Race Set to Grab Investors' Attention", Strategas, August 11, 2023.
2. Goldman Sachs, "How much does a U.S. government shutdown cost the economy?" September 1, 2023. Congressional Budget Office, "The Effects of the Partial Shutdown Ending in January 2019," January 2019. Office of Management and Budget, "Impacts and Costs of the October 2013 Federal Government Shutdown," November 2013.

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spending on the economy by the government, its workers, smaller-business vendors, and other federal contractors. Moreover, consumer and business sentiment historically has suffered from the uncertainties created by lost government services, apparent from the divot in consumer sentiment indexes during each of the three longer shutdowns since the mid-1990s.

Historically, Treasury yields have fallen in the weeks before, during, and after the three long shutdowns depicted in Table 1. However, yields have risen ahead of this shutdown as the market adjusts to the (Federal Reserve's (Fed's) "higher for longer" messaging. We see the potential for further upside to rates — a repeat of the temporary increase in Treasury yields following the 2013 shutdown — due to a pullback by investors dissatisfied with rising deficits and interest expenses. Dissatisfaction over the budget could be punctuated by a possible outlook downgrade from the last of the major rating agencies assigning an AAA rating to Treasury debt.

Table 1. Asset performance around long government shutdowns*

	1995 – 1996**	2013**	2018 – 2019**
S&P 500 Index	+5.9%	+6.2%	+2.6%
% change in U.S. dollar	+3.6%	-0.9%	-0.8%
Change in 10-year U.S. Treasury yield	-24 basis points***	-21 basis points	-37 basis points

Sources: Wells Fargo Investment Institute and Bloomberg. *Performance period includes cumulative change three weeks prior to the government shutdown, during the shutdown, and four weeks after the shutdown. **The 1995 – 1996 government shutdown occurred between December 16, 1995 and January 6, 1996. 1995-1996 shutdown returns for S&P 500 Real Estate sector are unavailable. The 2013 government shutdown occurred between October 1, 2013 and October 17, 2013. The 2018 – 2019 government shutdown occurred between December 22, 2018 and January 25, 2019. *** One basis point equals 0.01%. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

S&P 500 stocks typically sagged immediately before and through the early part of the longer shutdowns in 1995 – 1996, 2013, and 2018 – 2019, but quickly regained composure after the government reopened in each instance. In fact, a healthy gain, on average, after the past three longer shutdowns was broad-based across the S&P 500's 11 sectors.[3] If a new shutdown develops, however, it could risk aggravating other potential body blows to the economy as the year rounds to a close. That mosaic of negatives includes renewed student-debt repayments, the United Auto Workers strike, rising fuel costs, the growing fiscal deficit, and higher interest rates.

Government shutdowns can stop outlays to industrial firms, but we remain favorable on the Industrials sector when we consider the positive trends in several sub-industries. We believe the strongest theme in the Industrials sector is the long-term structural buildout in business capital goods spending and infrastructure improvements — unlikely to be derailed by a temporary shutdown.

We encourage investors to look beyond the market's twists and turns in the weeks during and immediately following a shutdown by aligning with our more defensive portfolio guidance, positioning for an economy approaching an anticipated recession. That includes a focus on quality and liquidity in equities, as well as a similar bias to investments in the fixed-income space split between short- and long-term securities.

3. 1995-1996 shutdown returns for S&P 500 Real Estate sector are unavailable.

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Equities

Thomas Christopher
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Broadband funding should offset capital spending needs

The pandemic highlighted the importance of a reliable broadband connection while also calling out substantial deficiencies within the broadband infrastructure. Multiple government-sponsored programs have recently been implemented with the intent to provide reliable broadband coverage to unserved and underserved regions of the country, notably within rural areas. These programs should increase the number of broadband-connected households while potentially expanding overall user bases.

The cable and broadband landscape remains competitive and has become quite crowded, notably from non-traditional players. Consequently, we believe near-term broadband subscriber growth may be subdued relative to historical levels, likely translating into lower churn and subscriber growth. While the broadband environment may not revert back to the high-growth environment from just a couple years ago, cable companies may look for ways to accelerate subscriber growth.

