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Investment Strategy

Weekly guidance from our Investment Strategy Committee **January 29, 2024**

Alternatives Spotlight: Strategies to help navigate volatile credit markets 2

- Heightened bond market volatility suggests risk levels remain elevated in today's market environment.
- Hedge fund strategies such as Long/Short Credit may add further diversification to a portfolio of traditional stocks and bonds and allow investors to potentially mitigate risk in difficult market environments.

Equities: Energy up, Financials down 4

- Higher oil prices by year-end 2024 should help Energy outperform, while the economic slowdown and regulatory environment should pressure Financials.
- We upgraded Energy from neutral to favorable and simultaneously downgraded Financials from neutral to unfavorable.

Fixed Income: High yield — performing but expensive 5

- While not predicted, the high yield asset class is susceptible to an unexpected market shock.
- We remain unfavorable in high yield fixed income due to expensive valuations; a weakening economy may lead to more stress for lower rated credits. Should the economy continue to perform better than expected, we believe high yield would likely continue to outperform many other fixed income asset classes.

Real Assets: Despite record production, crude inventories remain low 6

- Despite the U.S. achieving record crude oil production of 13.3 million barrels per day in late 2023, U.S. inventories remain below their 5-year average.
- The U.S. is exporting much of its extra oil production, due to strong overseas demand, which we expect to continue in 2024.

Current tactical guidance 7

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Alternatives Spotlight

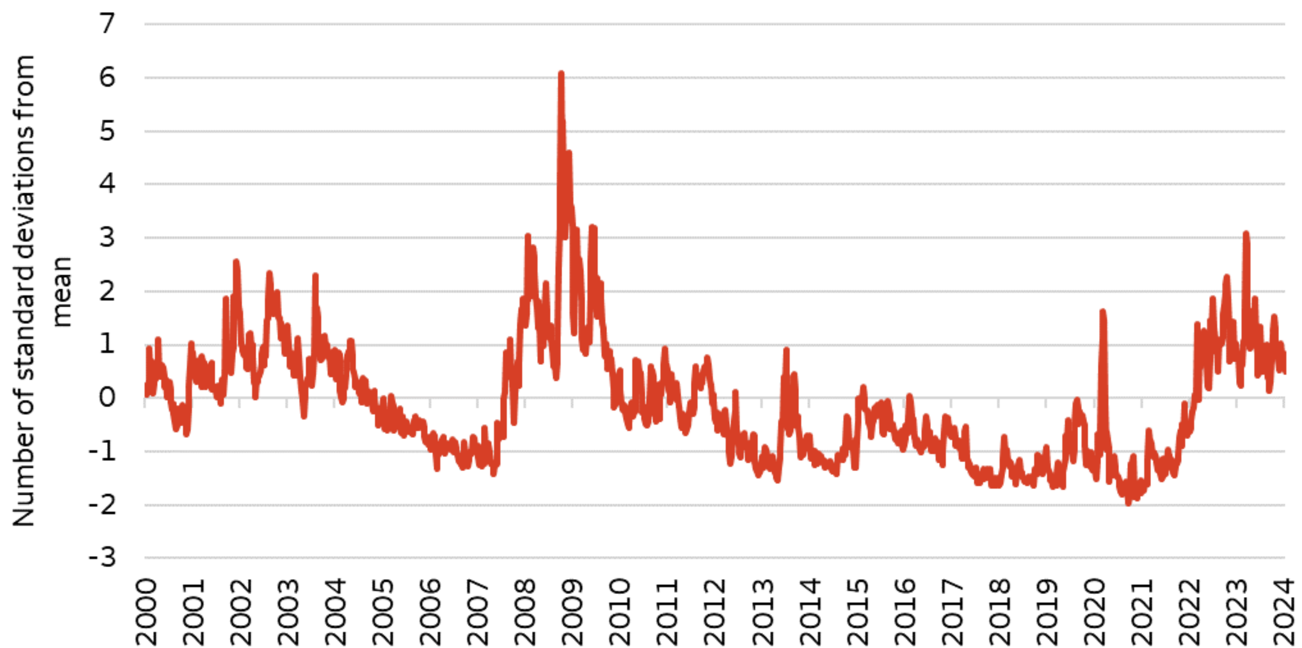
Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

