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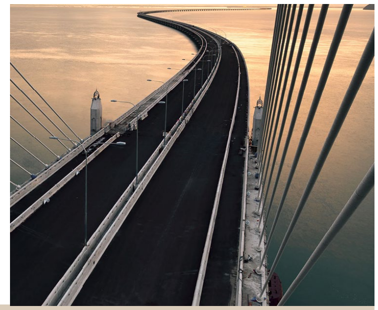
Investment Institute



Investment Strategy

Weekly guidance from our Investment Strategy Committee **October 23, 2023**

Real Assets Spotlight

"The more things change, the more they stay the same." — Jean-Baptiste Alphonse Karr, French journalist

John LaForge
Head of Real Asset Strategy

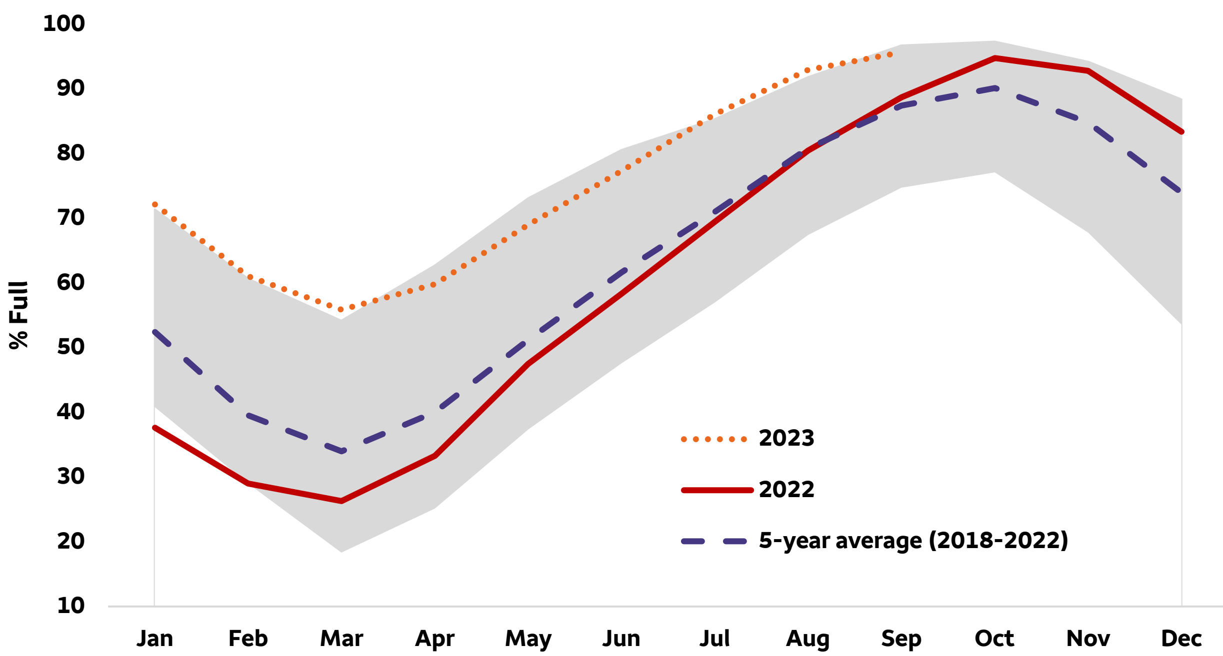
Mason Mendez
Investment Strategy Analyst

Europe's second winter without Russian gas

At this time last year, Europe was scrambling to contain an energy crisis. Natural gas prices had tripled to all-time highs, and the continent was desperate to secure and store as much natural gas as possible before winter arrived. Russia had been steadily cutting supplies to the continent, following the start of the Russia-Ukraine war. Russia cut natural gas supplies to Germany in half by June, and then entirely in September. Pre-conflict, Russia had accounted for more than 45% of the European Union's natural gas imports.

