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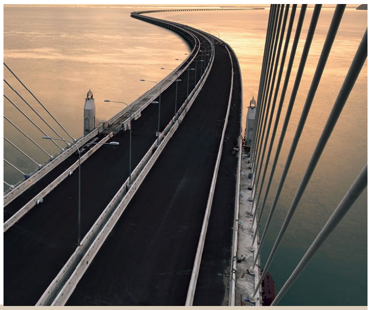
Investment Strategy



Weekly guidance from our Investment Strategy Committee November 27, 2023

Asset Allocation Spotlight: Positioning portfolios for a potential soft patch 2

- As the economy slows, we encourage investors to focus on directional trends of economic activity. In our view, attempting to time economic setbacks or market selloffs is not a productive investment strategy.
- We believe our current guidance will help position portfolios for near-term economic weakness and market uncertainty associated with it. As year-end approaches, now may be an opportune time to consider taking gains, harvesting losses, or rebalancing asset holdings.

Equities: Whoa, that was fast! 4

- As the economy continues to weaken, we anticipate pressure on equity earnings and prices as well as range trading.
- We would suggest trimming over-allocations to areas rated unfavorable as we approach the top end of the range. Alternatively, we would suggest adding to under-allocations to areas rated favorable as we approach the bottom.

Fixed Income: Financial liquidity declining, but still plenty available 5

- The Federal Reserve's overnight reverse repurchase facility (RRP) has become like a proxy of liquidity in the financial system.
- After topping at more than $2.5 trillion in December of 2022, the RRP currently stands below $1 trillion as market participants are searching for other investment opportunities.

Real Assets: Growing U.S. crude inventories hitting oil prices 6

- U.S. crude oil inventories have risen to a three-month high of 439 million barrels, driven by stronger U.S. production.
- Historically, West Texas Intermediate crude (WTI) prices have had a negative correlation with inventories, which typically leads to price weakness.

Alternatives: Investor activism at seven-year high 7

- Activity remains robust with investor activism reaching seven-year highs.
- Despite inherent long bias and beta exposure, activist strategies are distinct in their approach toward unlocking value through operational improvements or corporate restructuring.

Current tactical guidance 8

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Asset Allocation Spotlight

Michael Taylor, CFA
Investment Strategy Analyst

Positioning portfolios for a potential soft patch

The U.S. economy continues to lose steam. Overseas, the global economy has also been slowing; any additional hiccups in the U.S. economy would likely exacerbate the trend. Yet, persistent weakening should eventually usher in a pickup in disinflation and the potential for rate cuts. Both factors historically have helped spark an economic recovery, which we expect to materialize once the slowdown is behind us.

For now, we encourage investors to focus on directional trends of economic activity. The combination of inflation and higher-for-longer interest rates tightens credit in an economy that has already weakened significantly. The problem is that while the economy grows, wages are likely to grow and block disinflation in services. That should keep interest rates higher and credit tighter for longer. The economy needs to slow further to break this cycle of sticky inflation, elevated interest rates, and tightening credit. Yet, as the economy slows further, it will approach a point of contraction.

The point is not so much when or where the economy reaches a bottom — it is, rather, our contention that equity and fixed-income markets will remain volatile and the reason our positioning focuses on quality and playing defense. Patience is usually an investor's most important ally. In an effort to better position portfolios for today's macroeconomic uncertainty, we recently updated our investment guidance. Below we recap highlights from our guidance adjustments, review the perils of market timing, and discuss portfolio actions investors may wish to consider at this time.

Modest guidance adjustments[1]

We recently made modest adjustments to year-end 2024 price targets and sector-level guidance for U.S. Municipal Bonds (Munis), yet our overall guidance has not changed. For now, we remain defensive and oriented toward quality should economic growth stumble in the coming months. But we anticipate a bounce back in economic activity following a relatively short-lived economic pullback — this should present broader opportunities for investors across risk markets, such as equities and commodities. The guidance changes include:

Fixed income: We increased our year-end 2024 interest-rate targets to reflect a "higher for longer" rate environment, including raising the 10-year U.S. Treasury yield target to 4.75% – 5.25% and raising the 30-year U.S. Treasury yield target to 5.00% – 5.50%. Within U.S. Munis, we upgraded State and Local General Obligation bonds from neutral to favorable and downgraded Essential Service Revenue bonds from favorable to neutral. We maintain our overall favorable guidance on Munis and extend our quality bias to this asset class.