Strategies to help navigate volatile credit markets

Interest rates have been in a long-term downward trend for the past four decades. Peaking in the early 1980s with the 10-year U.S. Treasury rate that exceeded 15%, the benchmark rate began its long-term march downward that eventually registered under 1.0% for several months during mid-2020. That 40+ year stretch of downward trending interest rates was a large tailwind for bond investors as fixed-income allocations served as an effective diversifier to a portfolio's equity allocation over time.

However, with interest rates rising from the historic lows in 2020, the Federal Reserve (Fed) began its inflation-fighting campaign in early 2022 with a series of interest rate hikes designed to ensure that consumer price inflation would not become entrenched in the economy. This recent rise in interest rates also contributed to greater bond market volatility and higher stock versus bond correlations in recent years. As highlighted in the chart below, bond market volatility (as measured by the ICE BofA MOVE Index) is at levels only reached during 2008 and the late 1990s. This gauge of investor fear reflects, in large part, the growing uncertainty as to whether the Fed will remain committed should inflationary pressures re-emerge, or geopolitical tension disrupt global supply chains again. These dynamics have led investors to seek out other asset classes that can serve to diversify their portfolios and add value in periods of heightened bond market volatility.

Bond market volatility as measured by the ICE BofA MOVE Index (MOVE Index)



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of January 14, 2024. The ICE BofA MOVE Index measures Treasury rate volatility through options pricing. The chart measures the number of standard deviations (a measure of volatility) from the mean between January 2, 2000, and January 14, 2024.

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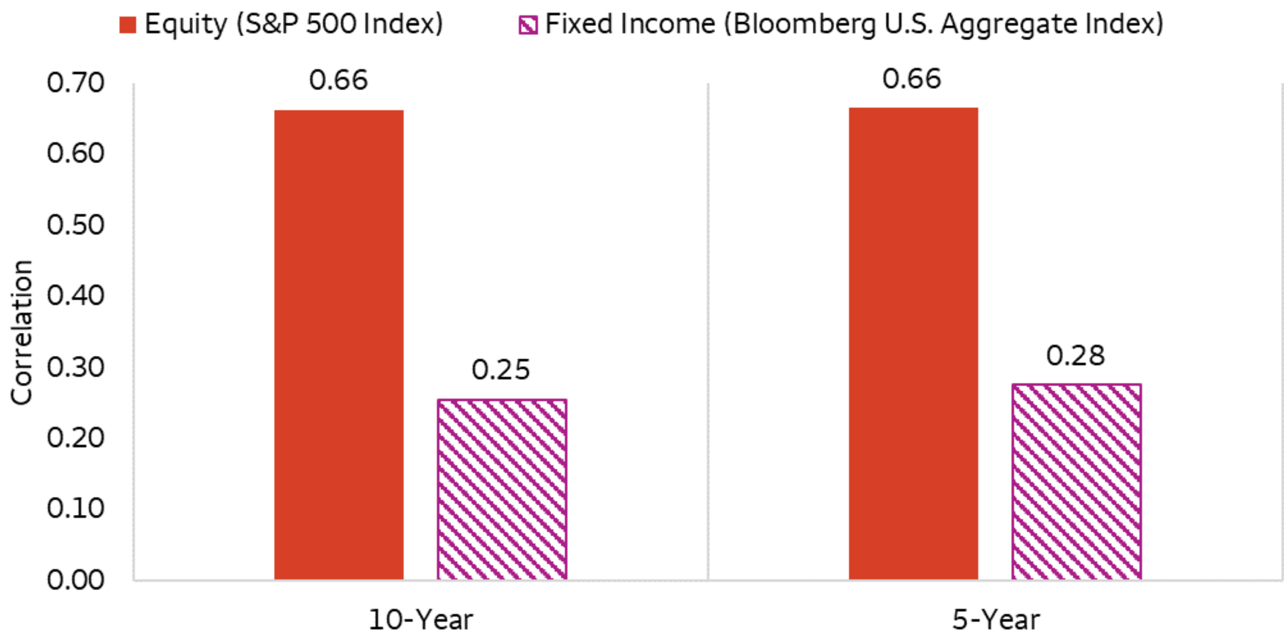
Within the alternative investment landscape, we believe one strategy that may perform well in this environment is the Relative Value – Long/Short Credit strategy. Long/Short Credit strategies invest across a wide array of fixed-income securities and often seek to capture mis-pricings across debt securities and related derivative instruments. These strategies tend to offer more defensive attributes and have generally performed well during periods of higher volatility, in which the identification of attractive credit fundamentals is rewarded. The elevated fixed income market volatility witnessed in recent periods should reward skilled managers with ability to deploy both long and short positions that allow the manager to dampen market volatility. A long position is one that allows the manager to benefit when the price of an asset rises, and conversely, a short position is one that benefits when the price declines. The greater flexibility may allow managers to reduce unintended risks as they seek to better navigate difficult markets.