It was feared often during 2022 that Europe could not possibly fill the supply void left by Russia. Yet, it was filled, and then some. The solid red line in Chart 1 highlights Europe's natural gas storage levels throughout 2022. The purple dashed line represents the five-year storage average. Notice that during most of the year, Europe's natural gas storage levels lagged the five-year average, hence the persistent fear. Yet by September, Europe's natural gas storage levels had remarkably surpassed their five-year average.

Chart 1. Europe's current natural gas storage is 95% full



Source: Bloomberg and Wells Fargo Investment Institute. Monthly data is from January 2016 – September 2023.

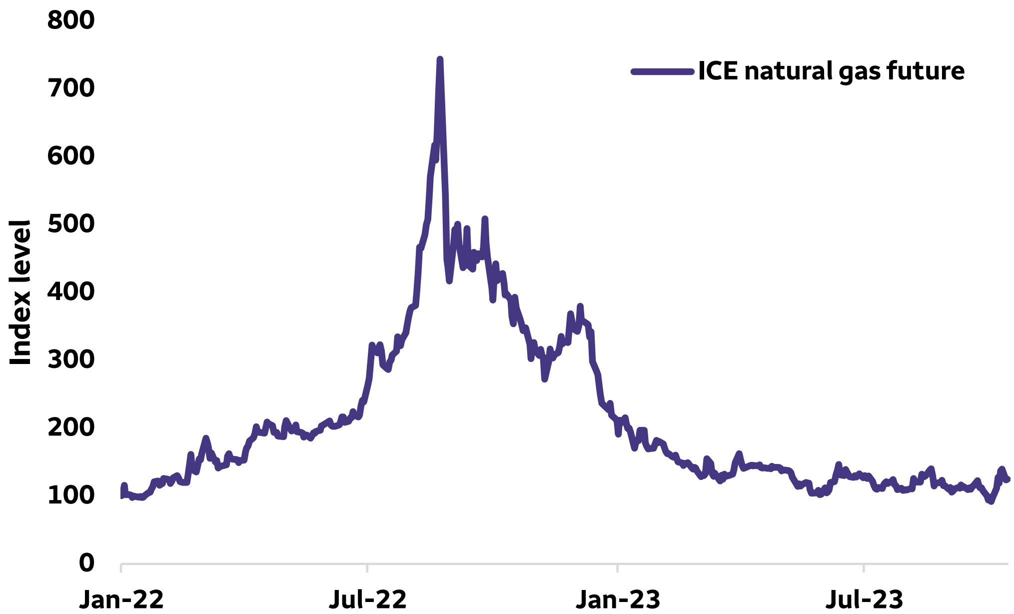
Europe's natural gas storage levels have continued to improve over the past year, which is also shown in Chart 1. The dotted orange line represents Europe's natural gas storage levels throughout 2023. As expected, with such high levels of storage, Europe's natural gas prices are down handily on the year, by roughly 34%, as of October 17.

Europe's supply turnaround has been impressive. Interestingly, though, it may surprise some to realize that the turnaround had less to do with importing or finding more natural gas than it did other factors. Milder weather played a role, as did policy changes, which led to record amounts of wind and solar capacity coming online.

Arguably the most influential factor, though, were high prices. As the old commodity adage goes, "high price cures high price." At one point in 2022 (August), natural gas prices had risen more than 500% year to date, and consumers reacted with record conservation. By the close of 2022, natural gas demand in the European Union had declined 813% — the steepest yearly decline on record.

All told, we remain hopeful that Europe will avoid an energy crisis during the 2023 – 2024 winter. We believe the continent's well-above-normal natural gas storage levels should keep heating prices relatively affordable, even with the price wild cards of weather and turmoil in the Middle East.

Chart 2. Europe's natural gas prices



Source: Bloomberg and Wells Fargo Investment Institute. Daily data is from January 4, 2022, through October 17, 2023, and indexed to 100 as of January 4, 2022.
Past performance is not a guarantee of future results.

