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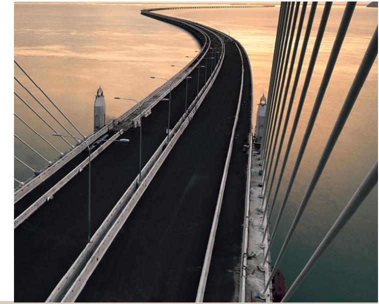

Investment Strategy

Weekly guidance from our Investment Strategy Committee **October 30, 2023**

Fixed Income Spotlight: The yield curve has inverted — Where is the recession? 2

- The U.S. Treasury yield curve has been inverted (10-year minus 3-month) since November 8, 2022, meaning that short-term interest rates have been trading above longer-term rates. Yield curve inversions historically have been a popular recession predictor with a strong track record.
- It is important to note that in six of the past eight recessions, the yield curve has moved from negative to positive slightly before or just about the time the recession appears.

Equities: How have stocks performed this year? 4

- The stellar performance of a handful of mega-cap stocks this year has masked the weakness observable in nearly every other corner of the stock market.
- With our forecast for a recession on the horizon, we believe the average stock will likely continue to struggle.

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- Global crude oil supply sitting in floating storage (ships) has sunk to levels not seen since March 2020.
- Ongoing OPEC (Organization of the Petroleum Exporting Countries) crude oil production cuts should continue to keep crude oil prices high, at least through year-end 2023.

Alternatives: Private equity — Activity in descent 6

- Private equity saw capital activity continue to slow during the third quarter of 2023.
- Despite this backdrop, we continue to see increased opportunities for qualified investors in secondaries, middle market, and growth equity.

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Investment and Insurance Products: ➤ NOT FDIC Insured ➤ NO Bank Guarantee ➤ MAY Lose Value

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Fixed Income Spotlight

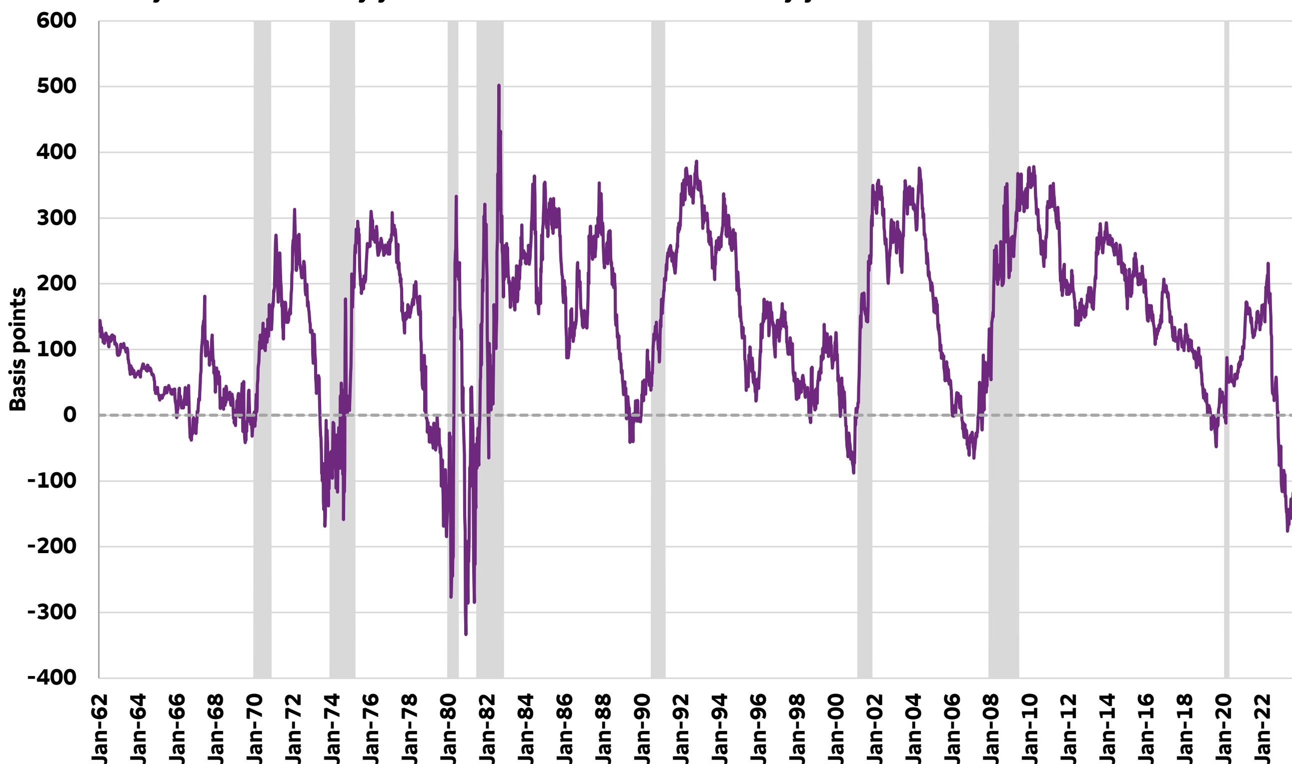
Luis Alvarado
Global Fixed Income Strategist

