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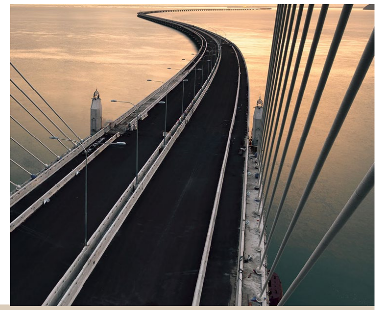
Investment Strategy



Weekly guidance from our Investment Strategy Committee — February 18, 2025

Asset Allocation Spotlight

Veronica Willis
Global Investment Strategist

The case for international diversification

Over the past 15 years, U.S. equities — particularly large caps — have far outperformed other asset classes, including international equities. 2024 marked another year of U.S. Large Cap Equities leading the way, which has prompted many investors to question the efficacy of international diversification. However, as market conditions evolve, we believe it is prudent to remain globally diversified and not let the previous decade and a half skew long-term expectations for returns. International equities tend to provide diversification benefits by helping mitigate some risks that may be unique to U.S. markets and offering exposure to attractive valuation opportunities.

Diversification works best when different asset classes or regions perform independently under varying conditions. Two of the recent, severe bear markets in equities were associated with global crises — the Global Financial Crisis of 2008-2009 and the COVID-19 pandemic in 2020 — causing equities across both U.S. and international markets to decline simultaneously. These global crises minimized the diversification benefits of international equities in recent years. Additionally, in both of these cases, the U.S. was best positioned to recover, benefiting from aggressive fiscal and monetary policy responses and the strength of its labor market and consumer. As a result, investors who concentrated their portfolios in U.S. equities were rewarded with significant gains during the post-crisis rebounds.

However, there is no guarantee that the next pullback will follow the same pattern. While recent downturns were global in scope, it is entirely possible that the next economic or market disruption could be U.S.-centric. Over the next several quarters, we expect increased volatility over concerns related to rising U.S. debt levels, uncertainty surrounding Federal Reserve policy, or geopolitical tensions with key trading partners. If at any time during our long-term strategic horizon volatility emerges that is more localized in the U.S., international equities could serve as an essential counterbalance, helping in an effort to offset U.S. market declines.

One common expectation from investors is that international markets must outperform U.S. markets to justify their inclusion in a portfolio. However, this overlooks a fundamental benefit of diversification: reducing risk while maintaining competitive returns. Investors who maintain international exposure stand to gain from this risk-mitigation potential.

Our long-term Capital Market Assumptions (CMAs) suggest that Developed Markets ex-U.S. (DM) Equities may not generate returns as high as U.S. equities over the long term. However, because they are not perfectly correlated with U.S. equities, we believe they still play a valuable role in asset allocation construction. When incorporated into a portfolio, DM equities can provide potential for similar or better long-term returns with lower overall expected risk. This is due to the impact of that less-than-perfect correlation between DM equities and the other asset classes included in the allocations.

Table 1. Historical vs expected return and risk

Asset class	15-year annualized total return (%)	15-year annualized standard deviation (%)	Strategic (long-term) expected return (%)	Strategic (long-term) expected standard deviation (%)
U.S. Large Cap Equities	14.4	14.5	7.8	16.0
U.S. Mid Cap Equities	12.7	16.7	8.3	17.0
U.S. Small Cap Equities	10.8	19.8	8.0	20.0
Developed Market ex-U.S. Equities	6.4	15.7	7.0	17.0
Emerging Market Equities	3.9	17.5	7.8	21.0