Equities: We maintain our 2024 S&P 500 Index price and earnings targets of 4600 — 4800 and $220, respectively, and we lowered all other equity class targets. We reduced our 2024 earnings targets for the Russell Midcap Index and the Russell 2000 Index to reflect U.S. mid- and small-sized companies' lower growth potential and greater sensitivity to economic weakness. We also lowered our MSCI EAFE Index and MSCI Emerging Markets (EM) Index 2024 price and earnings targets to better align with our near-term global economic forecast.

[1] For complete details see Wells Fargo Investment Institute's *Institute Alert* titled "Adjusting our 2024 targets and fixed-income guidance" from November 15, 2023.

Real assets: We lowered our Bloomberg Commodity Index price target range for 2024 to 235 – 255. Within asset classes, we made modest reductions to oil price targets for 2024, $85 – $95 for WTI and $90 – $100 for Brent. Although we remain positive on gold, we see less upside over the next year and trimmed our price target slightly to $2100 – $2300.

Currencies: We anticipate U.S. dollar strength against major developed-market currencies will continue in the near term. Yet, we believe that these factors will likely fade — and weaken the dollar — as the global economy reaccelerates later in 2024. While we expect global risk appetite to improve and U.S. interest rates to fall faster than European and Japanese rates, a lower dollar should allow the yen and euro to stage a rebound by year-end 2024.

Preparing portfolios for a prospective economic slowdown and beyond

We suggest investors look beyond market volatility related to unsettling headlines and stay aligned with our more defensive portfolio guidance that includes positioning for a developing economic slowdown. Regardless of market conditions, we believe that remaining invested in equity markets over a full market cycle is more beneficial than wholesale selling into unpredictable markets and attempting to avoid the worst-performing days. Historically, there appears to be some benefit from avoiding the worst days, so investors may wish to consider making periodic tactical adjustments to their portfolios, such as reducing equity exposure when the risk of an economic downturn rises or increasing equity exposure as the economy recovers. We believe our current guidance will help to position portfolios for near-term economic weakness and market uncertainty associated with it.

As we approach year-end, now may be an opportune time to consider taking gains, harvesting losses, or rebalancing asset holdings — that is, buying asset classes that have fallen below target allocations and selling those that are above target allocations. We believe periodic rebalancing can help to ensure that a portfolio’s allocation remains diversified and aligned with desired goals. In our view, a diversified portfolio has the potential to benefit from more consistent returns and less volatility than a more concentrated portfolio. Smoothing returns over time can be important for investors because it can help reduce the temptation to abandon an investment strategy when one asset class outperforms or underperforms others in a given period. As 2023 winds down, we encourage investors to check in with their investment professional regarding questions or concerns about a portfolio’s allocation mix or risk exposure.

Equities

"Diligence is the mother of good luck." — Benjamin Franklin

Austin Pickle, CFA
Investment Strategy Analyst

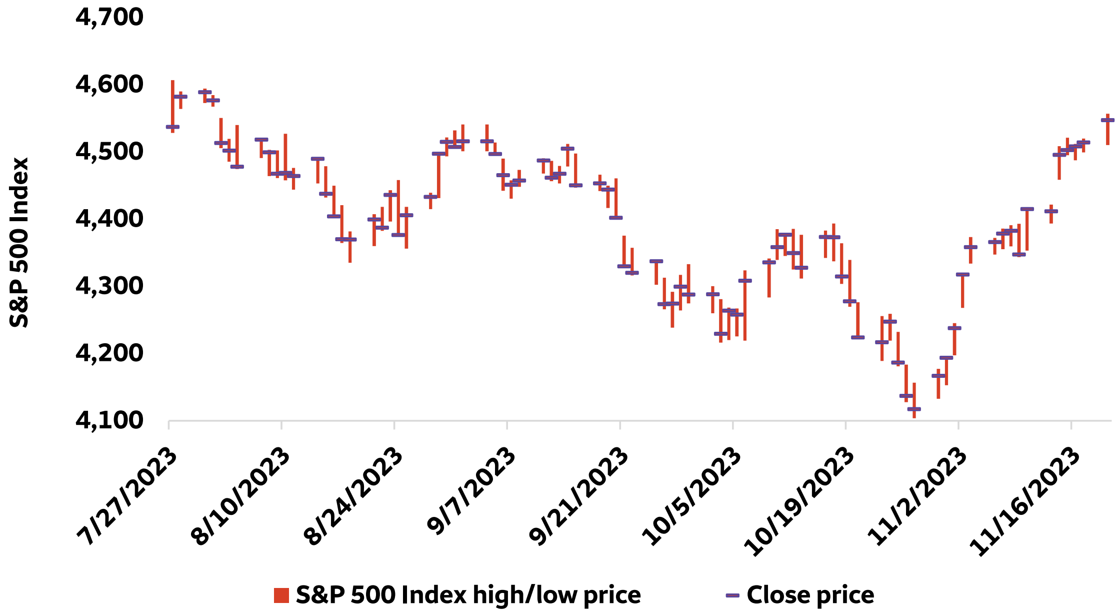
Whoa, that was fast!

