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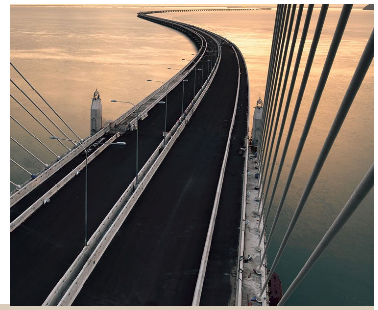
Investment Strategy



Weekly guidance from our Investment Strategy Committee **February 12, 2024**

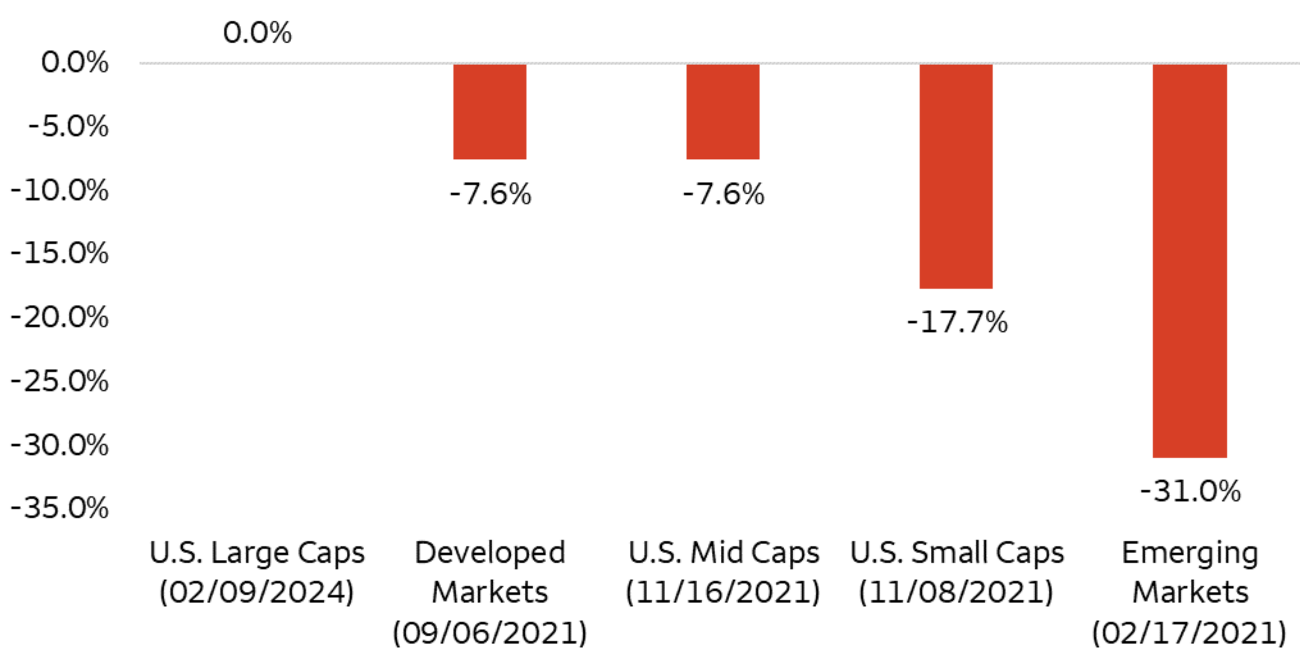
Equities Spotlight

Chris Haverland, CFA
Global Equity Strategist

The path forward after record highs

After reaching 3577 on October 12, 2022, the S&P 500 Index has experienced an impressive rally. Recently, the index touched a record closing high, which some would argue officially ends the bear market that started two years ago. Historically, when a bear market has exited without a recession and hit all-time highs has been positive for 12-month forward returns. Improving inflation readings, lower long-term yields, and anticipation of several rate cuts this year have supported equity prices. In addition, the market has rewarded potential artificial intelligence beneficiaries with premium valuations. This has powered the high-quality tech-heavy S&P 500 Index, while the lower-quality indexes have lagged. In fact, of the five major benchmarks we cover, only the S&P 500 Index has set a new all-time high this year (see chart below).