Sources: Sources: © Morningstar Direct, All Rights Reserved, and Wells Fargo Investment Institute. Historical data from February 1, 2010, to January 31, 2025. U.S. Large Cap Equities represented by S&P 500 Index, U.S. Mid Cap Equities represented by Russell Midcap Index, U.S. Small Cap Equities represented by Russell 2000 Index, Developed Market ex-U.S. Equities represented by MSCI EAFE Index, Emerging Market Equities represented by MSCI Emerging Market Index. An index is unmanaged and not available for direct investment. Strategic (long-term) return and standard deviation assumptions are based on the Capital Market Assumptions as of July 16, 2024. For illustrative purposes only. CMA forecasts are not promises of actual returns or performance that may be realized. They are based on estimates and assumptions that may not occur. **Forecasts are based on certain assumptions and on views of market and economic conditions which are subject to change.** Strategic expected returns are forward-looking geometric return estimates from Wells Fargo Investment Institute of how asset classes and combinations of classes may respond during various market environments. Geometric return is the compounded annual return that would give the same result as a given series of annual returns based on those same assumptions. The return and risk assumptions are statistical averages that do not represent or predict the experience of any individual investor or any specific time period. Standard deviation is a measure of volatility. It reflects the degree of variability surrounding the outcome of an investment decision; the higher the standard deviation, the greater the risk. **Past performance is no guarantee of future results.**

U.S. large caps significantly outperformed international equities over the past 15 years, and with lower risk, but over the long-term, we do not expect such outsized outperformance. Additionally, history suggests that prolonged periods of outperformance are often followed by a period of weaker performance. Investors who fail to maintain international exposure may find themselves adding these allocations after leadership has already shifted.

After years of U.S. equity strength, international markets — particularly in Europe and Japan — offer attractive relative valuations, in our view. For example, the forward price-to-earnings multiples implied by our year-end 2025 earnings targets and price as of January 31 are 22.0x for large caps and 14.0x for DM equities. Should investors search for better valuation opportunities, international equities may experience increased capital flows, providing a potential tailwind for future performance.

So far this year (as of February 10, 2025), DM equities are outperforming U.S. equities, as one of the top performing asset classes. In the emerging market (EM) space, Chinese equities have outperformed U.S. equities over the past 12 months. While these trends may not persist over the next several years, they highlight an important reality: No single market maintains dominance in all time periods.

Our long-term strategic allocations are built with a bias toward U.S. assets given our expectation for higher returns, but the allocations still include exposure to both DM and EM equities for their diversification benefits. We believe that utilizing a globally diversified approach can provide a more stable and resilient investment experience over full market cycles. Maintaining exposure to a variety of assets that do not necessarily move in the same direction or at the same magnitude during a downside event can potentially contribute to greater portfolio stability and higher returns in the long run.

Equities

"Start where you are. Use what you have. Do what you can." — Arthur Ashe

Austin Pickle, CFA
Investment Strategy Analyst

Negative equity risk premium a positive?

Recently, we have received several questions on the equity risk premium (ERP), which is now negative. What does this mean and what are the implications?