In addition, the strategy's low correlation to traditional equity and fixed-income markets highlights its diversification benefits and contributes to a lower overall portfolio risk level when combined with a traditional blend of equity and fixed-income investments. As shown in the chart, the Long/Short Credit strategy's historical correlation with equity and fixed-income benchmarks registers well below 1.0, suggesting its diversifying attributes.

Long/Short Credit has registered low historical correlations to equity and fixed-income markets



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of January 14, 2024. The HFRI Relative Value (RV): Fixed Income — Corporate Index is used as a proxy for Long/Short Credit strategies. The chart measures the historical correlation between the HFRI RV: Fixed Income – Corporate Index and the S&P 500 Index (equity) and the Bloomberg U.S. Aggregate Index (fixed income). The chart shows correlation data from January 1, 2014, to December 31, 2023 on a 10-year and 5-year trailing basis. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

We remain favorable on Relative Value – Long/Short Credit strategies as we believe their defensive characteristics can offer greater portfolio diversification in the current environment. Our expectation for slower economic growth and continued bond market volatility may allow these strategies to add value and participate in up markets while potentially limiting downside participation in challenging markets relative to their long-only peers.

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Equities

"The only thing we know about the future is that it is going to be different." — Dr. Peter Ferdinand Drucker

Austin Pickle, CFA
Investment Strategy Analyst

Energy up, Financials down

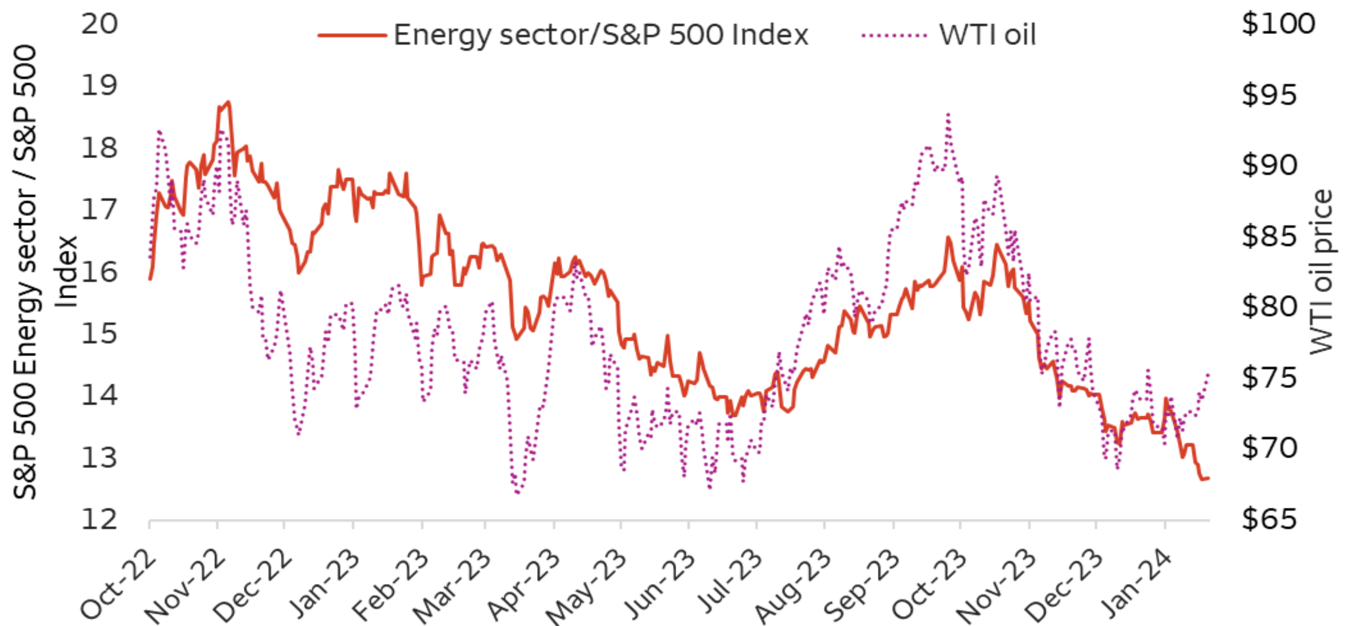
Earlier this month we downgraded the S&P 500 Financials sector from neutral to unfavorable while simultaneously upgrading the Energy sector from neutral to favorable. We review the rationale below.

