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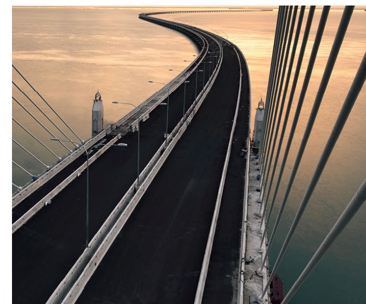
Investment Strategy



Weekly guidance from our Investment Strategy Committee **November 13, 2023**

Real Assets Spotlight: Gold's central driver 2

- Gold has been one of the best performing commodities in 2023, up 7.1%.
- Gold prices appear to be reacting to supply and demand, as opposed to macroeconomic factors, such as real interest rates and the U.S. dollar.

Equities: Volatility can create opportunities 4

- We believe markets will continue to be range-bound as the economy weakens further, and that volatility will create opportunities.
- Investors should continue to focus on the favorable-rated U.S. Large Cap Equities asset class, and the Industrials, Materials, and Health Care sectors on pullbacks.

Fixed Income: Asymmetrical returns in long-term Treasuries 5

- It is important for investors to evaluate the potential upside and downside return of their bond holdings if interest rates move higher or lower from current levels.
- We believe that long-term Treasuries remain an effective way to blunt the effects of many types of economic and political uncertainty.

Alternatives: Merger and acquisition environment remains subdued 6

- While merger and acquisition volumes have stabilized in recent periods, the widening deal spreads indicate that the remaining uncertainty around deals is reaching completion.
- We continue to maintain our unfavorable guidance on the category and remain patient for a more opportune entry point, which we expect after the economy recovers from its current weakening trend.

Current tactical guidance 7

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Real Assets Spotlight

John LaForge
Head of Real Asset Strategy

Mason Mendez
Investment Strategy Analyst

Gold's central driver

In a tough year for commodities, gold has performed quite well in 2023. We believe a gain of 7.1% is significant outperformance with the average commodity down 5.2%[1]. Gold's performance has been especially impressive, after accounting for rising real interest rates and a strong U.S. dollar. These two macroeconomic factors, when trending higher, have historically combined to weigh on gold prices. Gold has not reacted much to these forces in 2023, and it has been influenced by supply and demand. The demand side, especially, has begun to heat up with central banks buying record amounts of gold.

In any given year, multiple factors can help move the price of gold. Real interest rates and the U.S. dollar have routinely been at the top of the most influential list, so it has been a bit surprising to see gold shrug off these factors in 2023. Let's take a look at long-term real interest rates first, which most basically is an interest rate less an inflation rate. Some of the best macroeconomic environments for gold prices, historically speaking, have been periods of falling real rates (most commonly, falling interest rates but rising inflation). So far in 2023, real rates have risen, yet gold performance has not suffered. The U.S. 10-year Treasury yield, as an example, has risen from 3.9% to 4.5%[2], while the headline inflation rate has dropped from 6.5% to 3.7%, as measured by the Consumer Price Index. If we consider the trend, this measure of long-term real interest rates has trended from -2.6% at the start of the year, to +0.8% today.

A rising U.S. dollar is another important macro factor that has traditionally weighed on gold prices, but not so much in 2023. Because the dollar and gold both tend to attract investors during times of uncertainty, they historically have been substitutes during years like this one, when geopolitical concerns have arisen. Nevertheless, the U.S. dollar is modestly higher by 2% so far this year, but gold's rise has bucked the historical tendency.

So, which factors are influencing gold prices today? The answers are supply and demand. Supply growth has been weak for years now, following the commodity bear super cycle from 2011 through 2020[3]. Missing was a fresh spark in demand, which gold is now receiving (see chart 1). While each central bank has its own reasons for buying, many have voiced concerns regarding elevated global debt levels, rising interest costs, and the associated liabilities. Gold, on the other hand, can be physically purchased and stored, removing the potential liability of another country's debt.

