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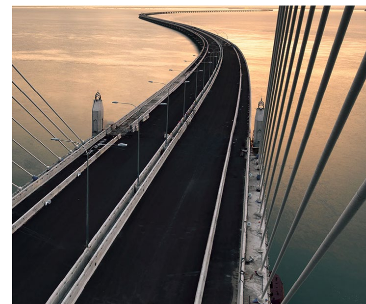

Investment Strategy

Weekly guidance from our Investment Strategy Committee **October 9, 2023**

Global Macro Spotlight: Investors deal with the pandemic's aftermath....2

- The aftershocks of the pandemic are still shaping this economic cycle, reversing historical dynamics between the goods and services sectors.
- An analysis of gross domestic product industry growth during the 2007 – 2009 cycle reiterates our view of an economy cascading into a recession.

Equities: Higher rates likely to deliver another round of pain........................4

- The recent rise in interest rates increases the possibility of another credit crunch, and we believe U.S. Small Caps and Emerging Market Equities, along with the Real Estate and Consumer Discretionary sectors, will feel the most pain.
- We believe investors should continue to avoid these areas and focus on the favorable-rated U.S. Large Cap asset class, and the Industrials, Materials, and Health Care sectors.

Fixed Income: Hold the line as long-term yields increase..............................5

- For now, in our view, there doesn't seem to be much keeping long-term yields from pushing higher as they react to strong technical forces between supply and demand, higher expected Treasury issuance, and a resilient consumer.
- Still, despite rising yields, we remain favorable on duration[1] and buyers of long-term fixed income. We believe that yields at these levels are potentially good entry points.

Real Assets: Mortgage applications slump to 28-year low.............................6

- Mortgage applications have dropped to a 28-year low, as higher interest rates weigh on affordability and demand for home purchases.
- While higher interest rates are a headwind for real estate investment trusts, we believe some residential sub-sectors could benefit as consumers are pressured to rent for longer.

Alternatives: Private real estate remains under pressure...............................7

- The private real estate market remains under pressure from rising interest rates, tightening lending standards, slower capital commitments, and a potential recession.
- Given these growing distresses and public-private market price discrepancies, we remain cautious in our outlook for the private real estate market.

Current tactical guidance...8

[1] Duration is a measure of a bond's interest rate sensitivity.

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Global Macro Spotlight

Jennifer Timmerman
Investment Strategy Analyst

Gary Schlossberg
Global Strategist

Investors deal with the pandemic's aftermath

Economic cycles often have similarities, but no two are exactly alike. Table 1 illustrates the similarities and differences between performance this year and what preceded a more severe 2007 – 2009 recession than the moderate slowdown we have forecast for 2023 and 2024. Then, as now, economic data were uneven — that is, trending weaker, but with pockets of strength. And then, as now, the economy had support from essential service industries, such as financial services, education, and government. Another similarity has been the leading-edge role housing has played in an approaching economic slowdown, due to the jolt from higher mortgage rates.

Table 1. Industry performance rhymes in this economic cycle compared to 2007 – 2009*

	2007 – 2009 Economic cycle	2007 – 2009 Economic cycle	Current cycle
Industry/sector	Pre/early-recession[1]	Mid/late-recession[2]	Pre-recession[3]
Residential construction	**Low growth**	**Low growth**	**Low growth**
Non-residential construction	**High growth**	**Low growth**	**Low growth**
Manufacturing	**Low growth**	**Low growth**	**High growth**
Durable goods	**Low growth**	**Low growth**	**High growth**
Nondurable goods	**Low growth**	**Low growth**	**Low growth**
Retail trade	**Low growth**	**Low growth**	**Low growth**
Transportation and warehousing	**Low growth**	**Low growth**	**High growth**
Travel & entertainment	**Low growth**	**High growth**	**High growth**
Financial services (including real estate)	**High growth**	**High growth**	**High growth**
Professional and business services	**High growth**	**High growth**	**High growth**
Education, health care and social services	**High growth**	**High growth**	**High growth**
Information	**High growth**	**High growth**	**High growth**
Utilities	**High growth**	**Low growth**	**Low growth**
Government	**High growth**	**High growth**	**High growth**