We had downgraded the Energy sector in August 2023, in part to lock in gains on our previous tactical favorable rating. Since then, oil prices are off more than 20% from their September highs and the Energy sector has underperformed the broader S&P 500 Index by roughly 14% from our downgrade through January 10, 2024.

However, we believe that oil prices may struggle to break meaningfully below recent lows while our year-end targets suggest upside potential. An eventual spike in oil prices alone would likely drive outperformance (see chart) but that is not the only rationale for our upgrade. Energy sector valuations are near historically cheap levels, both in absolute terms and relative to the S&P 500 Index; global oil supply growth is likely to remain muted, and U.S. producers have shown a commitment to capital discipline and a preference for increasing shareholder returns over maximizing production.

The Financials sector, on the other hand, has been a top performer over the past two months, but we believe prices have run too far ahead. The sector will likely feel the brunt of the economic slowdown as spending weakens and deal and payment activities slow. Earnings growth expectations are poor, valuations remain uncompelling, and the sector screens poorly on common quality characteristics. In our view, these headwinds plus a heightened regulatory environment suggest Financials may struggle.

Potential for Energy outperformance as oil prices move higher



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data: October 3, 2022 – January 22, 2024. WTI = West Texas Intermediate. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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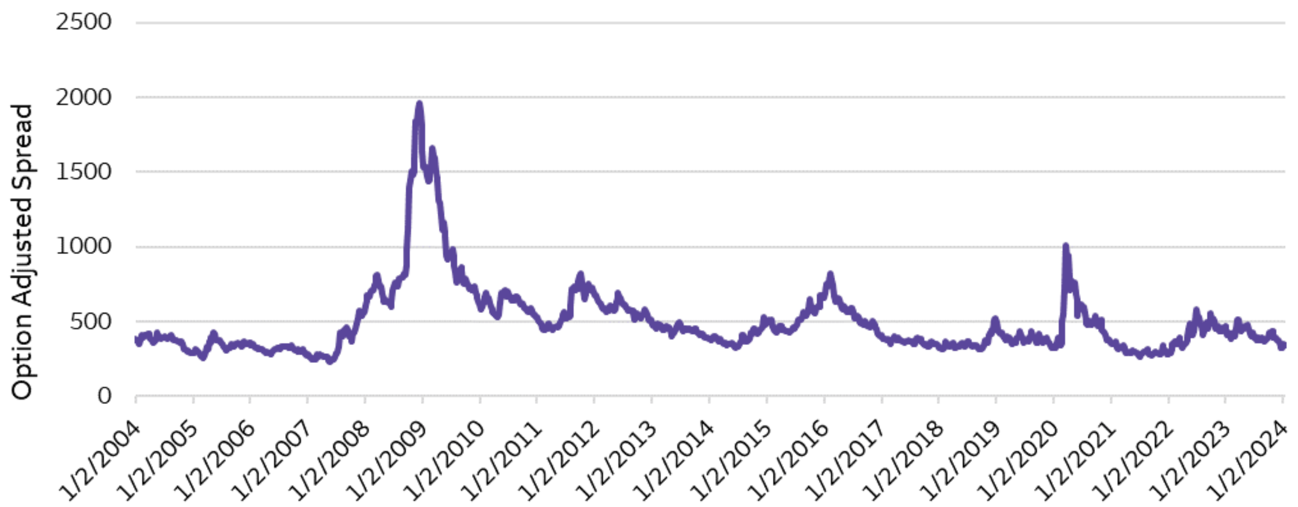
Fixed Income

