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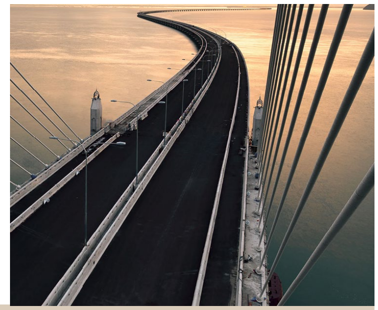
Investment Strategy



Weekly guidance from our Investment Strategy Committee **December 18, 2023**

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

Fixed Income Spotlight

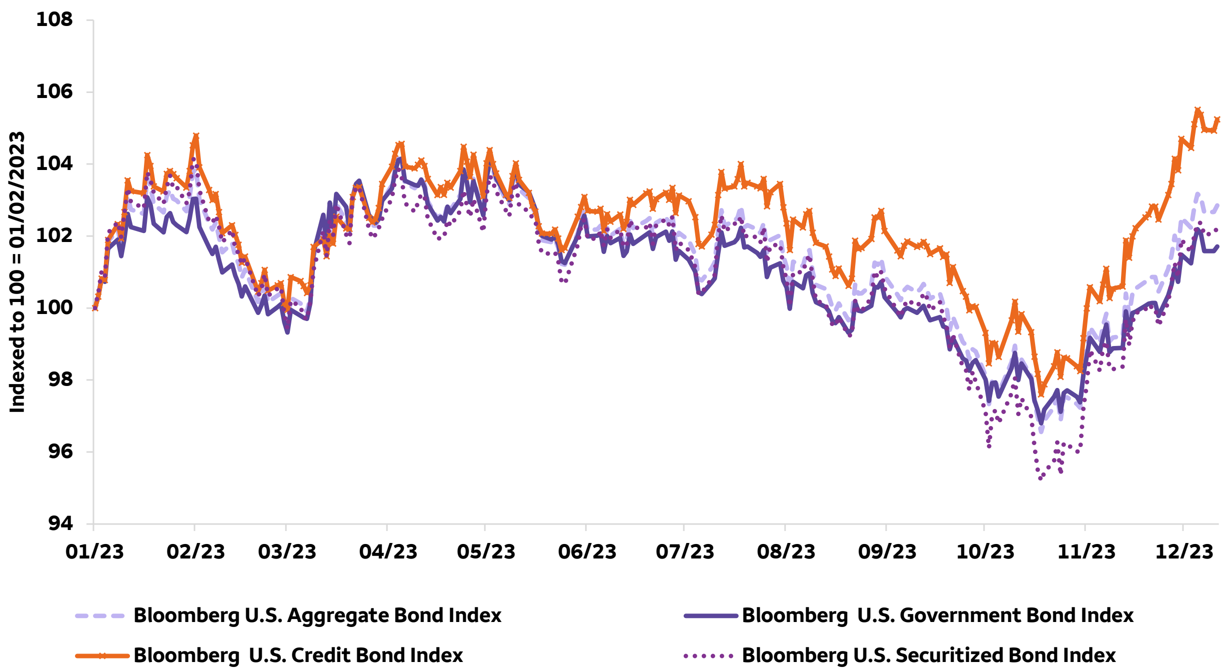
Luis Alvarado
Global Fixed Income Strategist

Corporate fixed-income outlook — 2024

As we get closer to year-end, we can almost assert that U.S. credit markets outperformed in 2023 — as many investors sought the higher yields available in credit markets without much concern over credit risks. The market remained sanguine about the U.S. economic outlook, fueled by a resilient consumer, and fixed-income volatility stayed mostly range-bound after the regional banking crisis in March of this year.

Corporate fixed income — investment-grade (IG) corporates, preferred stock, high yield (HY), and leveraged loans (LL) — managed to display positive performance through most of the year. We believe that the main drivers that helped sustain corporate fixed-income performance this year remain mostly intact as we step into 2024. As we wrote in our 2024 Outlook, we believe next year will be a tale of two halves. Credit markets may see some price declines in the first half as the economic slowdown develops, but we expect them to gain ground once again in the second half as a potential economic recovery comes in sight.