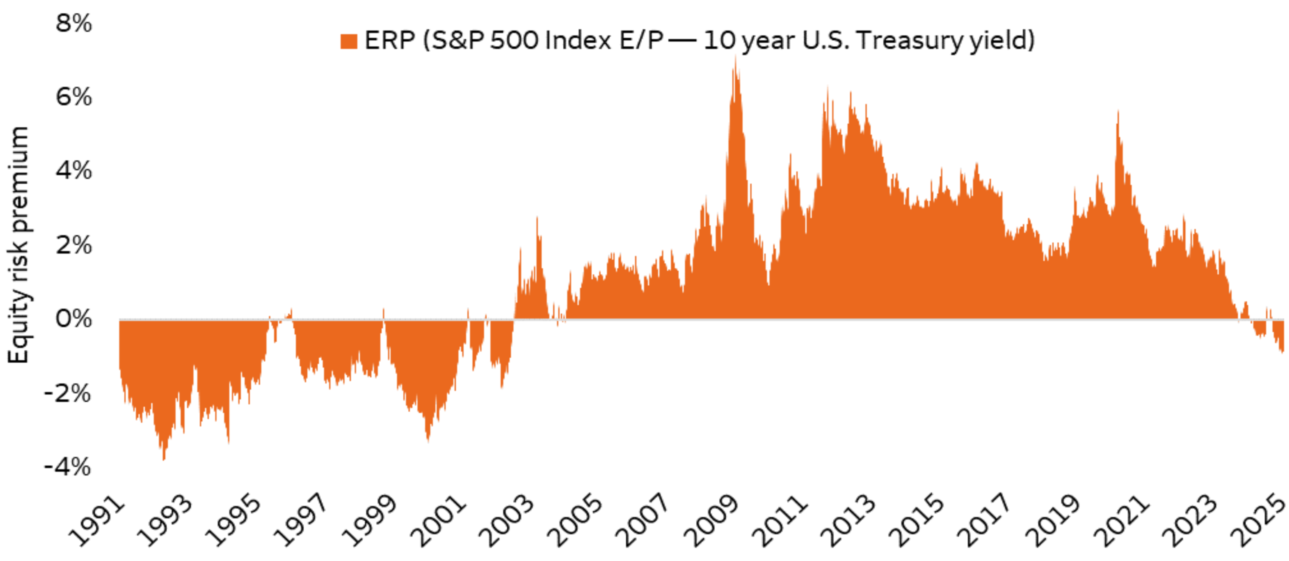
For those unfamiliar, the ERP is an equity earnings yield minus a bond yield. The equity earnings yield is calculated by dividing earnings by price (the inverse of the well-known price-to-earnings ratio). A positive ERP suggests that stocks are cheap relative to bonds and vice versa. With the S&P 500 Index near record highs and bond yields elevated, the ERP has dipped into negative territory (see chart).

Like other valuation measures, the ERP gives little insight into future returns. Take the 1990s as an example. The ERP spent virtually the entire decade in deeply negative territory, yet the S&P 500 Index enjoyed one of the best 10-year return periods in its history. Alternatively, during the so-called lost decade of the early 2000s — when the ERP was largely positive — the S&P 500 Index experienced one of its worst 10-year return periods.

What should investors take away from the current ERP level? In our view, the opportunity cost of holding bonds has come way down. In other words, bonds, after such a long post-global financial crisis period of very low yields, finally offer a reasonable income, in our view.

We see a resilient economy and accelerating earnings growth powering stocks to another year of outperformance versus bonds. Yet, as the ERP reminds us, don't forget about fixed income. We suggest investors move out on the maturity curve to lock in these attractive yields. We are most unfavorable U.S. Short Term, neutral U.S. Long Term, and favorable U.S. Intermediate Term Taxable Fixed Income.

Equity risk premium at multidecade lows



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data: January 1, 1991 – February 07, 2025. E/P is the earnings yield, which is calculated as the trailing-12-month earnings per share divided by the current price. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Fixed Income

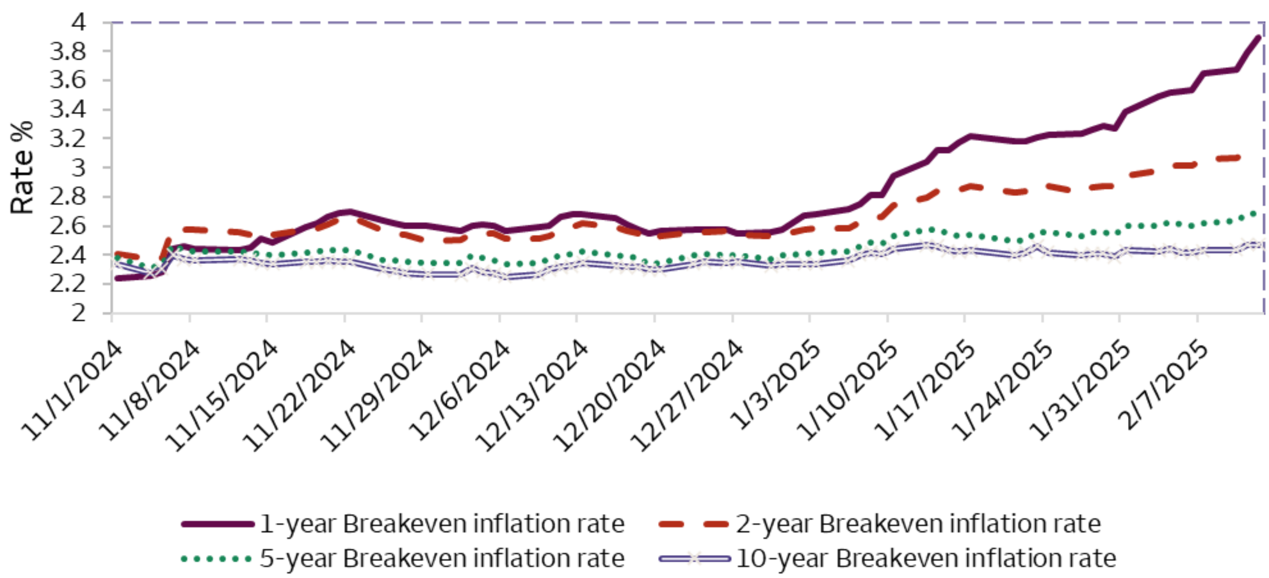
Luis Alvarado
Global Fixed Income Strategist

