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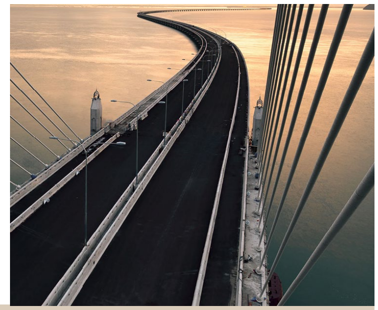
Investment Strategy



Weekly guidance from our Investment Strategy Committee — January 8, 2024

Global Economy Spotlight

Gary Schlossberg
Global Strategist

Jennifer Timmerman
Investment Strategy Analyst

Whither inflation?

There is much riding on the outlook for inflation in the new year, including the timing and extent of the Federal Reserve's (Fed's) interest rate cuts, the strength of consumer and business spending, and perhaps, this year's presidential election outcome. Inflation's gratifying descent over the past 18 months still leaves Main Street and Wall Street pondering these issues in 2024:

- Is inflation already low enough to justify market expectations for Fed rate cuts early this year?
- Will the economy's slowdown be enough to sustain disinflation into the second half of 2024?
- Over the longer term, can inflation resume its secular decline beyond the next economic cycle, returning to its ultra-low average observed in the decade before the pandemic?

Are we there yet … and are we staying when we arrive?

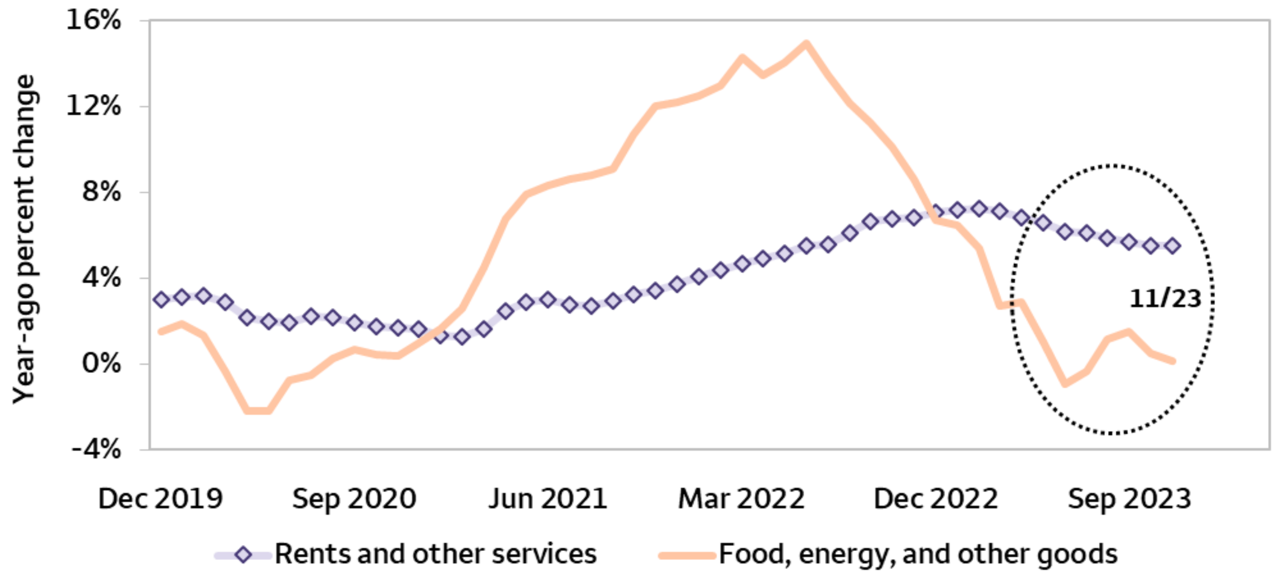
An 18-month decline left inflation, measured by the November Consumer Price Index (CPI) and the Fed's favored Personal Consumption Expenditures (PCE) deflator at just over 3% and 2.6%, respectively — close enough to the central bank's 2% inflation target for investors to anticipate Fed rate cuts early in 2024. The issue now is whether inflation can reach and hold the line at a satisfactory level. That would reduce the risk of the Fed responding to a false dawn in prematurely cutting rates and leaving itself exposed to an inflation flare-up like the one policymakers faced in the 1970s.