Chart 1. Credit has outperformed year-to-date



Sources: Bloomberg and Wells Fargo Investment Institute, as of December 12, 2023. Daily data from January 2, 2023, to December 12, 2023. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment.

Key drivers of performance

We also mentioned in our 2024 Outlook:

"Investment-grade corporate issuers enter 2024 with strong credit metrics and largely supportive outlooks from the major rating agencies, while a quality-centric approach to high-yield credit should benefit investors in 2024, as most BB-rated companies have the credit quality and business strength to manage a downturn without substantial credit risk."

Therefore, in our view, credit risk appetite should remain elevated, and we expect fund flows to follow suit, particularly toward high quality corporate issuers.

This year, IG corporate bond issuance remained almost on par with 2022 at nearly $1.2 trillion, and the expectation for 2024 is for issuance to come in slightly higher at $1.3 trillion[1]. HY issuers increased issuance in 2023 to almost $180 billion with an expectation for issuance to climb toward $250 billion in 2024[2]. Despite the rising rate environment in 2023, both IG and HY issuance held their ground, supported in part by the benign financial conditions still available in the market and by the appetite for credit risk from investors.

Although many firms managed to refinance their debt at more attractive rates in 2020 and 2021, effectively extending their maturities and lowering their interest expense, some IG issuers will face the first phase of their maturity wall next year — with almost $800 billion set to mature in 2024. Still, our expectation for an earnings recovery in the back half of 2024 should improve credit metrics and allow investor demand to stay strong.

On the other hand, HY issuers still have some time before facing their maturity wall — with only around $60 billion maturing in 2024. However, HY maturities are set to progressively increase from 2025 to 2029, topping out at more than $250 billion. However, at least in the short term, HY issuers have yet to come under significant pressure due to rising funding costs.

HY Taxable Fixed Income (+10.2%) and LL (+12.1%) — as measured by the Bloomberg U.S. Corporate High Yield TR Index and the Morningstar LSTA U.S. Leveraged Loan TR Index — outperformed many other fixed-income asset classes and sectors so far in 2023[3], and we must acknowledge that we missed the majority of this rally by being unfavorable HY since June of 2022 and unfavorable LL since June 2023. Our unfavorable guidance on both asset classes has been mostly predicated on the expectation for a U.S. economic recession, which has not materialized yet.

We believe HY valuations appear somewhat expensive today, as credit spreads seem very tight relative to historical averages, while yields have declined. We will look for opportunities in 2024 to adjust our guidance on HY once more attractive entry credit spreads and yields become available. We also expect HY default rates to peak in the first quarter of 2024 for this cycle, increasing slightly from the level (5.2%) reached in October 2023, according to Moody's Investors Service (Moody's). We anticipate a decline in default rates by year-end 2024 if, as we expect, corporate earnings improve with a U.S. recovery in the second half of next year.

Investor implications

We maintain a neutral position on IG corporate fixed income. If risk-off sentiment in financial markets begins to develop in the first half of 2024 as the economic slowdown sinks in, we believe that the strong demand for yield and high-quality credit should benefit IG bonds over the next 12-months. We currently favor the Financials, Health Care, and Utilities sectors in the IG space.

Also, we maintain our unfavorable view on the HY Taxable Fixed Income asset class, despite stable fundamentals, especially ahead of an economic slowdown. However, for investors willing to bear the risk, we still believe there are potential opportunities in the double-B credit rating space. Differences are beginning to surface among HY sectors and credit ratings, so selectivity remains paramount.

For individual securities, our Global Securities Research team maintains a Credit Opportunities List with its best ideas within the double-B space from Moody's. For broader HY exposure, which requires more robust due diligence to uncover HY value and yield potential, we favor professional, active management.

1. CreditSights "US IG and Leveraged Finance 2024 Outlook", December 4, 2023.
2. Ibid.
3. Year-to-date as of December 12, 2023.