The bottom line is that we continue to favor gold in 2023, and into 2024, and our year-end 2024 target range remains $2100 to $2200 per ounce. We suspect that gold demand will continue to outstrip supply next year, and by year-end, gold may even pick up two traditionally important macro tailwinds in falling real interest rates and a fading U.S. dollar.

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1. Bloomberg, year-to-date.
2. December 31, 2022 – November 8, 2023, year-to-date.
3. Metals Focus Ltd., and United States Geological Survey.

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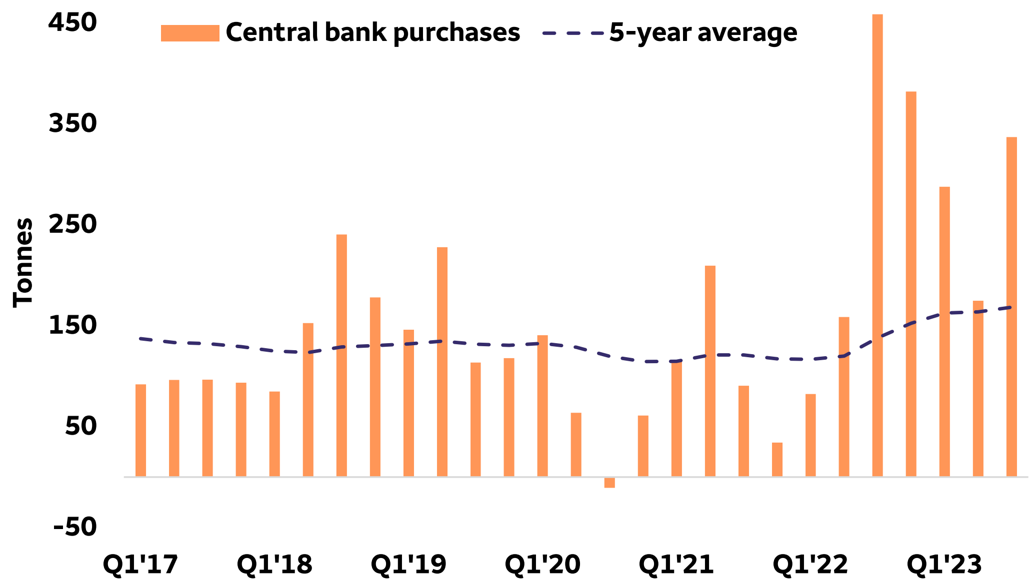
Chart 1. Central bank purchases of gold



Sources: World Gold Council and Wells Fargo Investment Institute. Quarterly data is from Q1 2017 – Q3 2023. Data as of September 30, 2023.

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Equities

Sameer Samana, CFA
Senior Global Market Strategist

Volatility can create opportunities

It has been a wild couple of weeks in equity markets. On October 17, the S&P 500 Index closed at 4373. Since that close, the S&P 500 Index fell 6% to 4104, the intraday low on October 27, and subsequently recaptured the losses in just a handful of trading days. Despite this volatility, which has seen the S&P 500 Index trade both below and above its 50-day and 200-day moving averages, we believe markets will continue to be range-bound as the economy weakens further in the coming months.

The factors capping it to the upside include long-term interest rates, which remain close to multi-decade highs, worsening geopolitics, and a slowing economic and corporate earnings outlook. In addition, we believe the Federal Reserve's goal of taming inflation will keep monetary policy tighter for longer than markets expect. Where the S&P 500 Index may trade to the downside will be a function of the length and severity of an economic slowdown, which now seems to be unfolding and will adversely impact corporate profits. As a reminder, our year-end target range for 2023 remains 4000 – 4200.

While we believe it would be fair to describe the risk-reward at current levels as mildly unfavorable, at the recent lows (4104) the S&P 500 Index presented solid returns (about 14.5%) to the midpoint of our 2024 year-end target range of 4600 – 4800. We believe long-term investors will have to be disciplined about executing their investment plans as markets present these types of opportunities. Specifically, we would focus on putting excess cash to work with the U.S. Large Cap Equities asset class, with a focus on the Industrials, Materials, and Health Care sectors.