Sources: Wells Fargo Investment Institute and U.S. Commerce Department. Data as of September 25, 2023. 1 = 2007 Q4 – 2008 Q2. 2 = 2008 Q3 – 2009 Q2. 3 = 2022 Q3 – 2023 Q1. *As measured by quarter-to-quarter growth in industry real gross domestic product (GDP) compared to real GDP growth for the overall economy, smoothed using three-quarter moving average data for periods specified. "High growth" denotes industry GDP growth above the growth rate for the overall economy; "Low growth" signals industry GDP growth below the growth rate for the overall economy. Note: Latest data for industry real GDP is through 2023 Q1. **Past performance is no guarantee of future results.**

The differences are also notable. First, the 2007 – 2009 recession's severity stemmed from large household mortgage debt and a greater degree of leverage — borrowing to boost returns—in both the household and banking sectors. That is not the case today, due to bank capital rules, lower mortgage debt, and a tight housing market shoring up home values. These are the key reasons we anticipate a much more moderate economic downturn this time compared to the 2007 – 2009 version.

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Instead, we believe this cycle's defining difference with the past continues to be the pandemic and its after-effects, which fueled strong initial growth and even today are tempering the economy's inevitable slowdown. Sheltering in place during an economic lockdown initially favored goods over services spending in the brief, but deep, recession over three years ago, followed by a rotation toward travel, entertainment, and other services spending as the economy reopened. This is the reverse order of what occurred, on average, in the first year or two of seven prior recessions.

That reversal continues today. For example, the resilience of durable goods manufacturing is attributable to catch-up auto output from shortages earlier in the pandemic. Another reflection of pent-up demand this cycle has been the unusual strength of the travel and entertainment industry. We believe that an extended United Auto Workers strike would accelerate our expected slowdown in the manufacturing sector, though much of the auto industry's lost output would be regained once an agreement is reached.

Cascading cycle still in process

Notably, the role reversal of goods versus services performance has not prevented a typical cascading effect of industry performance, which we expect to become more uniformly weak at the onset of an economic slowdown. In the 2007 – 2009 cycle, the number of industries contracting jumped from 3 of 21 just prior to the deep 2007 – 2009 recession to a peak of 18 during the worst of the economic slump in late 2008 and early 2009. In what we believe will be a more moderate slowdown in the months ahead, the number of industries posting declines earlier this year in a slow-motion economic cycle actually surpassed those weakening on the eve of the last recession in 2007. A cascading effect should drive the number of slowing industries higher, once a recession takes hold, along with a typical increase in the dispersion of growth rates across industries.

Investment implications

The powerful technology stock rally this year has overshadowed the unusual pattern of goods versus service-industry performance shaping this economic cycle. Looking beyond industry-specific developments in tech, however, S&P 500 Index stocks of the benchmark's goods and services industries largely followed the pattern laid out by the economy since the onset of the pandemic. Recently, services-related stocks have given back some of those gains against goods-oriented stocks, as pent-up demand for travel and entertainment has eased and supply-chain disruptions affecting auto output have unwound.

If past is prologue, we believe the goods-focused portion of the S&P 500 Index should underperform the benchmark's services industries during our forecasted recession, much as it did during previous economic slowdowns. Weakness likely will be led by those industries selling big-ticket goods most sensitive to interest rates and whose purchases can be delayed until economic conditions improve.

These industries are concentrated in the Consumer Discretionary sector, for which we have an unfavorable rating. Our favorable ratings for Materials and Industrials — two other economically sensitive sectors — are based more on secular trends, such as the commodity super-cycle[2] and fiscal-policy support for capital goods and other industries within Industrials. In our view, these factors overshadow shorter-term threats to the two broad sectors from a weakening economy and are consistent with our overall defensive asset allocation guidance.

This prioritizes quality. We favor U.S. Large Cap Equities over international stocks, and we maintain a barbell approach to fixed income (balanced between short- and long-term securities).

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[2] Super-cycles are an extended period of time where commodity prices tend to move together. They are called super-cycles because these periods can last for 10+ years.