The S&P 500 Index ground lower from an intraday high of 4607 on July 27 to an intraday low of 4104 on October 27. This three-month, 11% slide reversed course in dramatic fashion and has been nearly erased in the past few weeks. Volatility like what we have just experienced can be unsettling for investors, and it can lead to emotional investment decisions that are inconsistent with account goals. In times like these, we want to emphasize the importance of staying disciplined and patient while keeping account goals and our guidance in mind.

We anticipate pressure on equity earnings and prices as markets and economy digest the most aggressive Federal Reserve tightening cycle in decades, the highest interest rates in the past 15 years, and a stressed and weakening consumer. It is our belief that equity rallies will be capped until a path to an economic and earnings recovery becomes clear. However, this range-trading environment that we foresee can provide opportunities for disciplined investors. As stocks approach the bottom end of the range — for example, where we were in late October — we would recommend putting excess cash to work, especially in areas where we hold favorable rankings such as U.S. Large Cap Equities. Alternatively, as stocks approach the top end of the range — like where we have been as of November 20 — we would suggest trimming over-allocations to areas rated unfavorable such as U.S. Small Cap Equities, Emerging Market Equities, the Real Estate sector, and the Consumer Discretionary sector.

As the past few weeks illustrate, opportunities on both ends of the range can present themselves in rapid succession — be prepared.

S&P 500 Index has approached bottom and top ends of its trading range in past few weeks



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data: July 27, 2023 – November 20, 2023. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.**

Fixed Income

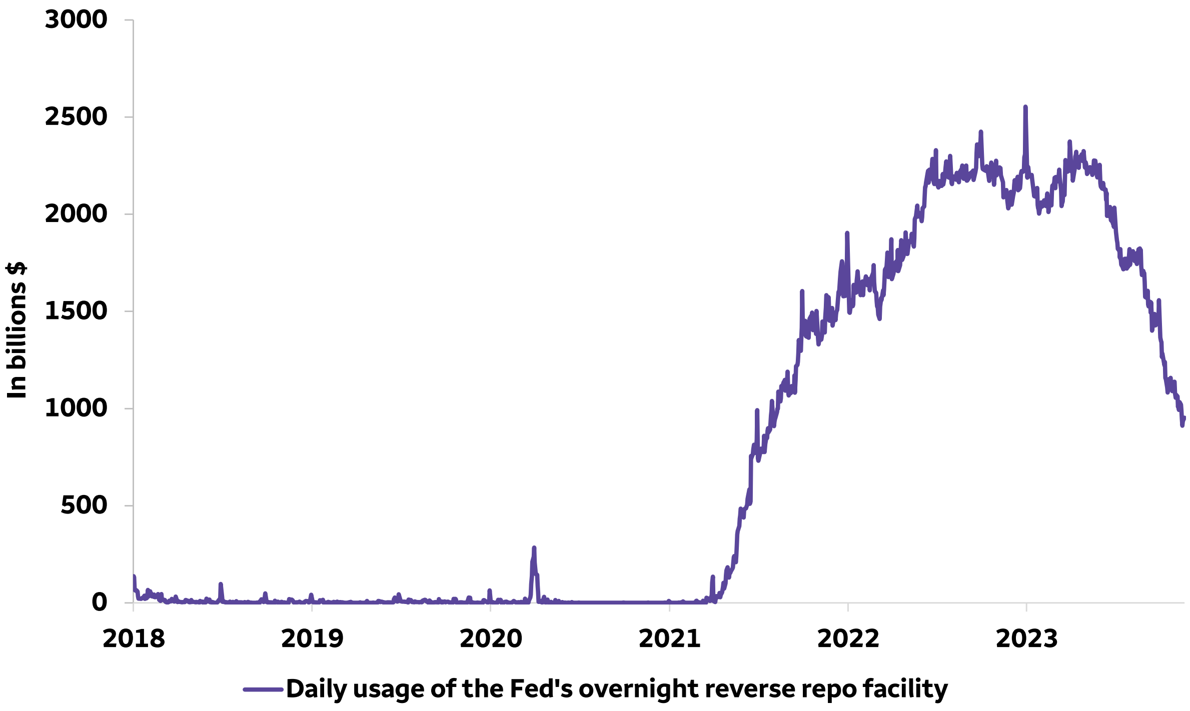
Luis Alvarado
Global Investment Strategist

Financial liquidity declining, but still plenty available

Over the past couple of years, financial liquidity (cash) started to build in the Federal Reserve's (Fed) overnight reverse repurchase facility (RRP). This facility has become like a proxy of liquidity in the financial system. Money market funds generally saw a large influx of capital from investors, searching for attractive interest rates with relatively low risk, and this prompted these money market funds to park capital at the RRP. This is how the overnight reverse repurchase transaction works: the Fed sells a Treasury security to an eligible counterparty (such as a primary dealer, money market fund, bank, or government-sponsored entity) with an agreement to repurchase that same security sometime in the future. This transaction implies a rate of interest paid by the Fed.