S&P 500 Index with moving averages

Sources: Bloomberg and Wells Fargo Investment Institute. Daily data from November 7, 2020, through November 7, 2023. **Past performance is no guarantee of future results.**

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Fixed Income

Luis Alvarado
Global Fixed Income Strategist

Asymmetrical returns in long-term Treasuries

As we approach a 5% yield level on the 10-year U.S. Treasury, we believe it is important for investors to evaluate the potential upside and downside returns of their bond holdings if interest rates move higher or lower from current levels. Doing some good old bond math comes in handy, especially taking into consideration a bond's duration (which is a measure of the sensitivity of a bond's price to a change in interest rate movements). Let's look at a hypothetical example, one intended to show how returns can be asymmetrical, depending on whether prices are rising or falling. The table illustrates returns to short-, intermediate- and long-term Treasuries if interest rates move higher or lower by 100 basis points (bps), or 1%. Notably, the asymmetry in price returns becomes more evident in bonds with a longer duration.[4]

Effects of yield curve moves on bonds with different duration

U.S. Treasury bond	Hypothetical yield on 10/31/2023	Duration	Market value after instantaneous 100 bps increase in the yield curve	Loss	Market value after instantaneous 100 bps decrease in the yield curve	Gain
30-year	**5.04%**	**15.77**	**86.22**	**-13.78%**	**117.30**	**17.30%**
10-year	**4.88%**	**8.03**	**92.52**	**-7.48%**	**108.22**	**8.22%**
2-year	**4.93%**	**1.93**	**98.14**	**-1.86%**	**101.91**	**1.91%**

Sources: Wells Fargo Investment Institute and Bloomberg. Data as of October 31, 2023. Hypothetical example to illustrate the effects of duration on the price of different Treasury bonds after an instantaneous increase and decline of 100 bps in the yield curve. 1% = 100 basis points.

An investor who purchased a 30-year Treasury bond on October 31, 2023, would have received a hypothetical yield of 5.04%. If interest rates were to increase by 100 bps (or 1%), the price of the bond would fall by over 13%. However, a 1% decline in interest rates would generate a 17% gain in the market value of the bond.

Moreover, the investor would still have a 5.04% yield on the 30-year U.S. Treasury bond regardless of what happens to the level of interest rates — in our view, this means that the current starting yields are offering an attractive cushion against a potential price decline. Further, we anticipate increased equity volatility and rising bond prices as the economy continues to weaken in the coming months, and so we favor holding long-term Treasuries as a potential risk hedge.

4. Duration is a measure used to determine a bond's or bond portfolio's sensitivity to movements in interest rates. Generally, the longer the duration the more sensitive a bond or bond portfolio is to changes in interest rates.

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Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

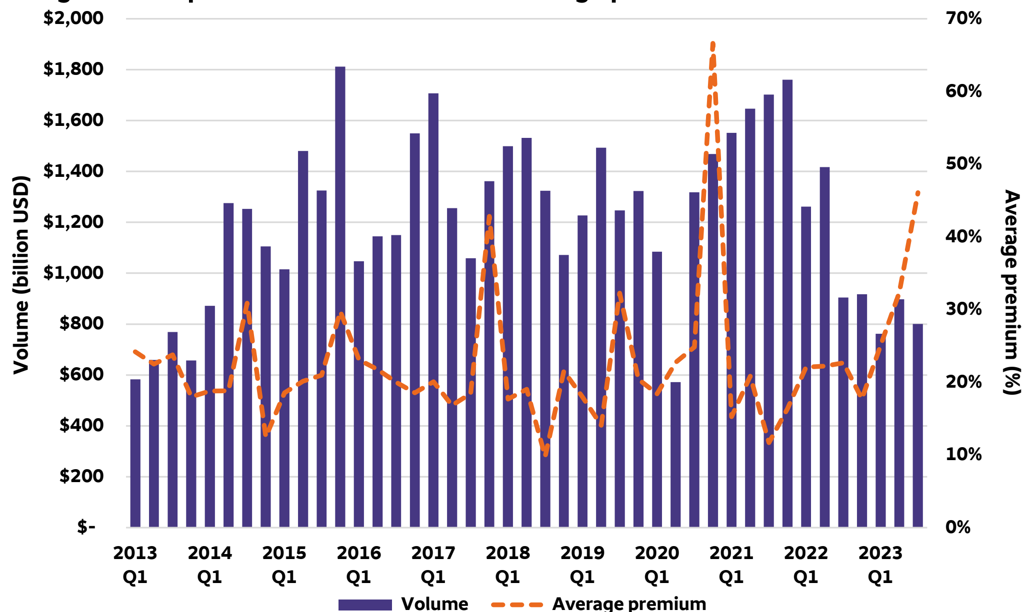
Merger and acquisition environment remains subdued