The yield curve has inverted — Where is the recession?

The shape of the yield curve, while it is a simple graph that connects the interest rate levels across different bond maturities, is valuable to market participants and investors because it has been known to tell a story. The current shape of the U.S. Treasury yield curve is inverted, meaning that short-term interest rates are trading above longer-term rates. This inversion — or negative difference between the 10-year U.S Treasury yield and the 2-year U.S. Treasury or 3-month U.S. Treasury yield — has been a popular recession predictor with an excellent track record.[1] The litmus test, based on our research, is that the inversion needs to be significant in magnitude (exceeding 25 basis points) or in duration (continuously for more than four weeks) to be a reliable recession signal. Both conditions have already been met for quite some time. So why is the recession not here yet?

To be clear, short-term interest rates moving above longer-term rates does not cause a recession, but it may send a signal. While the yield curve can help to diagnose a problem in the economy, it is not foolproof — it does not pinpoint exact timing or how fast conditions may change.

Chart 1. 10-year U.S. Treasury yield minus 3-month U.S. Treasury yield



Sources: Bloomberg and Wells Fargo Investment Institute. Weekly data from January 1, 1962, to October 23, 2023. 100 basis points equal 1%. Shaded area represents timeframe of a U.S. economic recession. Yields represent past performance and fluctuate with market conditions. **Past performance is no guarantee of future results.**

1. Federal Reserve Bank of San Francisco, Economic Research. *Current Recession Risk According to the Yield Curve*. May 9, 2022.

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Although the yield curve inverted before each of the past eight recessions since 1960, this indicator also provided a false positive for a recession in the mid-1960s — when a yield curve inversion was followed by an economic slowdown, but not by an official recession. At that time, an official recession did not materialize until December 1969, more than three years after the initial inversion. Also, the 2020 recession, which was essentially a forced shutdown of the economy in response to the pandemic, was preceded by a yield curve inversion; however, we do not believe yield curves are predictive for unexpected shocks like a pandemic.

Curve inversion is just half the story

It is important to note that in six of the past eight recessions, the yield curve has moved from negative to positive slightly before or just about the time the recession appeared. Also, historically, we have never started and finished a recession with an inverted curve. Since 1962, by the time we have come out of a recession, the curve has always been positive (see chart).

Over the past month, the U.S. Treasury yield curve has been un-inverting (becoming less negative) at a rapid pace as long-term Treasury yields have moved higher, chasing short-term Treasury yields, which are largely influenced by the Federal Reserve's (Fed's) policy rate. Since our base case is that the Fed will keep policy rates higher for longer, with a high hurdle to cut rates, we believe that in the near-term, most of the steepening move should continue to come from higher long-term yields.

Implications for investors

The higher cumulative move in yields over the past three years has been problematic for fixed-income returns. However, long-term U.S Treasury yields at current levels look attractive to us, especially given our expectation for a U.S. recession on the horizon.

Risk-off sentiment causes investors to look for perceived safe-haven vehicles, such as Treasuries, and this drives up demand and pushes yields lower. We also believe we are near the end of the Fed's tightening cycle and expect the Fed to cut rates if the recession materializes. In both instances, we expect that bonds on the short and long ends of the curve should eventually see some price appreciation. In the meantime, investors may consider more attractive interest payments compared to the past 15 years.