The major wireless and broadband providers have indicated they are nearing peak levels of capital spending.[4,5] The wireless carriers have been steadily deploying recently acquired spectrum across their networks. Meanwhile, the cable companies continue to edge out their service footprint and enhance offerings — primarily wireless service — to grow their user base. We believe the Broadband Equity Access and Deployment (BEAD) program should help in an effort to supplement capital spending needs. The BEAD program is part of the broader infrastructure bill passed into law in 2021, allocating more than $42 billion to help revitalize the U.S.'s digital infrastructure and provide reliable high-speed internet. Funds should begin to be distributed in early 2024.

We favor the broadband providers within the service footprints expected to receive the largest amount of funding, as we believe they should be able to edge out and expand their network, enhance product offerings, and grow their subscriber base.

Table 2. Top and bottom five states allocated funds

State	Allocation amount
Texas	$3.3 billion
California	$1.9 billion
Missouri	$1.7 billion
Michigan	$1.6 billion
North Carolina	$1.5 billion

State	Allocation amount
Massachusetts	$147 million
Connecticut	$144 million
North Dakota	$130 million
Rhode Island	$109 million
Delaware	$108 million

Sources: "Biden-Harris Administration Announces State Allocations for $42.45 Billion High-Speed Internet Grant Program as Part of Investing in America Agenda". White House Press Release. WhiteHouse.gov and Wells Fargo Investment Institute. *Guam, Puerto Rico, the District of Columbia, Northern Mariana Islands, American Samoa, and U.S. Virgin Islands were also allocated funds. Data as of June 26, 2023.

4. AT&T Q2 2023 Earnings Call FactSet Transcript dated July 26, 2023
5. Verizon Communications Q2 2023 Earnings Call FactSet Transcript dated July 25, 2023

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Fixed Income

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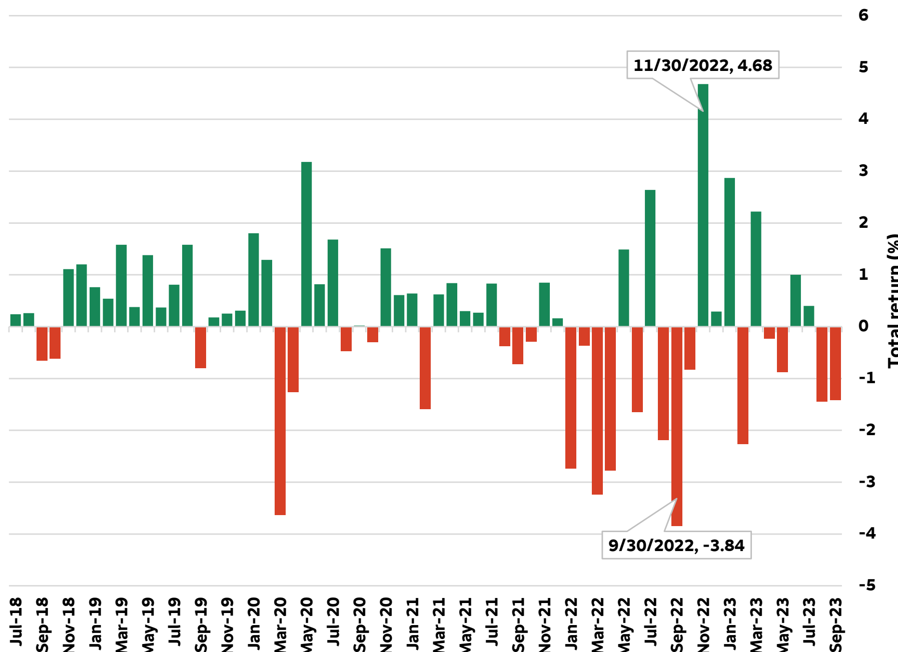
Fall pullback could offer holiday buying opportunity

Despite a recent sell-off across fixed income assets because of the Fed indicating that it intends to keep interest rates higher for longer, municipal bonds (munis) have managed to outperform year-to-date.[6] Negative net supply and reinvestment demand, particularly during the summer, have provided support to muni bond valuations. However, municipal bonds have historically seen negative performance during September and, to a lesser extent, October. For example, in September 2022, munis returned -3.8%, the worst single month of performance going back to 2018 (according to the Bloomberg U.S. Municipal Bond Index).