After topping at more than $2.5 trillion in December of 2022, the amount of funds in the RRP facility remained relatively steady throughout the first half of 2023, but after the Fed's last interest rate hike on July 26 and given the strong issuance of Treasury bills in the past two quarters, market participants started moving funds away from the RRP in search for more attractive investment opportunities. With just less than $1 trillion remaining in the RRP we could see those funds continue to move out of the facility in the coming months, and we believe this additional liquidity could have a positive impact on market prices. We still have a most favorable view of both short and long-term fixed income and believe that investors should continue to dollar cost average into high quality assets.

RRP - A popular place to park funds



Sources: Bloomberg and Wells Fargo Investment Institute as of November 20, 2023. Daily data of the usage of the Federal Reserve's overnight reverse repo facility from January 1, 2018, to November 20, 2023.

Real Assets

John LaForge
Head of Real Asset Strategy

Mason Mendez
Investment Strategy Analyst

Growing U.S. crude inventories hitting oil prices

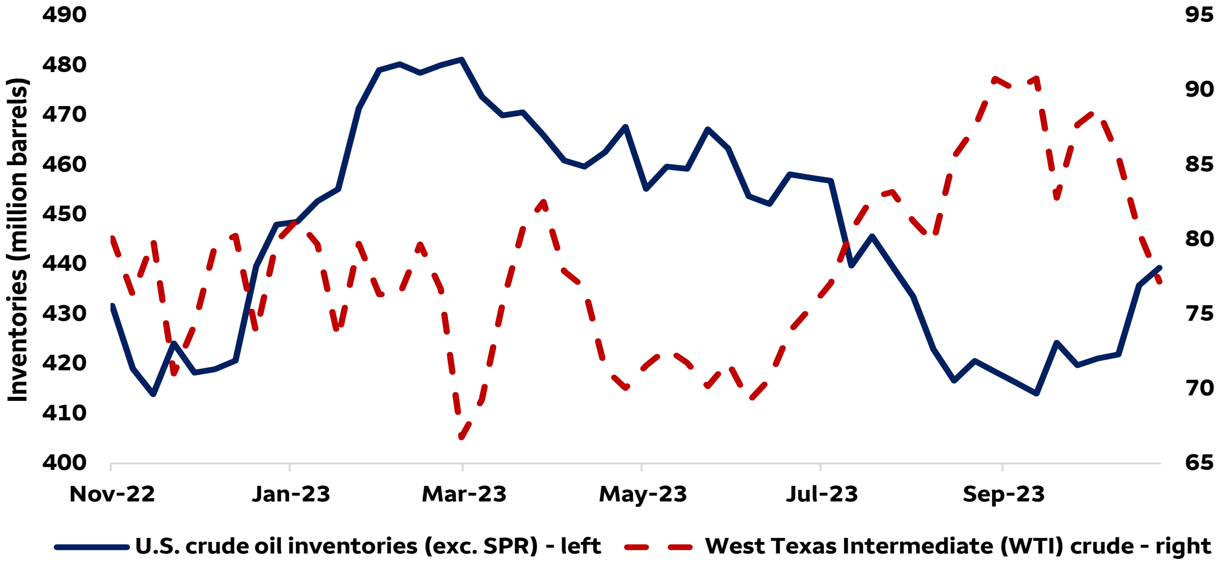
U.S. crude inventories reached a three-month high of 439 million barrels as of November 10, according to the Department of Energy (DOE). Unsurprisingly, the rise in inventories coincided with a drop in crude oil prices. We do not believe it is a coincidence that inventory levels rose to their highest in three months, while oil prices dropped to their lowest levels since July (see chart).

Historically, changes in crude inventories have had a negative correlation with crude oil prices. That relationship can be seen in the chart, as the rise in inventories (blue solid line) has coincided with falling prices (red dashed line). As of November 10, the one-year rolling correlation is -0.6, which indicates a strong negative correlation.