Our view is that inflation will unwind more slowly than it has in the past year for several reasons, delaying Fed rate cuts until the second half of 2024. First, we view declines in fuel and other goods costs, responsible for much of the disinflation in the past year, as being more limited, if not reversible. Oil prices have yet to fully reflect recent supply cuts by OPEC+[1], supply disruptions from Middle East disturbances, and cuts in U.S. output responding to recent price declines. We also expect other goods price deflation to unwind now that the risks to global supply chains are once again rising, China's deflation is being blunted by government stimulus, and inventory de-stocking is abating amid a recent upturn in goods spending.

Second, diminishing goods deflation likely will leave the work of disinflation to less economically sensitive and therefore, "stickier" rents and other services prices. Note the modest decline in services inflation compared to the collapse in goods prices since inflation peaked in June 2022 — as shown in the chart below. Uneven adjustment to the pandemic's impact on supply chains, labor markets, and the pattern of spending imbalances left the gap between services inflation and goods deflation at a seven-year high in November 2023.

[1] 1. Organization of the Petroleum Exporting Countries and its allies.

CPI's decline slowed by "sticky" services inflation



Sources: Wells Fargo Investment Institute and Bureau Of Labor Statistics. Monthly data December 2018 - November 2023. *CPI = Consumer Price Index.

We expect rents — inflation's most visible hot spot — to moderate as a temporary bulge in supply comes online, but inflation in other services prices may fall more gradually. Rebounding medical care inflation will offset much of the reduced pressure on travel and entertainment costs as pent-up demand there diminishes. More generally, labor-intensive, wage-sensitive services prices should benefit from a rebalancing of worker supply with demand tied to post-pandemic adjustment and to a slowing economy.

You can't go home again

Lastly, we believe structural forces responsible for inflation's decades-long decline are relaxing their grip, likely leaving inflation hovering noticeably above its sub-2% average seen in the decade before the pandemic. We believe labor's market power will be sustained by slowing growth of the workforce in an aging population reinforced by increased unionization. Additionally, reshoring and supply-chain fragmentation away from efficient, low-cost China are eroding globalization's cost-cutting potential.

Industrial policy encouraging reshoring of large-scale, capital-intensive manufacturing to the U.S. also could reduce competition by lifting financing requirements and entry barriers in these industries. The partial offset to wage pressures has and should continue to come from the internet's lift to competition from greater price transparency, along with productivity enhancements from artificial intelligence and other high-tech investment.

Investment implications

The challenging combination of more gradual disinflation in a slowing economy is fully consistent with our cautious investment strategy recommendations favoring high-quality stocks and an early rotation toward shorter-term, investment-grade securities now that yields likely have peaked. As the slowing economy eventually reduces inflation by enough for the Fed to cut interest rates, we expect a pivot to stronger economic growth and broader investment opportunities across a range of cyclically sensitive asset classes and sectors.