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Equities

Sameer Samana, CFA
Senior Global Market Strategist

Higher rates likely to deliver another round of pain

Long-term yields have broken out to 52-week highs (see chart below) and have shown no signs of slowing. Recent history shows that when rates accelerate to the upside, as they are now, the most fragile parts of the economy and markets feel the pain via lower multiples and/or a credit crunch. Last fall, higher rates impacted high-multiple growth stocks. This spring, they were enough to bring the viability of small- and mid-size banks into question. In these previous two periods, as volatile as rates were, economic growth was resilient enough to offset some of the impact.

Now, the economy is stalling out alongside rising rates, and we believe this time it may be the most economically sensitive asset classes and sectors that will struggle the most. Within asset classes, we believe U.S. Small Caps and Emerging Market Equities remain most vulnerable to a rise in borrowing costs that coincides with slowing economic growth. Within sectors, we believe Consumer Discretionary and Real Estate likely face the most intense headwinds from this toxic mix. The consumer has held up better than most anticipated given the slowing labor markets and the dwindling savings on household balance sheets, but we believe exhaustion is right around the corner.

With respect to real estate investment trusts (REITs), higher rates generally tend to be negative for property values, and we expect slowing growth to lead to a decline in occupancy rates. Instead of the aforementioned lower quality areas, we would continue to focus on the U.S. Large Cap asset class, and the Industrials, Materials, and Health Care sectors, in particular.

10-year U.S. Treasury (solid line), with 50-day (dashed line) and 200-day (dotted line) moving averages

Source: Bloomberg. Daily data from October 3, 2021 – October 3, 2023. RSI = Relative Strength Index. An index is not managed and not available for direct investment. Refer to index definitions at the end of report. **Past performance is no guarantee of future results.**

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Fixed Income

Luis Alvarado
Global Fixed Income Strategist

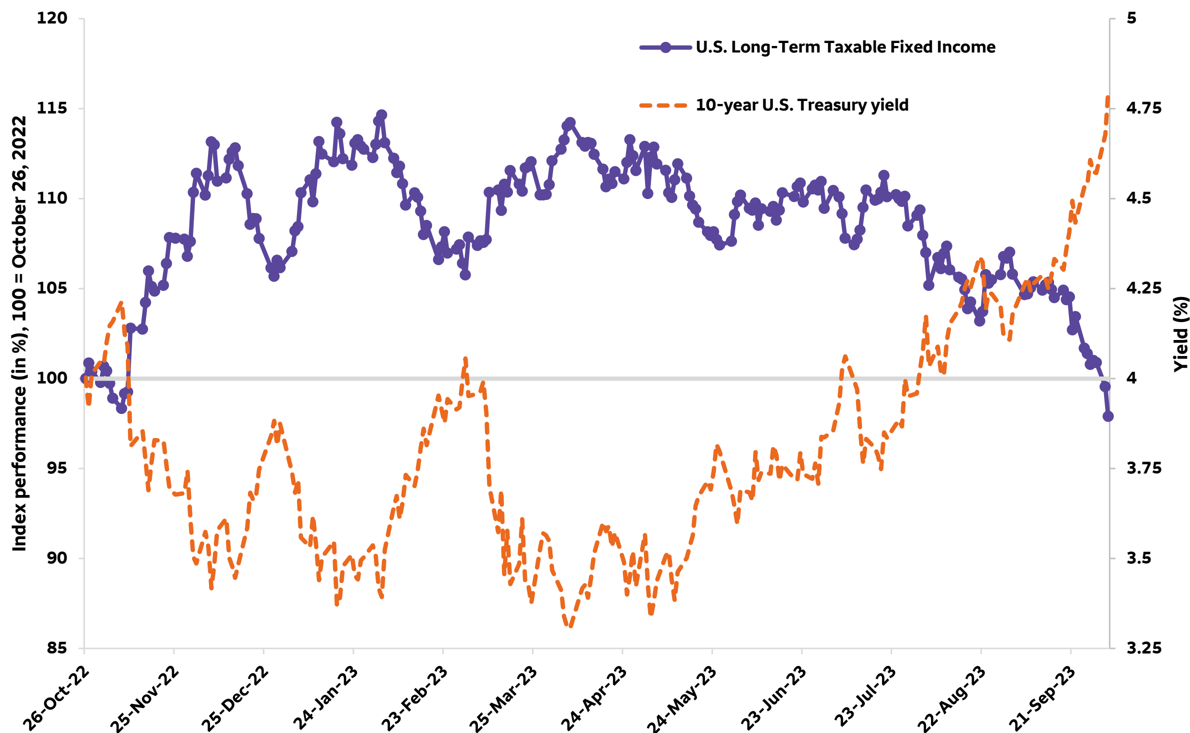
Hold the line as long-term yields increase