Equities

Chris Haverland, CFA
Global Equity Strategist

Earnings may have declined for fourth straight quarter

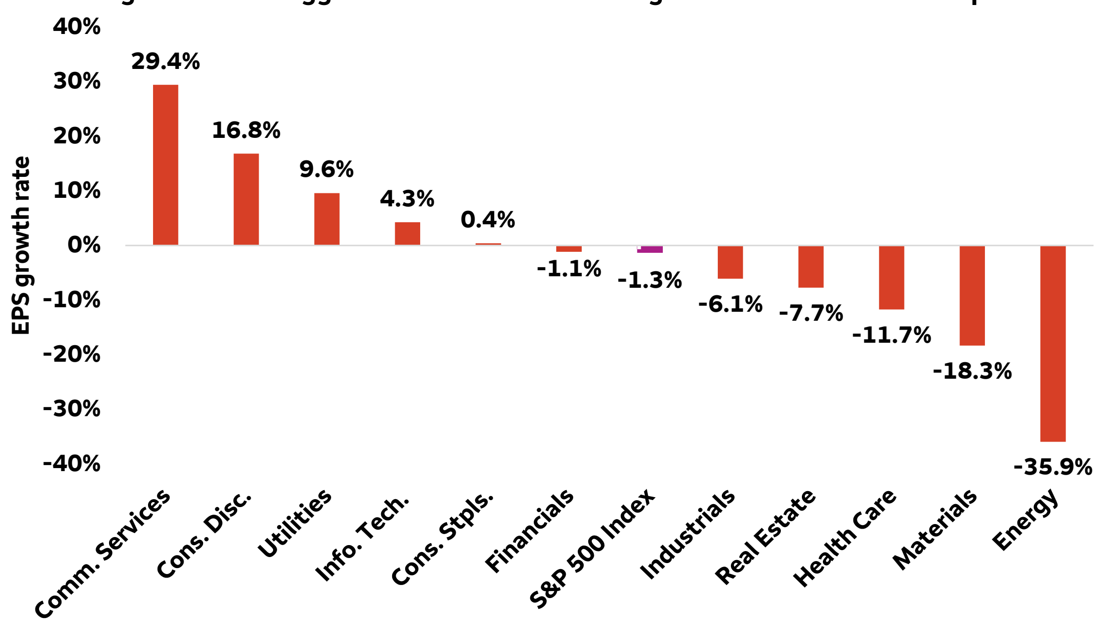
Third-quarter earnings season is upon us with Bloomberg consensus calling for S&P 500 Index profits to contract for the fourth consecutive quarter. Third-quarter earnings are expected to fall approximately 1%. However, if beat rates remain consistent with prior quarters, overall earnings could potentially end up in positive territory. Consensus shows revenue growth around 1% in the quarter, which implies margins should decline relative to third quarter 2022.

Six of 11 S&P 500 Index sectors are expected to be negative, with Energy sector earnings plunging more than 30% on tough comparisons to the elevated oil price environment in 2022. Excluding the Energy sector, S&P 500 Index earnings likely would be positive, and the operating margin would show expansion. Double-digit growth is expected in the Communication Services and Consumer Discretionary sectors.

While investors may yawn at a flat revenue and earnings reporting season, we believe forward guidance could provide fireworks. Many companies are still dealing with a tight labor market and an uncertain economic environment that could include a recession in the coming quarters. Additional headwinds to profit growth include: a weakening consumer, a rising dollar, increasing geopolitical tensions, and a higher cost of capital.

Surprisingly, 2024 Bloomberg consensus earnings estimates have moved higher over the past three months as the soft-landing scenario gained steam. We believe earnings will be challenged in the coming quarters as companies deal with a looming U.S. recession. In this environment, we maintain our preference for high-quality equities, favoring U.S. Large Cap Equities over U.S. Mid Cap and Small Cap Equities.