Granted, 10-year U.S. Treasury yields could still move higher in the near term, well beyond 5%. This is why we continue to favor implementing a barbell strategy within bond portfolios, extending duration (relative to the portfolio's specific benchmark), and prioritizing high-quality investment-grade fixed-income. After all, we believe the U.S. Treasury yield curve has proven to be a meaningful indicator throughout history — a history that covers many different types of economic and market regimes. This time could be different, but historical trends suggest to us that the yield curve is likely to act the same in this cycle as it has in the past.

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Equities

"It's better to look ahead and prepare than to look back and regret." — Jackie Joyner-Kersee

Austin Pickle, CFA
Investment Strategy Analyst

How have stocks performed this year?

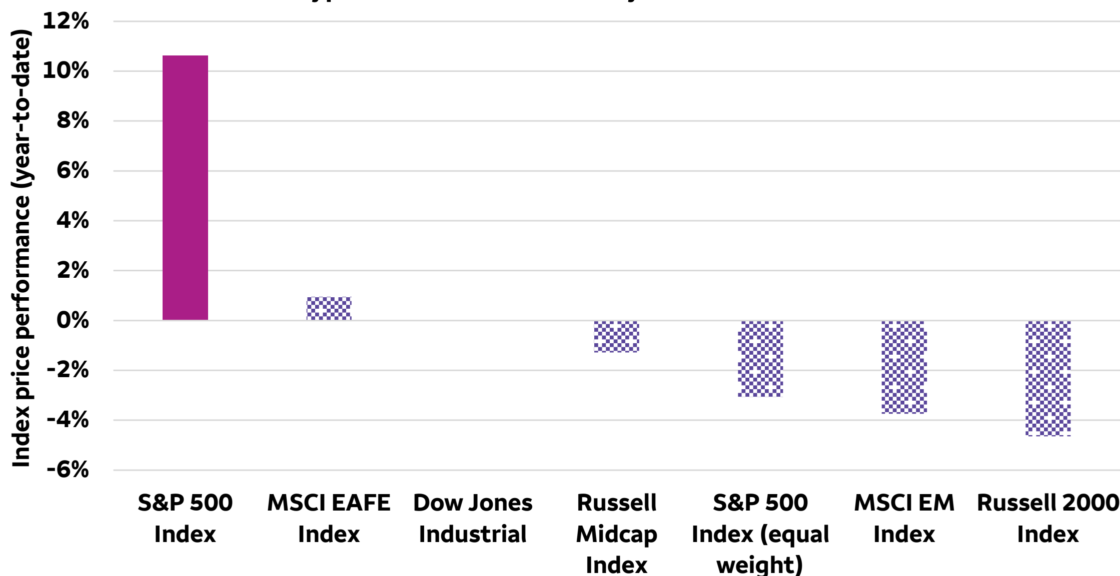
The title question is trickier than it appears. Our answer — "Stock returns this year have been by and large weak" — may come as a surprise to some and seems to contradict the double-digit S&P 500 Index year-to-date return. What is our rationale?

The S&P 500 Index construction methodology of weighting each constituent commensurate with its market cap means that the performance of a few of the largest companies can at times mask the performance of the many. 2023 has been one of those times. A group of seven mega-cap technology-related names have seen year-to-date returns jump over 88% on average[2] and, due to their immense size, they have pulled the S&P 500 Index return higher along with them. This has hidden the weakness observable in nearly every other corner of the stock market. When we take a look at other stock indexes, we can more clearly see the rationale for our earlier answer.

The chart plots the year-to-date price performance of the S&P 500 Index against other popular stock indexes covering large-cap, mid-cap, small-cap, developed market, and emerging market equities. The best of these other indexes rose a whopping 1%. Even the S&P 500 Index recalculated as an equal-weighted index has dropped over 3% on the year. We repeat, stock returns in 2023 have been by and large weak.

With our forecast for a recession on the horizon, we believe the average stock will likely continue to struggle. We suggest investors emphasize quality in portfolios and prefer U.S. Large Caps over U.S. Mid Caps and Small Caps, as well as Developed Market ex-U.S. over Emerging Market equities on the international side.

Want to know what the typical stock has done this year? Don't look at the S&P 500 Index



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data: December 31, 2022 – October 24, 2023. Returns are shown as price returns which exclude dividends. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** Please see end of report for index descriptions.

2. Year-to-date data as of October 24, 2023. The seven mega-caps include Alphabet, Meta, Amazon, Tesla, Apple, Microsoft and Nvidia.