Higher U.S. oil production is driving the buildup of inventories, amidst a weakening economy. Despite a slowing U.S. economy, U.S. production continues to grow as demand from outside the U.S. remains strong, which in turn incentivizes producers to increase production. As of November, U.S. crude oil production sits at 13.2 million barrels per day, or roughly 9% higher year-over-year. Notably, this represents the highest production level on record, finally surpassing pre-COVID-19 levels, according to DOE data.

The bottom line is that a combination of a weakening U.S. economy and growing U.S. oil inventories have hit oil prices. We are not changing our year-end 2024 target ranges, however, of $85 – $95 per barrel for WTI and $90 – $100 per barrel for Brent crude. Prices could weaken still from here, but any significant price dips will likely be countered by strategic purchases by governments and extended OPEC+ supply cuts. (*OPEC+ is a group of 24 oil-producing nations, made up of the 14 members of the Organization of Petroleum Exporting Countries (OPEC) and 10 other non-OPEC members.)* We are also anticipating crude oil demand to pick up by year-end 2024, with oil prices likely moving higher in anticipation.

U.S. crude inventories reach three-month high



Sources: Bloomberg and Wells Fargo Investment Institute. Weekly data is from November 18, 2022, to November 10, 2023. The strategic petroleum reserve (SPR) is the world's largest supply of emergency crude oil, established to reduce the impact of supply disruptions. **Past performance is not a guarantee of future results.**

Alternatives

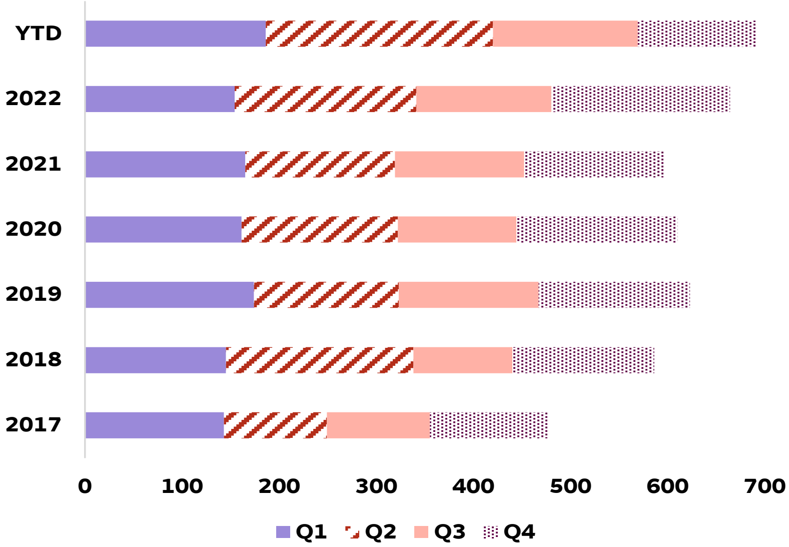
Jonathon Leung
Investment Research Analyst

Investor activism at seven-year high

In the backdrop of macro concerns including probable recession, heightened inflation, and rise in interest rates, investor activism campaigns have remained highly active. Year-to-date as of November 19, 2023, activists launched 691 campaigns globally (see chart below), reaching seven-year highs. The rise in cost of capital typically exerts pressure on micro- and small-capitalization companies to perform and deliver on their stated value proposition to their investor base. Concurrently, shareholders seek reassurance that companies are emphasizing the preservation or enhancement of profitability, acknowledging the difficulty of pursuing overall growth within the challenging economic climate. Activists' strategies can perform well under these conditions, capitalizing on improving company performance.

Despite inherent long bias and beta exposure, activist strategies are distinct in their approach toward unlocking value which often involves operational improvements, reshaping board composition, and influencing management decisions. Additionally, activists frequently propose financial restructuring measures including share buybacks, dividend increases, and debt reduction to bolster a company's stock price. While returns may coincide with market movements to an extent, success relies heavily on managers' ability to drive changes within targeted companies rather than merely riding market trends. Qualified investors should take note that the performance of activists' strategies notably differs depending on their focus on market capitalization and geographic concentration. While opportunities exist within micro-capitalization companies, liquidity often becomes challenging during stressful market conditions, and institutional investors tend to focus on small- to mid-cap companies for greater liquidity and maneuverability.

Investor activism campaigns launched globally by quarter



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of November 19, 2023. YTD = year-to-date. Years and quarters are categorized by campaign launch date. The activism universe includes shareholder proposals, proxy contests, board nominations, and various forms of investor intervention. Data gathered by Bloomberg may not encompass all activist campaign activities.

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.

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 27, 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. 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.

MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada.

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

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An index is unmanaged and not available for direct investment.

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