Bloomberg consensus suggests S&P 500 Index earnings contracted in the third quarter



Sources: Bloomberg and Wells Fargo Investment Institute. EPS = earnings per share. EPS growth measures actual third quarter 2023 EPS as of October 16, 2023, versus third quarter 2022 EPS. An index is unmanaged and not available for direct investment. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

Fixed Income

Luis Alvarado
Global Fixed Income Strategist

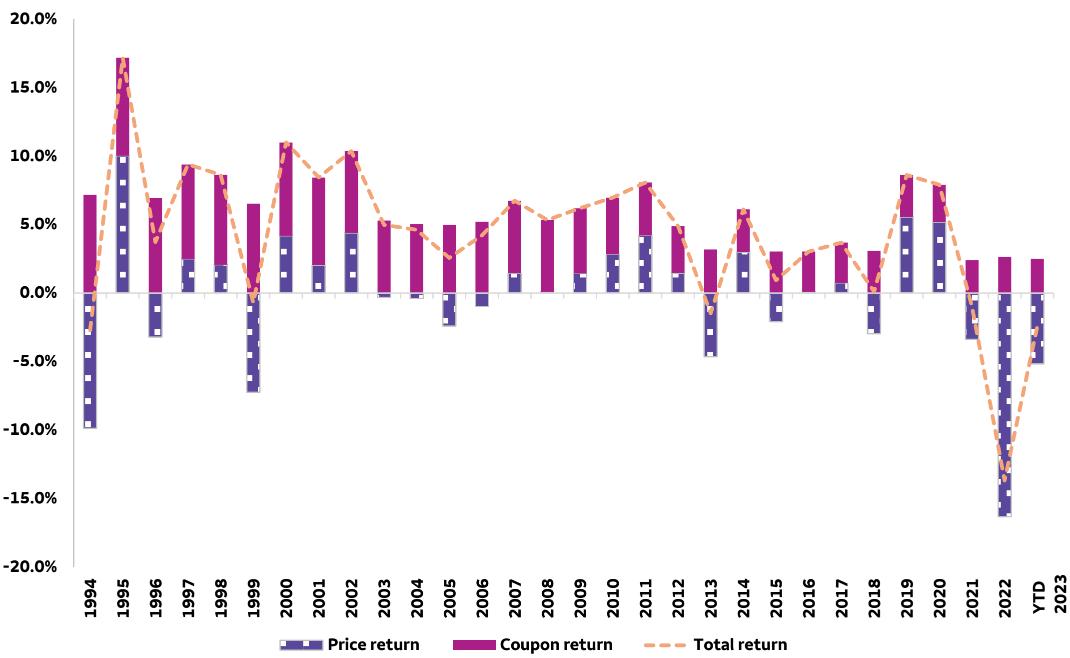
Fixed income investors: Consider a bond's total return

The move higher in bond yields over the past several weeks is causing bonds to underperform year-to-date.[1] Coming off the back of 2022, one of the worst years in bonds for decades, it is easy to understand why some investors are fearful that bond losses will continue mounting. Hence why it is important for fixed income investors to keep in mind that bond total returns comprise two factors — price movement and coupon (current yield income). Investors who consider price movement alone miss half the picture. Starting yields (yields at time of purchase) matter plenty in fixed income as it is one of the most critical factors in determining expected returns over the life of the bond (assuming the investor holds the bond until maturity).

For example, from July 2016 through November 2018 the bond market experienced a "taper tantrum"[2] and 10-year Treasury yields increased from 1.36% to 3.24%. During that time, the total return of the Bloomberg U.S. Aggregate Bond Index was slightly negative (-0.81%). However, looking at price alone, the index lost more than 7.5%. However, the coupon return from the index provided a positive return of over 7%, which helped cushion the blow to investors, despite the substantial rise in interest rates.

In our opinion, the current opportunities available for fixed income investors (higher available yields) could potentially provide enough cushion to withstand further pricing deterioration, while also allowing for price appreciation if yields decline as we enter into a recession or a risk-off period.

Bond total return components: Coupon plus price appreciation



Sources: Bloomberg and Wells Fargo Investment Institute. Data shown is from January 1, 1994 through October 17, 2023. Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, U.S.-dollar-denominated, fixed-rate taxable bond market. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

1. Bloomberg U.S. Aggregate Bond Index as of October 17, 2023.
2. "Taper tantrum" refers to when investors react to the news that the Federal Reserve will be stopping or slowing bond purchases, causing U.S. Treasury bond yields to increase.