U.S. Treasury yields have increased substantially in the past three weeks, influenced largely by the Federal Reserve (Fed) vowing to keep interest rates higher for longer and implying that the hurdle to cut interest rates would be quite high. So far, we have experienced what we call in bond jargon a "bear steepening" of the yield curve. In simple terms, yields on the long end of the curve have been moving higher (driving prices lower) while yields on the short end have remained flat, effectively causing a steepening of the curve.

For now, in our view, there doesn't seem to be much keeping long-term yields from pushing higher as they react to strong technical forces between supply and demand; higher expected Treasury issuance and rising debt levels; higher cost of debt; a resilient consumer; and some dysfunction in Washington. The Fed could also increase rates further if inflation levels don't display a clear trend downward, so in our view, the bias in yields is to the upside. Still, despite rising yields, we remain favorable on duration and buyers of long-term fixed income. We believe that yields at these levels are potentially good entry points to consider for dollar-cost averaging.

In the past five Fed hiking cycles, we have observed that long-term yields tended to peak before the end of the tightening cycle. The U.S. Treasury yield curve remains inverted; however, it is becoming less inverted. A dis-inversion and an eventual steepening of the yield curve has also been a sign of an imminent recession. We believe fixed-income portfolios should benefit as yields decline (driving prices higher, see chart below) in anticipation of a potential economic recession and eventual rate cuts from the Fed in 2024.

Long-term fixed income total returns have benefited when yields decline



Sources: Wells Fargo Investment Institute and Bloomberg. Daily data as of October 3, 2023. Cumulative total return of long-term taxable fixed income from October 26, 2022, to October 3, 2023. U.S. Long Term Taxable Fixed Income = Bloomberg U.S. Aggregate 10+ Year Total Return Index. An index is not managed and not available for direct investment. Refer to index definitions at the end of report. **Past performance is no guarantee of future results.**