Asset classes' distance from record highs

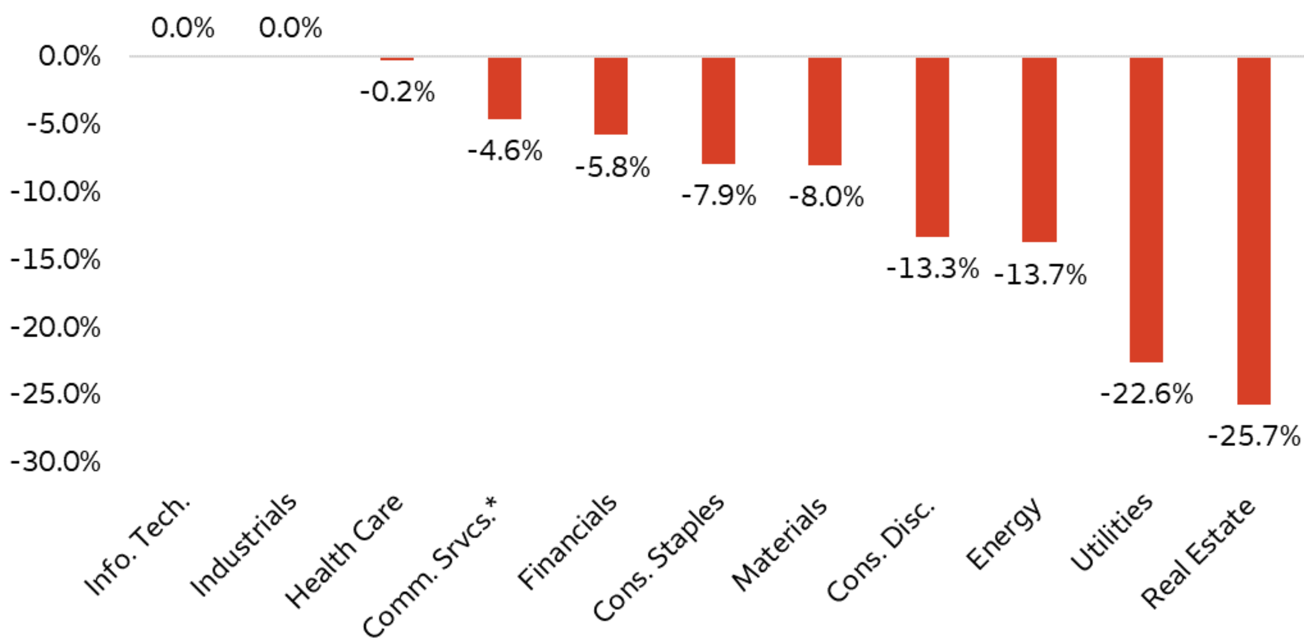


Sources: Bloomberg and Wells Fargo Investment Institute as of February 9, 2024. U.S. Large Caps - S&P 500 Index, Developed Markets - MSCI EAFE Index, U.S. Mid Caps - Russell Midcap Index, U.S. Small Caps - Russell 2000 Index, Emerging Markets - MSCI Emerging Markets Index. The dates are the days when the all-time highs were reached. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

The chart above shows how far behind the lower quality asset classes (U.S. Small Cap Equities and Emerging Market Equities) are from reaching new highs. High-quality companies (those with solid cash positions, consistent earnings growth, and low debt levels) have outperformed over the past several years and that theme has been expressed in our guidance. We have favored U.S. Large Cap Equities (the highest-quality asset class) since early 2020 with the benchmark more than doubling over that timeframe. We have been unfavorable on lower-quality asset classes since March 2022. Both the Russell 2000 Index and the MSCI Emerging Markets Index have had negative returns since then. While we did see some broadening of the rally in the fourth quarter of 2023, that has fizzled in early 2024 with quality taking the lead again. In our view, it is still too early to add low-quality exposure to the portfolio. However, we likely will take advantage of pullbacks by adding risk in anticipation of broadening market participation later in the year.