Equities

Chris Haverland, CFA
Global Equity Strategist

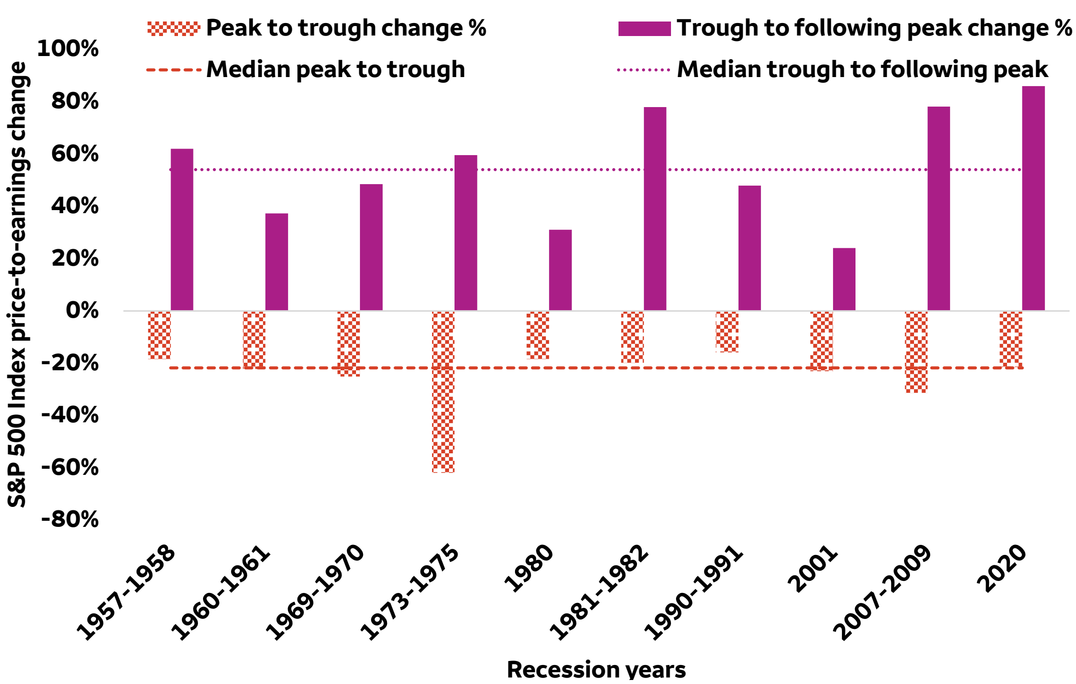
Stay defensive until market pivots toward recovery

Early in a recovery, we would expect to see broad-based equity market gains, which was not the case in 2023. This lack of market breadth (along with our call for an economic slowdown) suggests late-cycle dynamics are at play, leading us to maintain our defensive positioning entering 2024. Before the swivel to recovery, we suggest a patient and diligent focus on quality in equity markets. Specifically, we are favorable U.S. Large Cap Equities, neutral U.S. Mid Cap Equities, and most unfavorable U.S. Small Cap Equities.

Our work suggests U.S. Large Cap Equities (represented by the S&P 500 Index) leads all other equity classes in quality characteristics, such as profitability, earnings stability, liquidity, and healthy balance sheets. U.S. Small Cap Equities (represented by the Russell 2000 Index) scores poorly on several quality metrics, including profitability, with non-earning companies comprising more than 40% of the index.

Once the recession appears to be fully priced in to market valuations, we likely will look for an opportunity to position for a potential early-cycle recovery later in 2024. As is most often the case, that time will likely come while the economy is still in a downturn. Even so, market multiples historically have tended to bottom and begun to expand before the economy recovers. (The chart illustrates how multiples for the S&P 500 Index historically have moved around prior recessions.) Equities (specifically cyclically oriented equities) should benefit the most when the Federal Reserve begins cutting interest rates, the economy exits recession, and corporate earnings begin to grow again.

Recessions have pressured price-to-earnings (P/E) multiples early before recoveries sparked a spike



Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data, July 1957 to March 2021. P/E represented by the S&P 500 Index trailing 12 months price-to-earnings ratio. Horizontal axis shows the recession years. Peak measured from within the 12 months prior to recession start date. Trough measured from 6 months of recession end date. Following peak measured from 12 months after trough. Data as of December 13, 2023. An index is unmanaged and not available for direct investment.