Equities

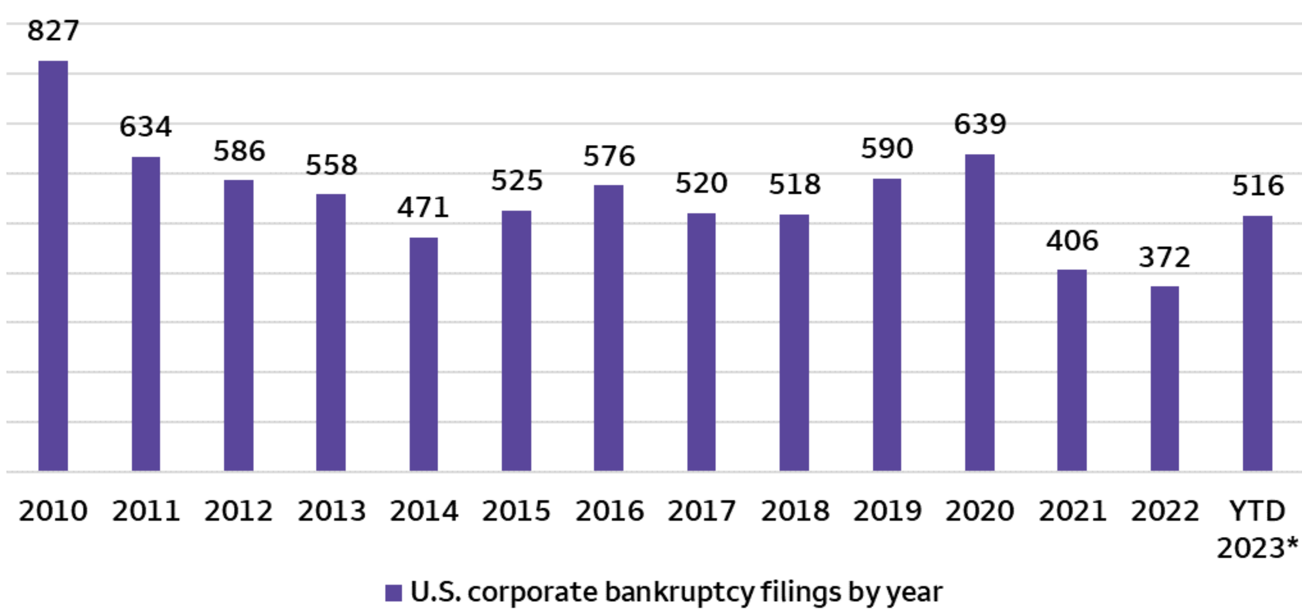
Mike Ruesy, CFA
Equity Sector Analyst, Financials

Reflections on secondary effects of Fed policy

The actions of the Fed over the past two years have focused on bringing inflation under control. It is an effort with secondary effects, including making financing conditions for individuals and businesses more challenging. Financing cost was not really a concern for most of the past decade, particularly for levered businesses — market liquidity was plentiful, and central banks leaned on rates. That said, circumstances have changed. The current period of higher interest rates may add pressure to already levered companies, those needing to refinance maturing debt, and those with floating-rate obligations. The new cost of financing is likely much higher than before and may lead to reduced debt service coverage and creditworthiness for borrowers.

For several quarters, consumer and commercial lenders have expected credit losses to normalize after a very benign period. We think this period of credit normalization may even evolve into a credit default cycle. Much though depends on the path of interest rates — specifically, how high interest rates stay and for how long. Should the stress become particularly severe, a cycle might even include rising bankruptcies. To that point, data compiled by S&P Global Market Intelligence shows that U.S. corporate bankruptcy filings in 2023 (through September 30) were 39% higher than the full-year total for 2022 and 27% higher than the full-year total for 2021, two periods in which credit was quite benign.

Corporate bankruptcy filings increased in 2023



Sources: S&P Global Market Intelligence and Wells Fargo Investment Institute. *Year-to-date figure through September 30, 2023. Data as of October 10, 2023.

Fixed Income

Eric M. Jasso, CFA
Senior Retail Fixed Income Analyst

Rising funding costs slow to impact single-B credit

High yield (HY) credit spreads have moved significantly tighter over the past 18 months despite the potential for an economic downturn. While double-Bs have come to populate a larger proportion of the ICE BofA U.S. High Yield Index (Index), single-Bs have historically had the highest correlation to index-wide performance. As of year-end, single-B spreads have moved near their tightest levels since 2007 and credit metrics have remained near historic averages. Interest coverage saw only a modest deterioration in 2023 across most sectors as stable earnings have allowed single-B companies to avoid relying on expensive short-term funding. The largest declines have been in cyclical industries, Energy and Industrials, where coverage remains above average owing to particularly strong metrics entering 2023. The only pocket of emerging distress has been the Communications sector driven by a secular decline among landline providers.