Sector performance within the S&P 500 Index has been concentrated as well. As mentioned above, Information Technology led the index to record highs, reaching its own all-time high this year (see chart 2 below). In addition, Industrials and Health Care (two of our favored sectors) are near record highs, but most other sectors have underperformed from their lows. While the Information Technology outperformance may be justified, valuations are high relative to history and the S&P 500 Index. This likely leaves the sector vulnerable for a correction if earnings disappoint. We suggest trimming some gains in Information Technology and tech-related sectors (Communication Services and Consumer Discretionary) and reallocating to sectors that may benefit from a shift to cyclical leadership (that is, Energy, Industrials, and Materials).

S&P 500 Index sectors distance from record highs



Sources: Bloomberg and Wells Fargo Investment Institute as of February 9, 2024. The all-time highs for each sector are included next to each listed sector name: Information Technology (February 9, 2024), Industrials (February 9, 2024), Health Care (February 7, 2024), Financials (January 12, 2022), Materials (December 31, 2021), Consumer Staples (April 20, 2022), Energy (June 23, 2014), Consumer Discretionary (November 19, 2021), Utilities (September 12, 2022), and Real Estate (December 31, 2021). *The Communication Services sector's all-time high was in 1999, but due to constituent changes we are using the recent cycle high (September 1, 2021). An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Our year-end 2024 target range for the S&P 500 Index is 4800 – 5000. As of this writing, the index is trading near the upper end of our range. The surge in prices over the past year has been driven by price/earnings multiple expansion with earnings essentially flat in 2023. In our view, it is unlikely that valuations will carry returns again in 2024. Instead, earnings growth will be needed to support the continued upward trajectory in prices. With equity prices around the top of our target range, we think it is prudent to rebalance portfolios. Until broader participation is sustained, and earnings growth accelerates, we continue to be defensive and focus on quality in our guidance. However, with the economic outlook improving and the Federal Reserve likely easing monetary policy later this year, we will look to add equity exposure as opportunities present themselves.

Fixed Income

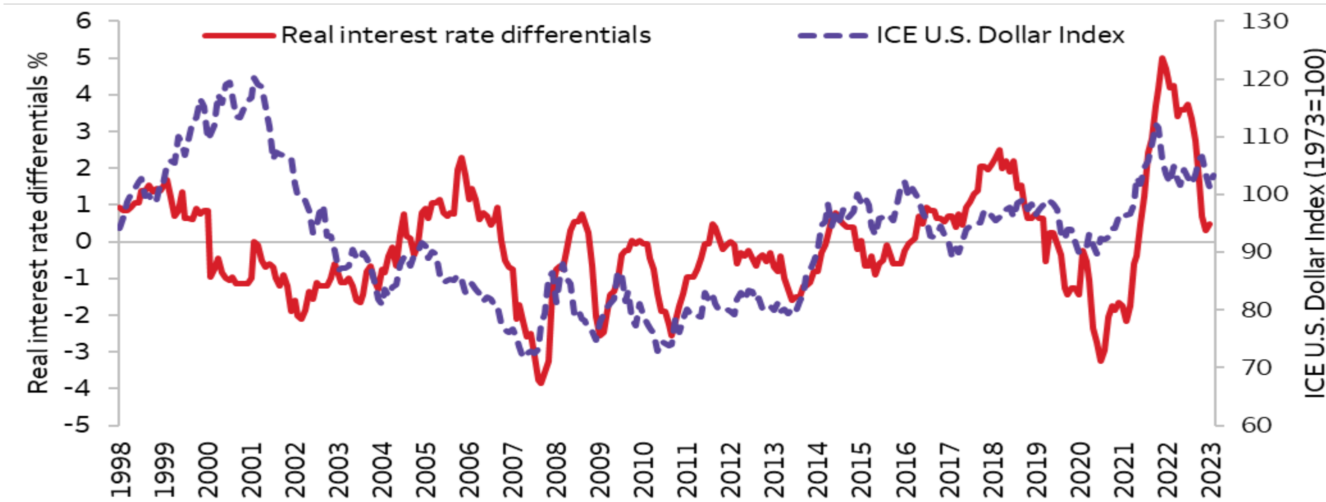
Tony Miano
Investment Strategy Analyst

Dollar strength, at least for now

The U.S. dollar (USD) has seen a period of notable strength since early 2022. The ICE U.S. Dollar Index (DXY)[1] crossed above 100 in April of 2022 and has not fallen significantly below that level since. The macroeconomic outlook and interest rate differentials have been a key driver for the USD. U.S. ultra-short interest rates remain above other developed countries' short rates and this historically tends to be supportive of the USD.