Real Assets

John LaForge
Head of Global Real Asset Strategy

Mason Mendez
Investment Strategy Analyst

With inventories peaking, oil prices may find a floor

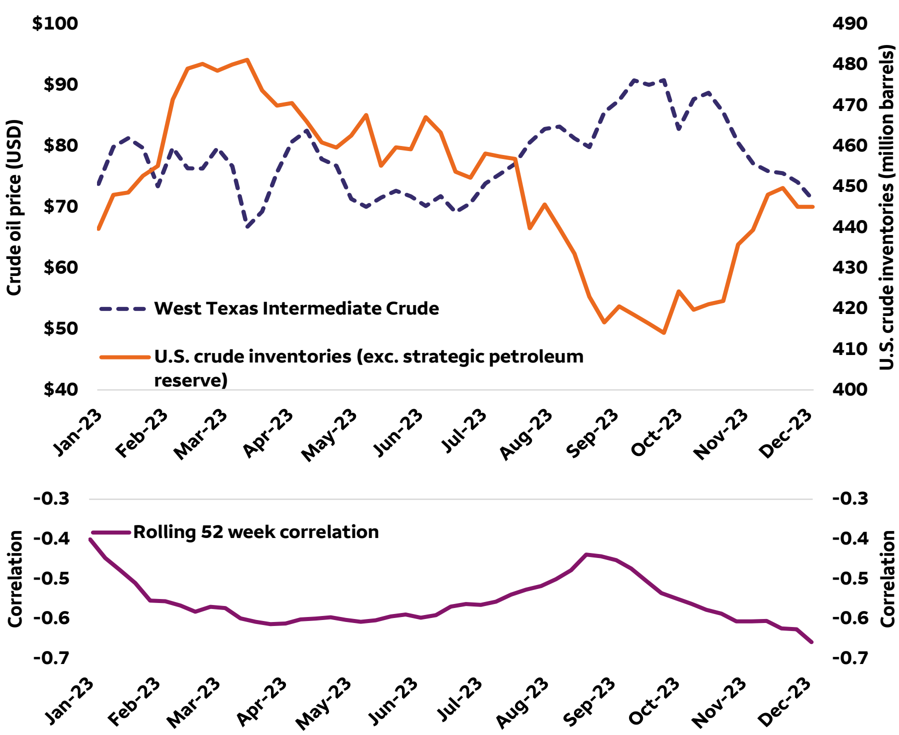
Since peaking at $93 per barrel in September 2023, West Texas Intermediate (WTI) crude prices are down 23% (through December 11, 2023). Notably, the fall in prices has coincided with a buildup of oil inventories in the U.S. This is not necessarily a surprise though, as crude oil prices have typically moved counter to changes in oil inventories.

This counter relationship can be seen in the chart. The solid purple line in the bottom panel, being a routinely negative number, indicates this inverse relationship. Notice that the negative correlation has become even more extreme since late September. According to this chart, growing U.S. oil inventories are the likely culprit behind weak oil prices in recent months.

U.S. inventories have been growing because U.S. refiners entered their fall maintenance season. This is a period from September to December when U.S. refiners shut down large portions of their refining capabilities to undergo routine maintenance. Less purchasing by U.S. refiners has often resulted in more crude oil production ending up in inventories this time of the year. The 2023 fall maintenance season has been especially important to oil prices because U.S. oil production recently returned to all-time highs.

Lastly, the growth in U.S. inventories appears to be peaking. If this is indeed the case, crude oil prices could find a floor soon. We view current oil price weakness as a potentially attractive opportunity for long-term investors aiming to add commodities to investment portfolios.

U.S. crude inventories in 2023



Sources: Bloomberg, and Wells Fargo Investment Institute. Weekly data is from January 7, 2023 – December 8, 2023. **Past performance is no guarantee of future results.**