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Real Assets

"The best time to buy a house is always five years ago." — Ray Brown, musician

John LaForge
Head of Real Asset Strategy

Mason Mendez
Investment Strategy Analyst

Mortgage applications slump to 28-year low

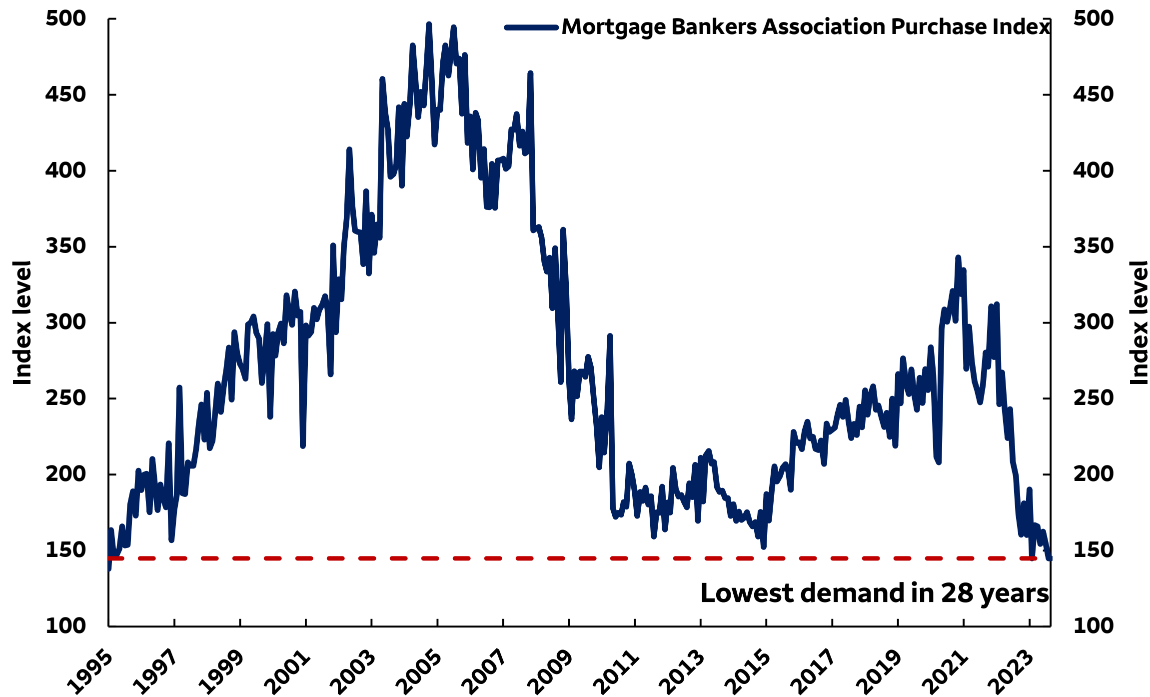
It is no secret that most real estate industries have struggled this year. And we suspect that most will continue to struggle into year-end as the Fed does not appear to be finished hiking interest rates. While tighter financial conditions have been a headwind for most REITs, some residential sub-sectors have outperformed the broader industry, as low housing affordability has pressured would-be home buyers to rent for longer.

These hopeful home buyers today are unfortunately facing the highest mortgage rates in 23 years, which, coupled with record high home prices, have crimped housing affordability. Mortgage applications, understandably, have dropped to their lowest level in 28 years (see chart) — lower even than the period following the 2007 – 2009 recession. Also problematic for home buyers are existing home inventories, which have continued to slide lower.

One major consequence to the lack of home affordability is that wannabe buyers have been forced to rent for longer. This trend has helped support select residential REIT sub-sectors in 2023, such as single-family homes and apartments. Year-to-date (as of September 29, 2023), the single-family home (11.02%) and apartment (-2.77%) REIT sub-sectors have both outperformed the broader FTSE NAREIT All Equity REITs Index (-5.61%).

The bottom line is that we remain unfavorable on REITs relative to the other 10 S&P 500 sectors, largely due to the current level of interest rates. Within the REITs sector, though, we remain relatively constructive (neutral) on the residential sub-sectors: single-family homes and apartments.

Mortgage demand



Sources: Bloomberg, Mortgage Bankers Association, and Wells Fargo Investment Institute. Data is monthly from January 1995 to September 2023. An index is not managed and not available for direct investment. Refer to index definitions at the end of report.