The chart below demonstrates that positive interest rate differentials have accompanied a rising DXY as money flowed into the U.S. Real interest rates differentials fell but remained positive. The USD softened noticeably from October to December of 2023, which coincided with a softening interest rate outlook as the market anticipated 150 – 175 basis points (100 basis points equal 1%) of Federal Reserve (Fed) interest rate cuts in 2024 and lower interest rate differentials. However, market expectations of rate cuts have fallen since late December which have contributed to a rise in the USD.

U.S. dollar and real interest rate differentials



Source: Bloomberg, as of January 31, 2024. ICE U.S. Dollar Index represents a weighted average of the value of the U.S. dollar relative to a basket of U.S. Trade partner currencies comprised of the euro, Japanese yen, pound sterling, Canadian dollar, Swedish krona, and Swiss franc. A higher index value indicated dollar appreciation. Real interest rate differentials is the difference between inflation-adjusted values for central bank rates between the U.S. Federal Reserve and European Central Bank. An index is unmanaged and not available for direct investment.

Economic concerns in the eurozone may also be additive to the DXY following Russia's invasion of Ukraine as well. Once the Fed begins to cut rates and the global economy begins to emerge from economic uncertainty later in the year, we believe the USD may depreciate as capital flows out of the U.S. and into recovering international and emerging market economies.

We believe that dollar strength should continue into the middle part of the year before some depreciating occurs. For now, we believe that a relatively stable USD will remain a headwind toward assets priced in other currencies. We remain unfavorable emerging market (EM) equities and neutral on EM bonds. We prefer EM bonds priced in USD relative to local currencies given the expected strength of the dollar.

1. The ICE U.S. Dollar Index is a weighted average index (1973=100) of the value of the U.S. dollar relative to a basket of U.S. trade partner currencies, composed of the euro, Japanese yen, pound sterling, Canadian dollar, Swedish krona, and Swiss franc. A higher index value indicates dollar appreciation.

Real Assets

Mason Mendez
Investment Strategy Analyst

John LaForge
Head of Real Asset Strategy

Commodity bull super-cycle update

It is amazing that it has been nearly four years since our long-term outlook for commodity prices turned bullish alongside the beginning of a new commodity bull super-cycle. Commodity bull super-cycles are multi-year periods marked by strong price performances by most commodities, often lasting a decade or longer. We believe March 2020 marks the seventh bull super-cycle since the year 1800, and it is the main reason we remain bullish on commodities still today.

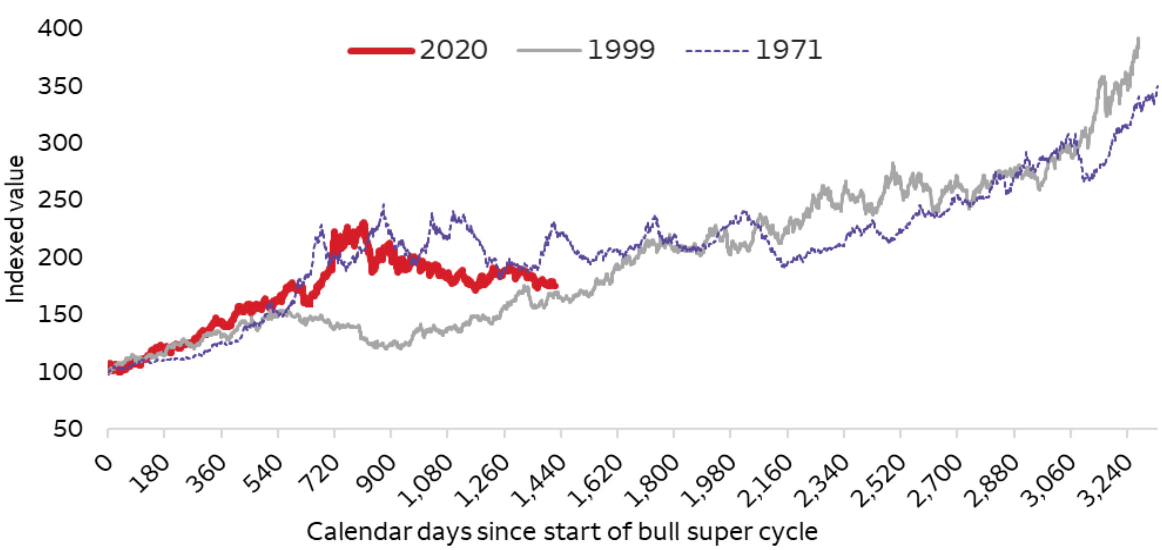
As a refresher, commodities are assets that move together through long-term boom (bull) and bust (bear) periods, known as super-cycles. Prior to 2020, we had witnessed six bulls lasting 17 years on average. The two most recent bull super-cycles, starting in 1971 and 1999, however, lasted only nine years each. These can be seen in the chart below, along with our current bull, which we suspect will track closely to these two cycles.