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Real Assets

"To keep the lamp burning, you have to keep putting oil in it." — Mother Teresa

John LaForge
Head of Real Asset Strategy

Mason Mendez
Investment Strategy Analyst

Floating crude oil sinks to three-year low

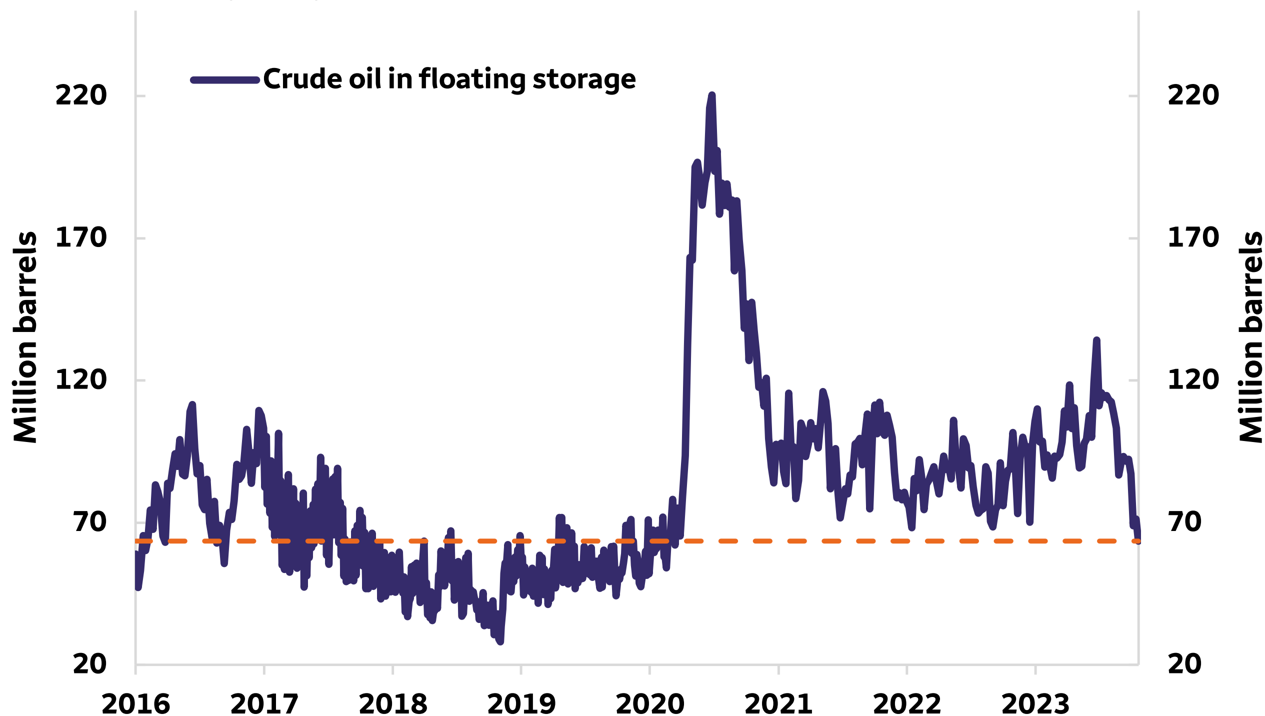
Since July, crude oil prices have been on a tear. From July 1 through October 23, the main crude oil benchmark prices, West Texas Intermediate (WTI) and Brent, have gained 23% and 21% respectively. For perspective, the broader Bloomberg Commodity Index (BCOM) has risen only 2%.

Oil's rally has been especially impressive, in our view, considering slower global gross domestic product growth. Thus, the main driver of higher crude oil prices has not been extra demand, but tight global supplies. And the prime culprit behind tight supplies has been OPEC+, a large consortium of oil-producing countries (OPEC members plus other oil producing countries) that has been cutting oil production for the better part of a year. Year-over-year, OPEC crude oil production has declined 7.5% (2.2 million barrels per day) through the end of September.

OPEC+'s cuts have proven effective at driving down global inventories, which in turn has helped keep oil prices high. The cuts have been so effective, in fact, that OPEC+ recently affirmed its commitment to maintain them through year-end 2023. The impact of production cuts can be seen in the chart, which highlights sinking global crude oil supplies sitting in floating storage (ships) — to the tune of 45% over the past six months.