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Alternatives

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

Private real estate remains under pressure

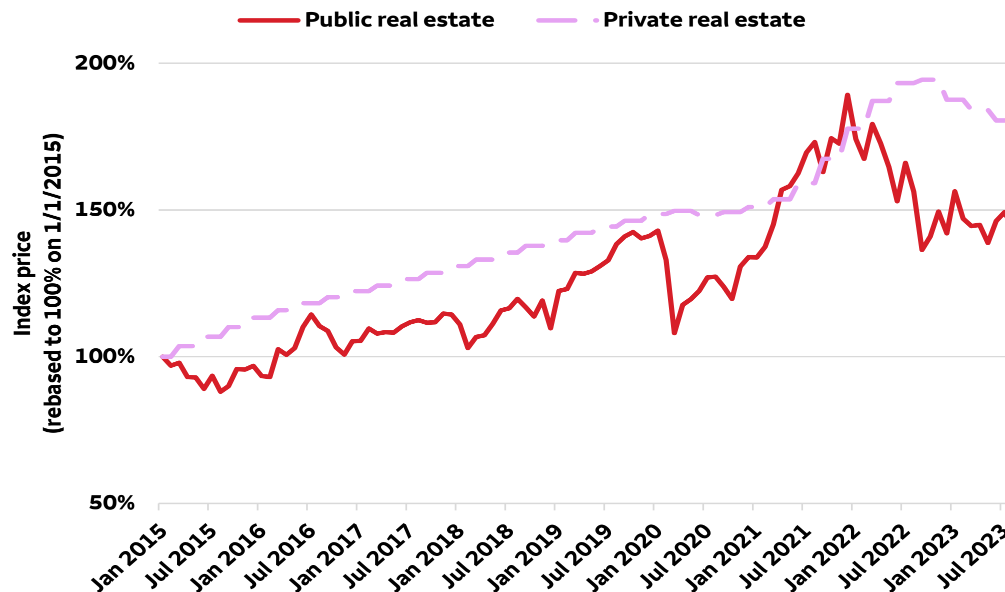
As we mentioned above, the commercial real estate market remains under pressure from rising interest rates. According to the Fed, over 60% of banks are tightening lending standards in commercial real estate during third-quarter 2023.[3] With many property loans coming due over the next few years, it appears to us that the recent trend of real estate properties experiencing distress, potentially leading to defaults, is likely to grow.

Given this backdrop, investors have slowed the pace of new capital commitments to public and private real estate investments (see chart). Over the first half of the year, fundraising was about 20% below the 10-year average, according to Pitchbook.[4] Within private real estate, over the first half of the year, opportunistic strategies garnered the majority of private real estate fundraising. This dynamic likely reflected investors' preference for strategies poised to capitalize on market dislocations. Opportunistic strategies often include flexible mandates and seek to capitalize on the disruptions and idiosyncratic opportunities that may be present in many sectors.

On the other hand, lower risk and lower return core and core plus strategies are on track for the slowest fundraising year since 2008. The return prospects of these strategies may be limited by rising interest expenses, inability to pass through costs, and the decreasing amount of loans available.

Although public real estate prices have seen material markdowns over the past year, the appraisal-based private market prices are often slower to adjust to reflect current market sentiment. As the chart shows, there is currently a notable gap between public and private prices, which we believe may narrow over time. This dynamic, along with a potential recession, leads us to remain cautious in our outlook for the private real estate market.

Public and private real estate index levels since January 2015



Source: Bloomberg and Wells Fargo Investment Institute. January 1, 2015, through August 31, 2023. Public real estate is represented by FTSE NAREIT all equity REITs Index. Private real estate is represented by NCREIF Property Index. An index is not managed and not available for direct investment. Refer to index definitions at the end of report. **Past performance is no guarantee of future results.**

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.

3. Net Percentage of Domestic Banks Tightening Standards for Commercial Real Estate Loans with Construction and Land Development Purposes. Federal Reserve Bank of St. Louis. Data as of October 5, 2023.

4. Pitchbook H1 2023 Global Real Estate Report. Data as of September 25, 2023.

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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 9, 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. **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. **Sector investing** can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. **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. **Real estate** has special risks including the possible illiquidity of 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.

A periodic investment plan such as dollar cost averaging does not assure a profit or protect against a loss in declining markets. Since such a strategy involves continuous investment, the investor should consider his or her ability to continue purchases through periods of low price levels.

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

Bloomberg U.S. Mortgage-Backed Securities (MBS) Index measures the performance of investment grade fixed-rate mortgage-backed pass-through securities of GNMA, FNMA and FHLMC.

Bloomberg U.S. Government/Credit Bond Index is a market-weighted index generally representative of intermediate and long-term government and investment grade corporate debt securities having maturities of greater than one year.

FTSE NAREIT All-Equity REITs 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.

Mortgage Bankers Association Purchase Index is a weekly report of mortgage loan applications based on a sample of 75% of U.S. mortgage activity.

NCREIF Property Index is a quarterly, unleveraged composite total return for private commercial real estate properties held for investment purposes only.

Relative Strength Index (RSI) is a momentum indicator that attempts to determine overbought and oversold conditions of an asset. It oscillates between 0 (very oversold) and 100 (very overbought).

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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