Brian Rehling, CFA
Head of Global Fixed Income Strategy

High yield — performing but expensive

High yield debt valuations are expensive by almost any valuation metric. Credit spreads (the excess yield over a comparable U.S. Treasury security) for the Bloomberg U.S. Corporate High Yield Index stand near 336 basis points (3.36%; 100 basis points equals 1%), as of January 23, 2024. The 20-year average spread level of the Bloomberg U.S. Corporate High Yield Index is 493 basis points (4.93%).

High yield option adjusted spread



Source: Bloomberg and Wells Fargo Investment Institute. Data as of January 19, 2024. Measured by the Bloomberg U.S. Corporate High Yield Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

The economic environment is slowly weakening, which generally presents a negative backdrop for lower-rated credits. However, the economy continues to show it is resilient and any slowdown is expected to be mild and limited in duration, in our view. This provides an environment in which the high yield asset class may continue performing well. Investors should be cognizant that significant credit events can occur with little warning.

Inherent credit risks

Historically, there have been a number of events that led to a substantial change in the way markets value credit risk. These events have included:

Dot-com bubble (2000), September 11 terrorist attacks and Enron bankruptcy (2001), WorldCom accounting scandal (2002), Subprime mortgage and credit crisis (2008 – 2009), Greek government debt crisis (2011), Collapse of energy prices (early 2016), and Covid-19 pandemic (early 2020).

Each of these events resulted in significant negative adjustments in the valuations of fixed-income investments that contained meaningful credit-risk exposure (such as high-yield debt).

It is possible that the current stable environment may continue to persist for some time. We remain unfavorable on the asset class given the relatively expensive valuations in the fixed income space, but we continue to reassess the asset class given its potential to outperform other fixed-income assets in a stable credit and yield environment.