Be cautious of using TIPS as an inflation hedge

The ongoing threat of new tariffs on imports is causing some investors to consider increasing their exposure to TIPS to mitigate inflation concerns. Although TIPS can help an investor protect their purchasing power against unexpected changes in inflation, the benefit is mostly felt when actual inflation exceeds the market's expected inflation.

Tariffs can create transitory price increases, but, longer-term market expectations[1] for future inflation remain moderate. Breakeven inflation rates (the difference between nominal Treasury yields and TIPS yields) have already increased for the one-year and two-years tenors while five-year and 10-year breakeven inflation rates have not risen significantly, indicating that investors are not pricing in sustained higher inflation.

U.S. breakeven inflation rates



Sources: Bloomberg and Wells Fargo Investment Institute as of February 11, 2025. The breakeven inflation rate represents a measure of expected inflation derived from subtracting Treasury Inflation-Indexed Constant Maturity Securities from Treasury Constant Maturity Securities. The latest value implies what market participants expect inflation to be in the next year, two years, five years, and 10 years, on average.

In addition to changes in inflation expectations, TIPS' market value is mostly impacted by changes in real interest rates. As is the case for any bond — when interest rates increase, the market price of the bond typically decreases, and when interest rates fall, the market price of the bond increases. These interest-rate movements often help to explain how the TIPS' market value sometimes increases even as inflation expectations fall, and it can explain how TIPS' market value can fall when inflation expectations increase.

We currently have a neutral guidance on TIPS and believe they can play a role in providing diversification to a fixed-income portfolio. However, we would be cautious of potential return surprises, as TIPS indices are relatively long duration which increases sensitivity to interest rate movements.

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1. 1. 5-year and 10-year U.S. breakeven inflation rates.