Single-Bs have a fairly heavy schedule of debt maturing in the 2025 – 2029 time; however, the impact of doing so at higher funding costs alone will only modestly impact interest coverage if these credits underlying businesses remain stable. We believe credit spreads are currently far too tight in most cases to be considered attractive; however, low bond prices and relatively high yields can provide investors with some attractive opportunities as more visibility emerges on the economic trajectory. As investors prepare a shopping list, we encourage them to prioritize issuers that will likely have the business strength to grow earnings as funding costs rise. Global Securities Research[2] maintains a Credit Opportunities List with our best individual bond ideas within the HY asset class.

Category	Current interest coverage ratio	10-year average (Q4 2013- Q3 2023)
Single-B	2.24	2.48
Discretionary	2.14	2.62
Communications	1.22	1.85
Staples	2.61	2.63
Energy	2.88	2.77
Basic Industry	3.23	3.02
Capital Goods	2.41	2.97
Technology	2.00	3.12

Sources: Bloomberg Data and Wells Fargo Investment Institute – Interest Coverage Ratio as of most recent financial reporting (Q3 2023).

[2] Global Securities Research is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly-owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

Real Assets

Ian Mikkelsen, CFA
Equity Sector Analyst, Energy

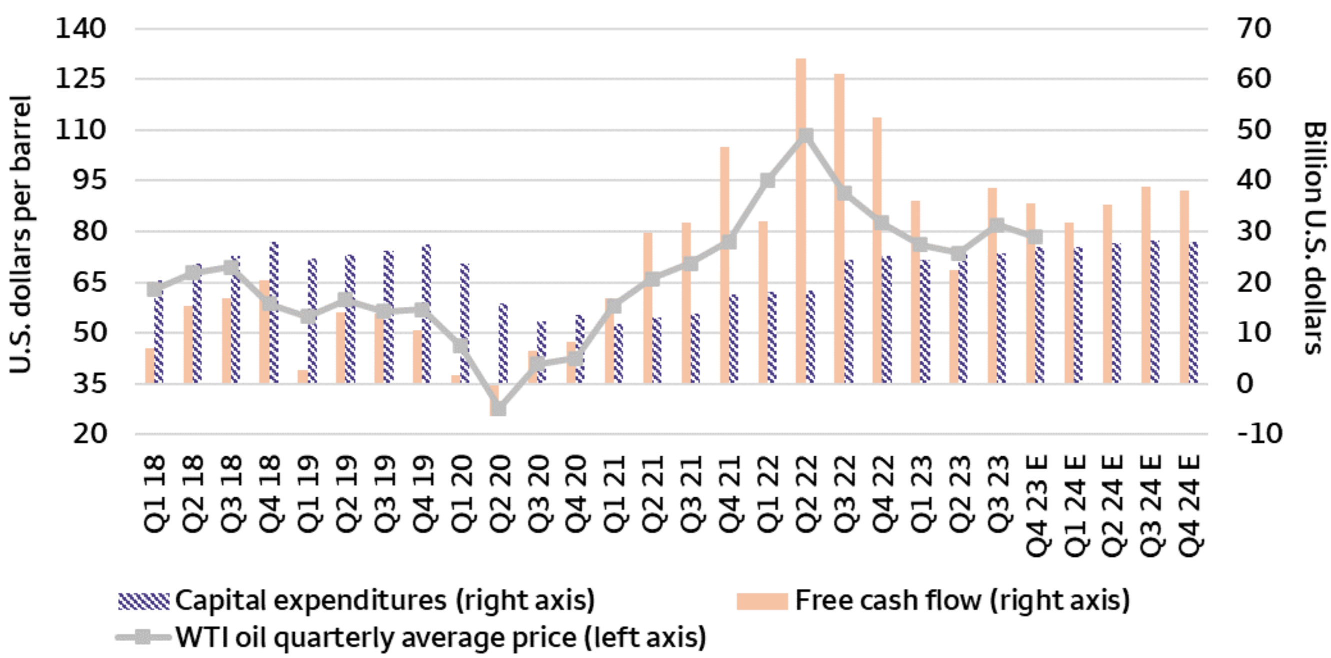
Energy sector: Outlook for 2024

After strong outperformance in 2021 and 2022, Energy sector performance took a breather in 2023. Cash flows have retreated from peak levels in 2022 due to lower commodity prices and higher capital expenditures (see chart). The good news is that we believe most companies within the sector have the ability to maintain strong balance sheets at current commodity price levels and will continue to allocate excess capital toward shareholder returns.