2023 was a lackluster year for most commodities, which has some wondering if we remain bullish. Our answer is yes; we remain bullish on commodities, and likely will for a few more years. As seen in the chart below, historically it has been common for commodity prices to take breathers during bulls.

Our take is that the bull will likely resume sometime in 2024. We believe this because the underlying driver of commodity bulls, lack of supply growth relative to demand growth, remains intact. And we do not expect to see this balance changing anytime soon. Price weakness in 2023 has kept supply growth muted for many commodities, while demand is likely to improve as global central banks cut interest rates in 2024.

The bottom line is that we remain bullish on commodities and believe the bull super-cycle that started in March 2020 remains intact. We view recent price weakness as an opportunity for investors to gain exposure to commodities for the next leg of the commodity bull super-cycle.

Modern commodity bull super-cycles



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data is indexed to 100 as of the start of the bull super-cycle. Performance is measured from October 4, 1971 – November 20, 1980; July 13, 1999 – July 2, 2008; and March 18, 2020 – February 6, 2024. Commodity performance measured by the Refinitiv Equal Weight Commodity Index from October 4, 1971 – November 20, 1980. The Bloomberg Commodity Total Return Index is used to measure performance from July 13, 1999 – February 6, 2024. **Past performance is not a guarantee of future results.** Indexes are unmanaged and are not available for direct investment.