Since 2018, the average return for munis in September and October has been -1.2% and -0.4%, respectively. This trend is primarily driven by the end-of- summer reinvestment season and a relative increase in new issuance. Conversely, over the same period, the average return for munis in November and December has been 1.4% and 0.5%, respectively. In November 2022, munis returned 4.7%, the best single month of performance going back to 2018. While past performance is not indicative of future results, we expect that a pullback in the market may potentially offer a more attractive entry point heading into the final quarter of the year, when the technicals for munis have traditionally been more favorable.

The Bloomberg U.S. Municipal Bond Index has returned 0.2% year to date, outperforming the Bloomberg U.S. Aggregate Bond Index, which has returned -0.6%. Sectors that have notably outperformed the broader municipal market include tobacco (2.0%), transportation (1.0%), and health care (0.5%) while laggards have included education (-0.2%), water and sewer (-0.3%), and general obligation (-0.4%).

Bloomberg U.S. Municipal Bond Index Monthly Total Return



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of September 22, 2023. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

6. All year-to-date figures as of September 22, 2023.

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Real Assets

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Equity Sector Analyst, Real Estate (REITs)

REIT second-quarter earnings review

As second-quarter 2023 REIT earnings have been reported, we believe a review of REIT earnings is timely.

Data provided by the National Association of Real Estate Investment Trusts (Nareit) shows the REIT industry generated growth in FFO, the primary earnings measure utilized by REITs, per share of 5.4% over second-quarter 2022 results. These results follow first-quarter 2023 FFO per share growth of 6.4%. Additionally, REITs reported 5.0% growth in net operating income (NOI) from their same-store portfolios relative to second-quarter 2022. Most REIT investors view same-store performance as a good indicator of internal growth.

We view the FFO per share and same store NOI growth generated by the REIT industry during second-quarter 2023 as relatively attractive despite moderation from recent quarters. It is worth noting we believe REITs faced challenging comparisons with second-quarter 2022; data from Nareit indicated REITs generated 14.7% growth in FFO per share in second-quarter 2022 (likely reflecting an economic recovery as business operating restrictions mandated by the pandemic were lifted) and a 7.9% increase in same-store NOI.

In conjunction with their second-quarter 2023 earnings, the majority of REITs we closely monitor updated their 2023 earnings guidance. In general, the bulk of the REITs we closely monitor either reiterated their prior 2023 earnings guidance or made modest adjustments to their 2023 earnings expectations. Given current economic conditions, we recommend investors interested in REITs focus on the data center, industrial, self-storage, and residential REIT sub-industries.

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Alternatives

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Global Alternative Investment Strategist