Alternatives

Tom Carlin
Lead Investment Research Analyst

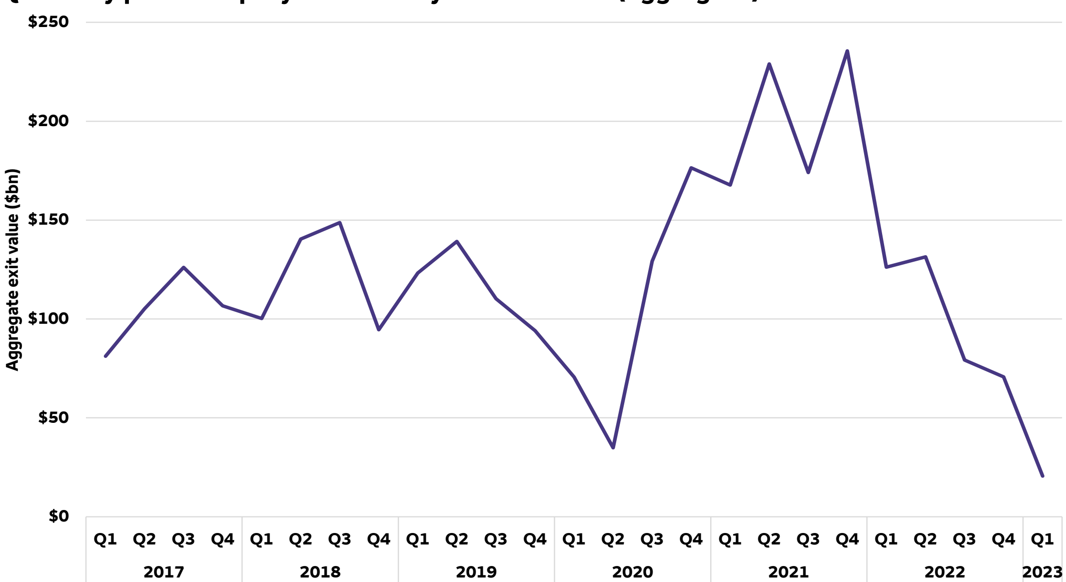
Supply glut creates opportunity for secondary buyers

Private equity is an alternative asset class by which the private equity firm – the sponsor or GPs collects investments from LPs to acquire private companies seeking to enhance their value over a multi-year time horizon and ultimately exit the investment via sale or initial public offering. Once the GP exits the investment, it distributes proportional gains to LPs. However, average exit volumes across the entire private equity ecosystem fell 49.4% in 2022 from the 2021 peak (see chart). Ultimately, this means LPs are receiving fewer distributions than they have in years past and otherwise would have expected.

Irrespective of the exit environment, investors still need liquidity, as LPs typically rely on distributions from prior investments to fund new private capital commitments. This also directly weighs on GPs' ability to fundraise for new vintages. To address these issues, the secondary market has gained importance, as it allows qualified investors to trade interests in private companies before a natural exit occurs.

Additionally, weak performance in public markets in 2022 caused many investors to have inflated private markets allocations. Though public markets have rebounded from their 2022 lows, the average private market investor (as of May 2023) remained 43% overallocated to the asset class.[3] We expect that GPs and LPs will continue to leverage the secondary markets as a means of generating liquidity and rightsizing private markets allocations. We believe this may potentially lead to an attractive opportunity set for qualified investors on the secondary market. In addition, should further financial market stress (such as a recession) occur, history suggests that discounts on secondary purchases should widen. This has historically enabled secondaries to outperform following times of market turbulence, according to Preqin data from 2007 to 2020.

Quarterly private equity-backed buyout exit value (aggregate):



Source: Preqin Pro and Wells Fargo Investment Institute. First quarter 2017 through first quarter (Q1) 2023. Data as of July 11, 2023. **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.

3. Preqin: Strategy in Focus: Private Equity Secondaries July 11, 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, October 23, 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. 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.

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.

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.

Definitions

Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

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 Communication Services Index comprises those companies included in the S&P 500 that are classified as members of the GICS® communication services sector.

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

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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An index is unmanaged and not available for direct investment.

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