Capital expenditures have risen significantly from trough pandemic-era levels and are expected to increase by a reasonable 8% in 2024. Cash flows are expected to increase by 9% year over year in 2024 based on current consensus commodity price estimates. Following three years of transformational change across the sector, we do not believe there is much potential for capital expenditures to deviate from current expectations, and thus, we expect that cash flows will primarily be dictated by commodity movements in 2024.

Recently, investor sentiment toward Energy equities has been weighed down by global economic uncertainty. These concerns are fair, in our view, as we forecast continued softening economic conditions in 2024. However, negative sentiment may prove to be shortsighted once the economy finds more stable footing, which in turn should support commodity prices. This outlook is embedded in our West Texas Intermediate oil price forecast of $85 – $95 for year-end 2024, which we would expect to drive positive performance for the Energy sector. In the near term, however, uncertainty may continue to drive periods of downside volatility for Energy equities.

Oil prices relative to Energy sector capital expenditures and free cash flow



Sources: FactSet and Wells Fargo Investment Institute. The chart compares quarterly aggregate capital expenditures to free cash flow generation (the amount of cash leftover after expenses) for the S&P 500 Energy sector, with an overlay of the average West Texas Intermediate (WTI) crude oil price for each quarter. For capital expenditures and free cash flows, we show actual quarterly results from Q1 2018 through Q4 2023 and consensus estimates for 2024 quarterly figures. "E" indicates estimated figures as of January 2, 2024. **Past performance is no guarantee of future results.**