Alternatives

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

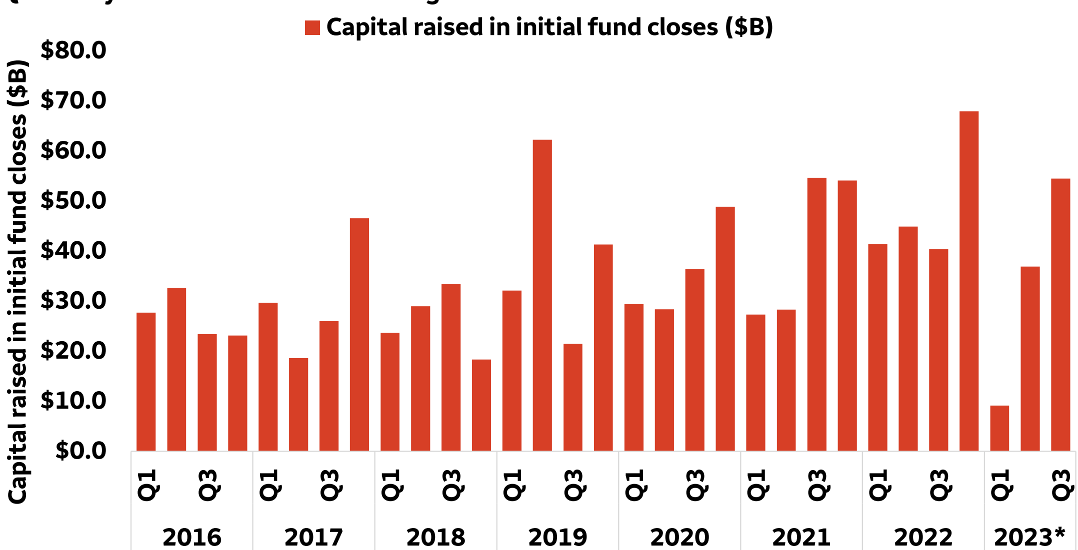
Infrastructure benefiting from long-term tailwinds

Infrastructure investing refers to investments made in essential facilities that support economic and social activities, such as utilities, transportation, energy, education, and healthcare. It has gained traction among investors over the past decade (see chart). Although capital raised dipped to a multi-year low in the first quarter of 2023, we saw resilience in the second and third quarters, with a resurgence in fundraising and dealmaking activities as well as persistent performance, according to Preqin.

Looking forward, we remain constructive on infrastructure investments, based on the short-term and longer-term secular tailwinds outlined below:

- Defensive and inflation-hedged returns: The income from infrastructure investments is typically generated from essential assets and is often linked to inflation. Therefore, infrastructure returns are less impacted by changes in economic activity and public market prices. This characteristic benefited the category in recent periods, as the market experienced elevated inflation and above-average market volatility, which we believe will continue into early next year.
- Sustainability and digitization: Growing investor interest in decarbonization, social welfare, and artificial intelligence should align with investing in upgrading infrastructure assets. In recent years, a variety of infrastructure funds have been created to support the transition to a low-carbon economy, improve access to affordable healthcare and education, and develop the infrastructure for electric vehicles and smart cities.
- Government spending support: Recent government legislation earmarked future budget spending for certain infrastructure types, through either direct investment or tax incentive. With a focus on clean energy transition and digital infrastructure, these public-private partnerships have the potential to benefit investors in the years to come.

Quarterly infrastructure fundraising in initial fund closes



Sources: Wells Fargo Investment Institute, Preqin. Data as of September 30, 2023. *The data for 2023 is 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.

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, December 18, 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 U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Bloomberg U.S. Corporate High Yield Index covers the universe of fixed-rate, noninvestment-grade debt.

Bloomberg U.S. Credit Bond Index measures the performance of investment grade corporate debt with a maturity of one year or more and is dollar denominated.

Bloomberg U.S. Government Bond Index includes U.S. dollar-denominated, fixed-rate, nominal U.S. Treasury securities and U.S. agency debentures.

Bloomberg U.S. Securitized Index includes agency mortgage backed pass-through, investment-grade market of US Agency and US Non-Agency conduit and fusion CMBS deals and asset-backed securities.

Morningstar LSTA U.S. Leveraged Loan Index is designed to deliver comprehensive, precise coverage of the US leveraged loan market.

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity 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.

An index is unmanaged and not available for direct investment.

Bond rating firms, such as Moody's, Standard & Poor's and Fitch, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ('BB', 'B', 'CCC', etc.) are considered low credit quality, and are commonly referred to as "junk bonds".

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