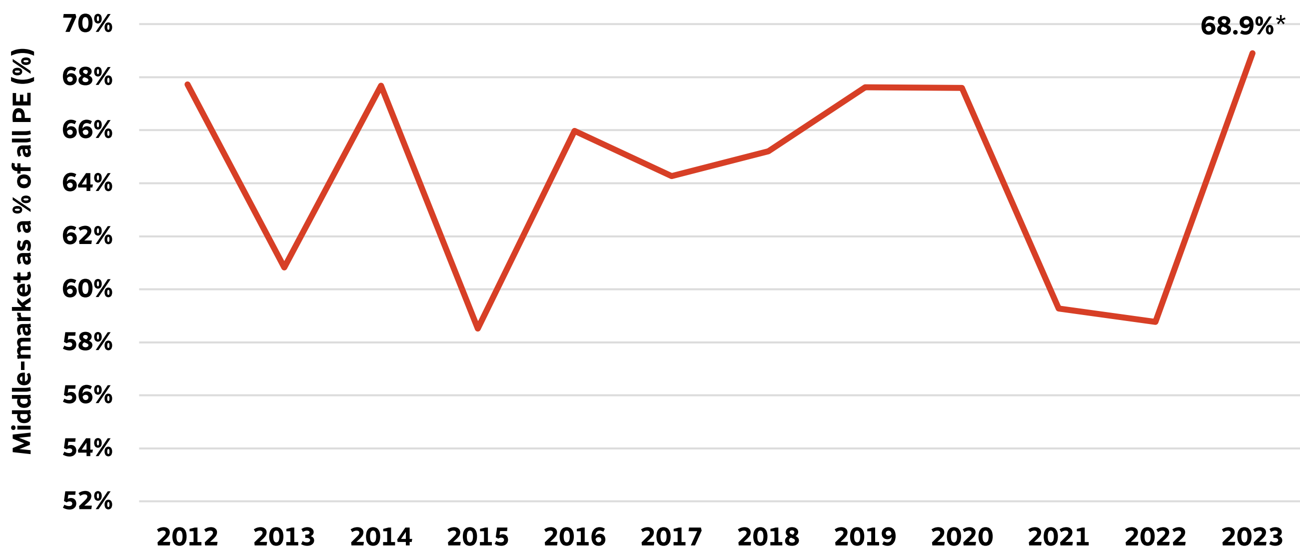
Middle market funds gain share in declining buyout market

Middle market buyout activity hasn't been immune from the decline in deal activity since the peak in late 2021, but we believe the sector has held up relatively well versus larger buyout deals. According to data from Pitchbook, year to date, through end of June, middle market buyout deals accounted for approximately 69% of the deal volume, a notable increase from 59% registered in all of 2022. In addition, while the large buyout funds[7] held a performance advantage during 2021 that trend has reversed since the second quarter of 2022. Middle market funds[8] outperformed by over 5.0% over the past year, as of the first quarter of 2023.

The trends we believe are favoring middle market buyout strategies may be a result of several factors, most notably the more constrained lending environment that has disproportionately affected the large buyout markets. While larger deals have predominantly relied on financing via the leveraged loan market, where issuance has dwindled, small and middle markets have instead looked to private direct lenders that have continued to provide capital for new loan originations. In addition, according to Pitchbook, institutional investors have increasingly reduced exposure to markets reliant on publicly syndicated loans, reducing demand for larger deals. Lastly, valuations in the middle markets have declined, leading to a more buyer-friendly market in recent quarters. We believe the elevated interest rate environment should continue to act as a headwind as debt service costs rise for many small and middle market companies; yet, in our view, this may potentially ensure market dynamics remain tilted in favor of buyers for some time.

Given our longer-term cyclical outlook, we remain favorable on small-mid buyout strategies and neutral on the large buyout category, as we expect many of these factors to remain in place for the foreseeable future.

U.S. private equity middle market buyout value as a share of all private equity buyout value



Source: Pitchbook. Data as of June 30, 2023. *2023 data through June 30, 2023. PE= private equity. The universe is middle market buyout as a percentage of all private equity buyout. The "all private equity – buyout" universe is defined as all funds listed in the Pitchbook database that are classified in the buyout category. Middle market buyout fund universe is defined as buyout funds that raise between $100 million to $5 billion in capital and are listed in the Pitchbook database. **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.

[7] Large market buyout private equity fund universe is defined as buyout funds that raise $5 billion or more in capital and are listed in the Pitchbook database.

[8] Middle market buyout fund universe is defined as buyout funds that raise between $100 million to $5 billion in capital and are listed in the Pitchbook database.

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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, October 2, 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. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. 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. **Leveraged loans** are generally below investment grade quality ("high-yield" securities or "junk" bonds). Investing in such securities should be viewed as speculative and investors should review their ability to assume the risks associated with investments which utilize such securities. 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. There are special risks associated with an investment in **real estate**, including the possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions. Other risks associated with investing in listed **REITs** include the use of leverage, unexpected reductions in common dividends, increases in property taxes, and the impact to listed REITs from new property development.

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

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. Municipal Bond Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds.

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.

S&P 500 Real Estate Index comprises those companies included in the S&P 500 that are classified as members of the GICS Real Estate sector.

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