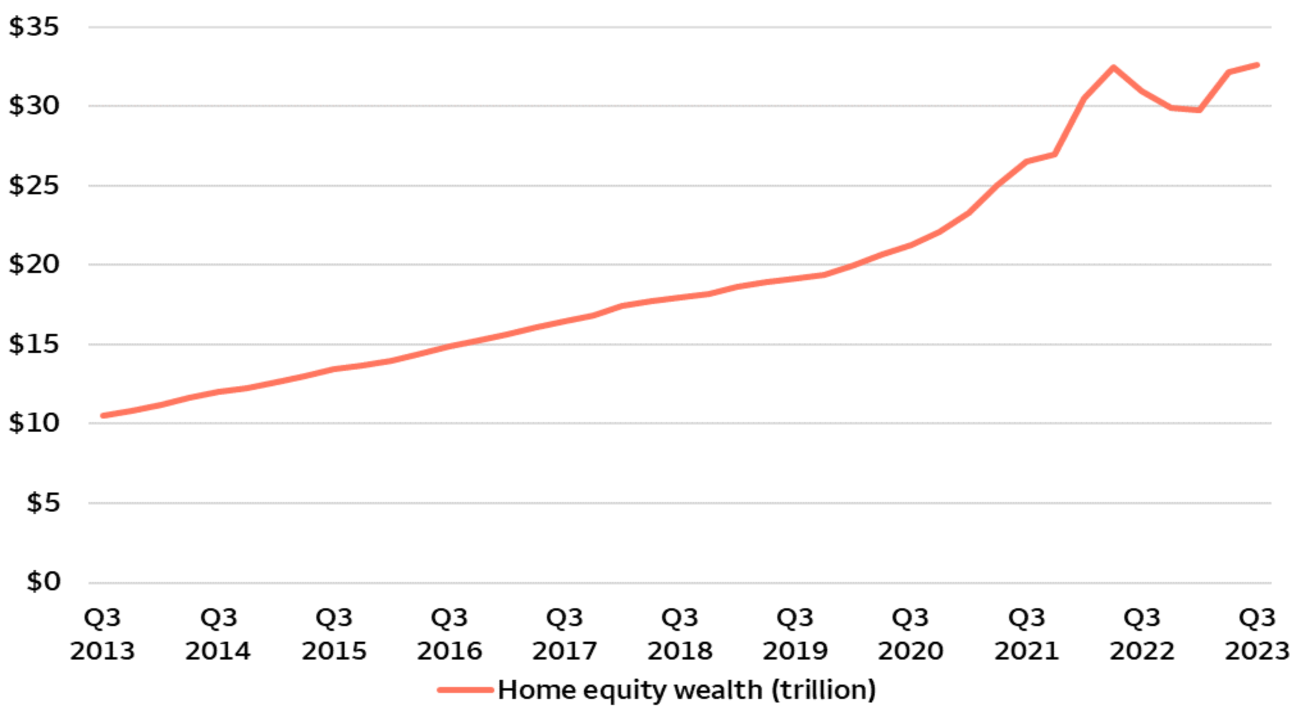
Alternatives

Muni Malhotra, CFA
Investment *Research Analyst*

The wealth in U.S. homes

The S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index stood at an all-time high in October (the latest data available) after rallying for nine consecutive months. While mortgage rates are down from recent peaks, they are still high with the 30-year fixed-rate mortgage at 6.61%, as per the most recent data for Freddie Mac's Primary Mortgage Market Survey. The high interest rates have driven down homeowner affordability as represented by the National Association of Realtors: Housing Affordability Index. Despite the high prevailing mortgage rates and the low homeowner affordability, the limited supply of home listings has pushed home prices upward. Contributing to the limited supply is the rate lock-in effect wherein effective mortgage rates which are locked in are on average 250 to 350 basis points (100 basis points equals 1%) lower than the prevailing rates and this has been a disincentive for homeowners to sell. Along with an increase in home prices there has been an increase in home equity wealth. Over the past 10 years, there has been a massive increase in home equity wealth from $10 trillion to $33 trillion. This has helped strengthen consumer balance sheets. With consumer spending amounting to about two-thirds of the U.S. gross domestic product, a resilient consumer has contributed to a resilient economy. While wealth accumulated in home equity would be expensive to draw upon due to the current high interest cost, it does bolster the balance sheet of the consumer and in turn the consumer's willingness to spend.

U.S. aggregate home equity wealth



Source: Board of Governors of the Federal Reserve System (U.S.), Households; Owners' Equity in Real Estate, Level, retrieved from FRED, Federal Reserve Bank of St. Louis. Data as of January 1, 2024.

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 guidance over tactical horizon (6-18 months)

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, January 8, 2024.

*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

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. 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

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.

Housing Affordability Index measures whether or not a typical family earns enough income to qualify for a mortgage loan on a typical home at the national and regional levels based on the most recent price and income data.

ICE BofA U.S. High Yield Index tracks the performance of U.S. dollar denominated, below investment-grade rated corporate debt publicly issued in the U.S. domestic market.

OPEC+ = 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

PCE deflators (or personal consumption expenditure deflators) track overall price changes for goods and services purchased by consumers. Deflators are calculated by dividing the appropriate nominal series by the corresponding real series and multiplying by 100.

S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index is a composite of single-family home price indices for the nine U.S. Census divisions and is calculated monthly. It is included in the S&P CoreLogic Case-Shiller Home Price Index Series which seeks to measure changes in the total value of all existing single-family housing stock.

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

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