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Real Assets

John LaForge
Head of Real Asset Strategy

Mason Mendez
Investment Strategy Analyst

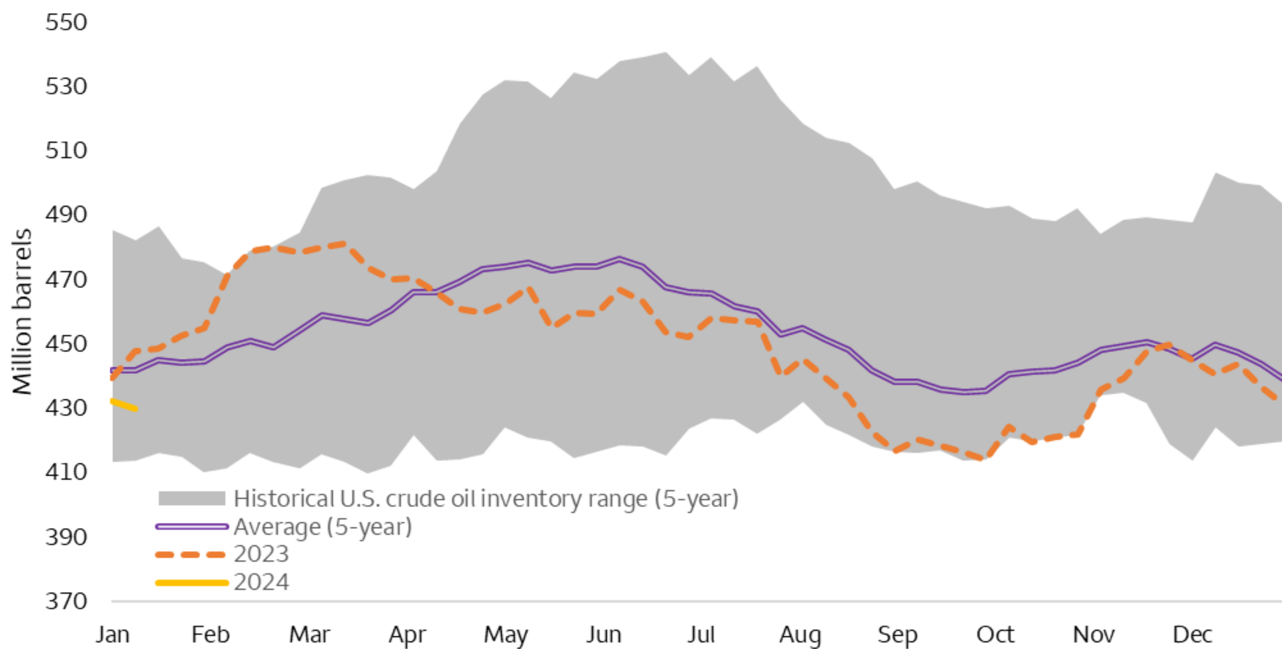
Despite record production, crude inventories remain low

In late 2023, the U.S. achieved record crude oil production of 13.3 million barrels per day, as more efficient drilling boosted supply growth. Given the record production volume, and slowing economic conditions in the U.S., we would usually expect crude inventories to rise. However, U.S. crude inventories remain quite low, and have even fallen below their 5-year average (see chart). The culprit behind lower U.S. oil inventories, even while production is growing, is the rise in exports. Year-over-year, U.S. oil exports are up 23%, as of January 12, 2024, while U.S. oil production is up roughly 9%.

The U.S. is exporting more crude oil because emerging markets are demanding it, especially China. According to the Energy Information Administration's data through October 2023, U.S. crude oil exports to China were on track to double from year-end 2022 to year-end 2023. As a result, China's average share of U.S. crude exports was also on track to double from 6% to 12%.

The bottom line is that U.S. oil production did rise in 2023, but U.S. oil inventories did not. Much of the U.S.'s extra oil production was exported to emerging markets, such as China. Emerging markets continue to be the main source of oil demand globally, and U.S. oil exports specifically. We expect emerging market oil demand to rise throughout 2024, and global oil prices with it.

Historical range of U.S. crude oil inventories



Sources: Bloomberg, Energy Information Administration, and Wells Fargo Investment Institute. Weekly data is from January 2019 – January 2024.

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Current guidance over tactical horizon (6-18 months)

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, January 29, 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.

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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. 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.

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.

Investing in long/short strategies is not appropriate for all investors. Short selling involves sophisticated investment techniques that can add additional risk, and involves the risk of potentially unlimited increase in the market value of the security sold short, which could result in potentially unlimited loss.

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.

HFRI Relative Value Fixed Income—Corporate Index includes strategies predicated on realization of a spread between related instruments in which one or multiple components of the spread is a corporate fixed-income instrument. Strategies are designed to isolate attractive opportunities between a variety of fixed income instruments, typically realizing an attractive spread between multiple corporate bonds or between a corporate and risk free government bond. They typically involve arbitrage positions with little or no net credit market exposure, but are predicated on specific, anticipated idiosyncratic developments.

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 Financials Index comprises those companies included in the S&P 500 that are classified as members of the GICS® financials sector.
An index is unmanaged and not available for direct investment.

Note: HFRI Indices have limitations (some of which are typical of other widely used indices). These limitations include survivorship bias (the returns of the indices may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information self-reported by hedge fund managers that decide on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.

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