Merger and acquisition (M&A) activity remains well below long-term trends but has stabilized in recent quarters as market conditions have improved modestly. Quarterly volumes appear range-bound near the $800 – $900 billion mark, significantly down from the elevated levels witnessed in 2021 that exceeded $1.5 trillion. In addition, the average premium (or spread between buyer bids and current market prices) of announced deals has continued to widen through the first three quarters of 2023, registering near 46% in the third quarter. The increasing average premium continues a longer-term trend that has been in place since the third quarter of 2021 and reflects the continued uncertainty of deals making it to the closing stage.

Increased regulatory scrutiny led to greater delays in closing deals early in the year. However, the environment has improved in recent months as several high-profile mergers received approval to move forward. Additionally, the pause in the Federal Reserve's hiking cycle and a rebound in equity markets has stabilized M&A markets in recent periods, yet significantly higher financing costs and concerns related to persistent inflationary pressures continue to weigh on the outlook through the end of the year.

Although conditions have stabilized, we maintain our unfavorable guidance on Merger Arbitrage strategies. The lower levels of deal activity, higher interest rates, and heightened geopolitical risks will all contribute to an environment that remains challenging for Merger Arbitrage strategies over the near-to-intermediate term. We remain patient for a more opportune entry point as the economy provides signs that it is on a path to recovery.

Merger and acquisition deal volumes and average premia



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of September 30, 2023. Volume = the aggregate value of all announced deals on a global basis, which include pending, proposed, completed, withdrawn, and terminated deal status. Average Premium = the average premium all announced deals on a global basis that includes all pending, proposed, terminated, completed, and withdrawn deal status.

Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not appropriate for all investors and are only open to "accredited" or "qualified" investors within the meaning of U.S. securities laws.

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Current tactical guidance

Cash Alternatives and Fixed Income

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
	U.S. Intermediate Term Taxable Fixed Income High Yield Taxable Fixed Income	Cash Alternatives Developed Market Ex-U.S. Fixed Income Emerging Market Fixed Income	U.S. Taxable Investment Grade Fixed Income	U.S. Long Term Taxable Fixed Income U.S. Short Term Taxable Fixed Income

Equities

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
U.S. Small Cap Equities	Emerging Market Equities	U.S. Mid Cap Equities Developed Market Ex-U.S. Equities	U.S. Large Cap Equities	

Real Assets

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
		Private Real Estate	Commodities	

Alternative Investments*

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
		Hedge Funds—Event Driven Hedge Funds—Equity Hedge Private Equity Private Debt	Hedge Funds—Relative Value Hedge Funds—Macro	

Source: Wells Fargo Investment Institute, November 13, 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. **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. Investments in **gold** and gold-related investments tend to be more volatile than investments in traditional equity or debt securities. Such investments increase their vulnerability to international economic, monetary and political developments. They are also exposed to the risk of severe price fluctuations in the price of gold bullion. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

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.

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

An index is unmanaged and not available for direct investment.

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

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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