Alternatives

Nick Sprague, CFA
Senior Investment Analyst

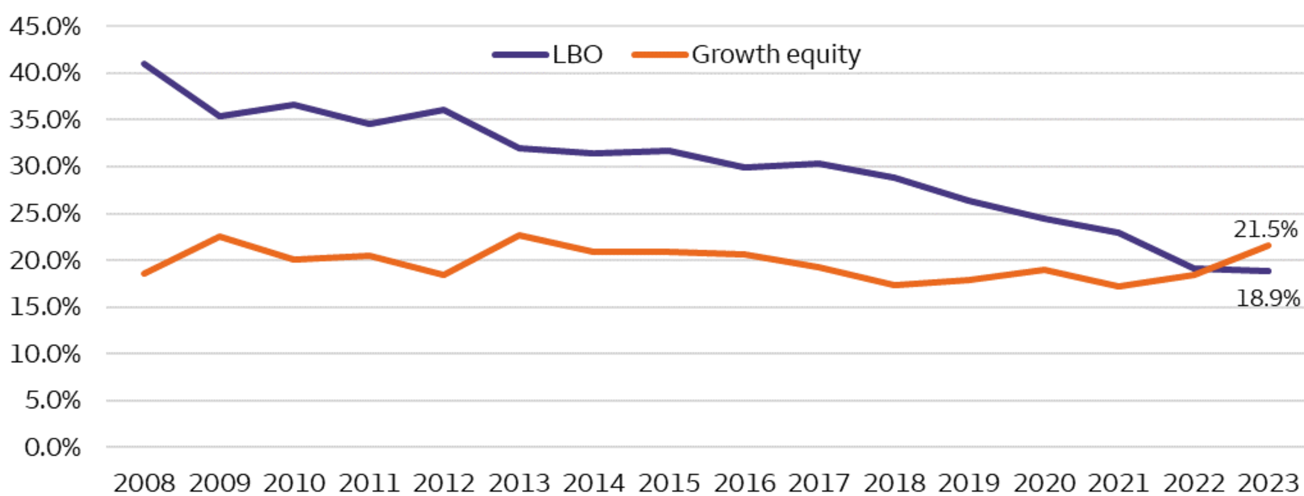
Growth equity gains share in 2023

Private equity (PE) deal activity continued its decline in 2023, characterized by a 29.5% decline in deal value and 7.3% decrease in deal count. The impact was most pronounced in traditional leveraged buyouts (LBOs)[2], which typically rely heavily on access to new debt. The high cost and limited availability of leverage posed significant challenges in financing LBOs, prompting a shift in the PE deal market to other deal types less reliant on new debt. Growth equity[3], for instance, increased its share of PE deal value by 2.8 percentage points year-over-year, and for the first time accounted for a greater share of all PE transactions than LBOs (see chart).[4]

The rise in deployment of growth equity can be attributed to several advantages it offers in the current macroeconomic environment. Growth equity deals are typically 100% equity financed, and thus unaffected by the current high cost of debt. Moreover, the strategy generally targets high-growth, profitable companies and relies on operating leverage rather than financial leverage to drive returns.[5]

Additionally, in 2023, U.S. PE enterprise value to revenue multiples (the valuation multiple on which growth equity deals are typically priced) contracted by approximately 40% year-over-year. With more attractive valuations and growth equity's relative suitability to current market dynamics, we maintain a positive outlook on the strategy. We anticipate continued momentum in 2024, providing investors with a pathway to sustainable value creation in uncertain times.

LBO and growth equity as a share of all PE deals



Sources: Pitchbook 2023 Annual U.S. PE Breakdown. Data as of December 31, 2023 . LBO = leveraged buyouts.

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.

2. Leveraged buyouts involve acquiring a company using a significant amount of borrowed funds.
3. Growth equity involves providing a mature company with capital for expansion in exchange for equity (usually a minority stake).
4. Source: Pitchbook 2023 Annual U.S. PE Breakdown
5. Operating leverage relates to a company's cost structure and its impact on profitability; financial leverage pertains to the use of debt financing and its effect on a company's risk and return profile

Tactical guidance*

Cash Alternatives and Fixed Income

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
	High Yield Taxable Fixed Income	Cash Alternatives Developed Market Ex-U.S. Fixed Income Emerging Market Fixed Income U.S. Long Term Taxable Fixed Income U.S. Intermediate Term Taxable Fixed Income	U.S. Taxable Investment Grade 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, February 12, 2024. *Tactical horizon is 6-18 months

**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 Total Return Index reflects the returns that are potentially available through an unleveraged investment in the futures contracts on 19 physical commodities comprising the Index plus the rate of interest that could be earned on cash collateral invested in specified Treasury Bills. The Index is a rolling index rebalancing annually.

ICE U.S. Dollar Index is a weighted average index (1973=100) of the value of the U.S. dollar relative to a basket of U.S. trade partner currencies, composed of the euro, Japanese yen, pound sterling, Canadian dollar, Swedish krona, and Swiss franc. A higher index value indicates dollar appreciation.

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.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

Refinitiv Equal Weight Commodity Index (formerly known as the Continuous Commodity Index) is a major US barometer of commodity prices.

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. The 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.

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.

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.

S&P 500 Consumer Discretionary Index comprises those companies included in the S&P 500 that are classified as members of the GICS® consumer discretionary sector.

S&P 500 Consumer Staples Index comprises those companies included in the S&P 500 that are classified as members of the GICS® consumer staples sector.

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

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

S&P 500 Health Care Index comprises those companies included in the S&P 500 that are classified as members of the GICS® health care sector.

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

S&P 500 Information Technology Index comprises those companies included in the S&P 500 that are classified as members of the GICS® information technology sector.

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.

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

An index is unmanaged and not available for direct investment.

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