All in all, it appears that global supply should remain tight, at least through year-end 2023. Our year-end 2023 target ranges remain unchanged at $80 – $90 per barrel for WTI and $85 – $95 per barrel for Brent crude.

Crude oil in floating storage was at its lowest level since 2020, as of October 20, 2023



Source: Bloomberg and Wells Fargo Investment Institute. Weekly data is from January 1, 2016 to October 20, 2023. The orange dashed line represents the current level of global floating storage.

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Alternatives

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

Private equity — Activity in descent

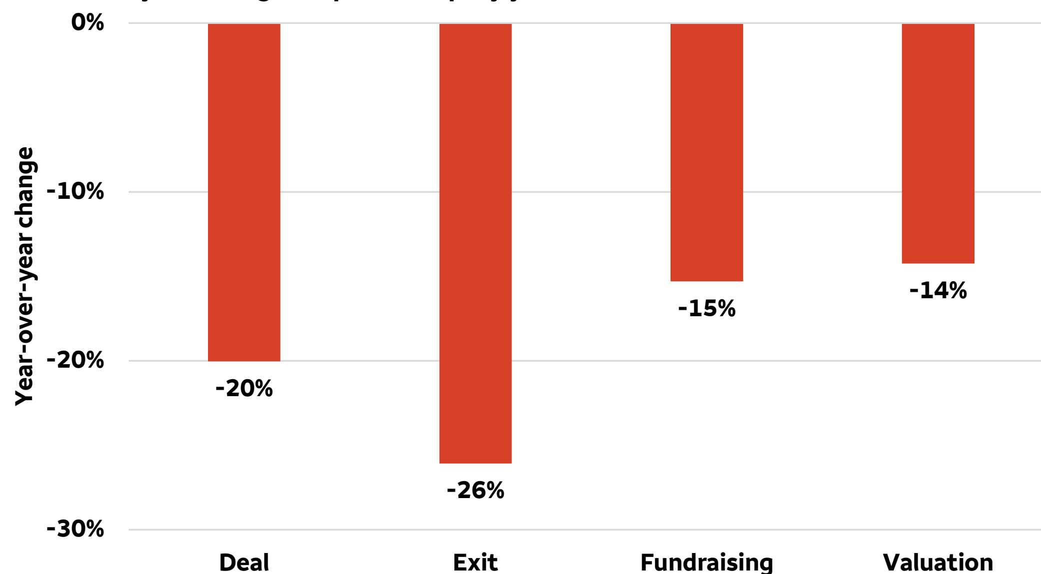
Private equity saw capital activity continue to slow during the third quarter of 2023. The quarter ranked as the second lowest in exit value since the 2008-2009 financial crisis — second only to the pandemic lockdown of second-quarter 2020. The low exit activity limited the capital returned to qualified investors. This, along with heightened economic uncertainties, led to a 15% decline in year-to-date fundraising through the end of September (see chart).

For the third quarter, private equity dealmaking — that is, the amount of new capital invested in private companies — dropped below $200 billion for the first time since 2020, according to Pitchbook. The difficulty of acquiring debt financing was particularly felt in the larger-sized leveraged buyout space. This contributed to the drop in private equity valuations, as highlighted by the 14% decline shown in the chart.

Given this backdrop, we continue to see increased opportunities in three areas we favor:

- Secondary market: Given the less-than-ideal exit environment, the secondary market has been used as a tool to return capital to investors.
- Middle market: Investors also showed more interest in the middle market, as its share of private equity fund closings in the third quarter reached the highest level since 2009. Middle market deal activity also increased; smaller deal size and lower valuations improved the feasibility to finance and close.
- Growth equity deals in 2023 are likely to outnumber other private equity deals for the first time, in our view. Growth equity typically focuses on faster growing and often profitable companies that require lower investment amounts.

Year-over-year changes in private equity year-to-date activities.



Source: Pitchbook and Wells Fargo Investment Institute. Data as of September 30, 2023.
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. Data is based on private equity funds and deals sourced by 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 30, 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. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is appropriate only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

Bloomberg Commodity Index is comprised of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity.

Dow Jones Industrial Average is an unweighted index of 30 "blue-chip" industrial U.S. stocks.

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Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000 Index.

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

An index is unmanaged and not available for direct investment.

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