Real Assets

Mason Mendez
Investment Strategy Analyst

Commodity performance is starting the year off strong

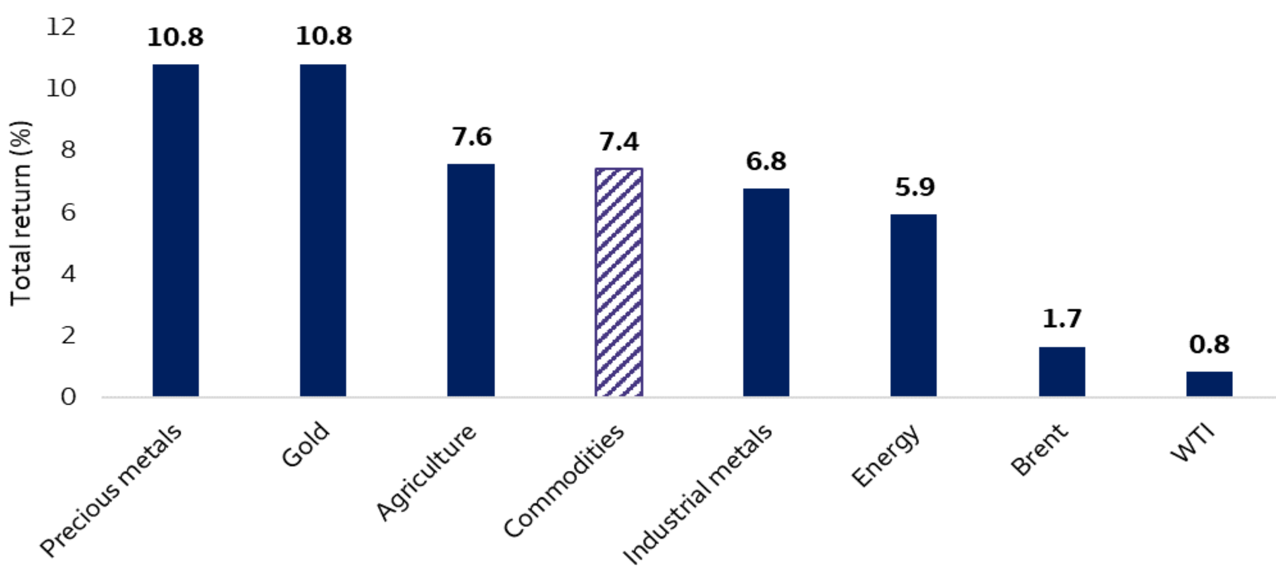
Commodities started the year off strong, with the Bloomberg Commodity Index up 7.4% year to date, outperforming U.S. Large Cap Equities and U.S. bonds as of February 10, 2025. The Precious Metals and Agriculture sectors have been the strongest performers, yet participation in the price rally is high, as all sectors have posted positive year-to-date returns (see chart).

Looking ahead over the tactical horizon, we remain favorable on Commodities and expect modest performance to be driven by an improving macro environment and stronger global demand growth. In addition, we believe that Commodities could act as an effective portfolio diversifier and hedge against ongoing geopolitical risks stemming from sanctions and tariffs. Precious-metal prices have been especially sensitive to these growing trade risks, as gold prices climbed to new highs of $2,908 per troy ounce on February 10, surpassing our year-end target of $2,800 – $2,900 per troy ounce.

While we welcome such strong performance, we believe that the risk to return of further upside appears less attractive at current prices. Our 2025 year-end target for the Bloomberg Commodity Index is 250 – 270, which leaves only a 2% return to the midpoint from current prices (January 10, 2025).

We do, however, see opportunities to rebalance within the sectors. One such opportunity would be to take profits from the relative outperformers (Precious Metals and Agriculture) and rotate into the favorably rated Energy sector. Crude oil and energy prices have softened over recent weeks, but we suspect that performance will improve throughout the year amid an improving macro environment. Therefore, we view current weakness in energy prices as an attractive opportunity to gain exposure and benefit from a brighter demand outlook in 2025.

Year-to-date commodity returns in 2025



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data is from December 31, 2024 – February 10, 2025. Commodities are represented by the Bloomberg Commodity Total Return Index. Brent= Brent Crude Oil. WTI = West Texas Intermediate. An index is unmanaged and not available for direct investment.
Past performance is no guarantee of future results.

Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

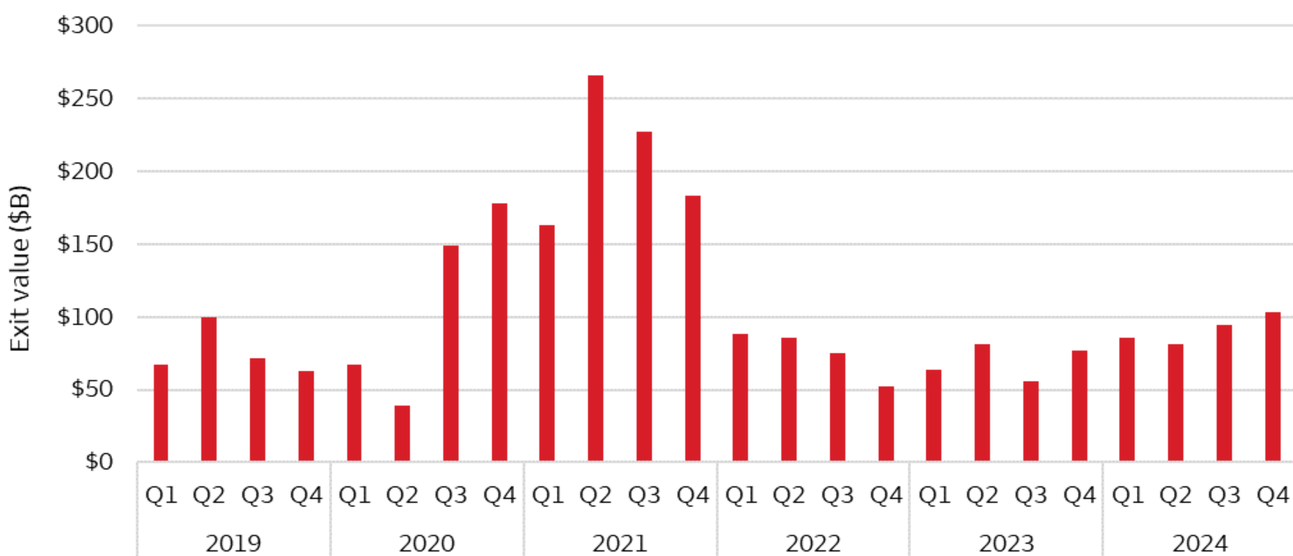
Signs of a recovery for Private Equity

The exit environment witnessed a notable increase in volumes during the second half of 2024 (see chart). Though levels remain well below the frothy 2021 market, the modest increase in exit-investment values provides hope that the Private Equity downturn may be nearing its end, and the initial stages of a rebound may be underway. Declining valuations over the past few years have led to a significant gap between what sellers believe their investments are worth and what buyers are willing to pay. However, the increased optimism that the economy may achieve the rare soft landing as well as the continued upward trend in public-market prices is likely contributing to rising activity levels in private markets.

Though the modest pickup is encouraging, the positive trends may be partially offset by the growing realization that interest rates may not fall as far (or as fast) as many investors expected. While lower rates may be needed before exit volumes accelerate from current levels, corporate leader's growing confidence that the economy is on the right track may be enough to keep the trend moving upwards through early 2025. Moreover, the inventory of Private Equity-owned companies continues to grow and now stands at over 11,800 firms at the end of 2024 (up nearly 3,000 firms since 2018).[2] Based on the current pace of exits, it would take approximately eight years to exit all investments held. The greater supply of mature investments that may be nearing an exit may force sellers to make concessions on pricing even as the economy recovers.

Despite the remaining risks, we believe disciplined investors that can commit new capital to Private Equity strategies may realize the longer-term benefits as we expect economic growth to accelerate in late 2025.

The value of Private Equity investments exited (or sold) rose modestly in recent quarters



Sources: Pitchbook and Wells Fargo Investment Institute. Data as of December 31, 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.

2. Pitchbook 2024 Annual US PE Breakdown report.

Tactical guidance*

Cash Alternatives and Fixed Income

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
U.S. Short Term Taxable Fixed Income		Cash Alternatives Developed Market Ex-U.S. Fixed Income Emerging Market Fixed Income High Yield Taxable Fixed Income U.S. Long Term Taxable Fixed Income	U.S. Intermediate Term Taxable Fixed Income	

Equities

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
	Emerging Market Equities	Developed Market Ex-U.S. Equities U.S. Mid Cap Equities U.S. Small Cap 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—Equity Hedge Hedge Funds—Relative Value Private Equity Private Debt	Hedge Funds—Event Driven Hedge Funds—Macro	

Source: Wells Fargo Investment Institute, February 18, 2025.

*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

Asset allocation and diversification are investment methods used to help manage risk. They do not guarantee investment returns or eliminate risk of loss including in a declining market.
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. **Treasury Inflation-Protected Securities (TIPS)** are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond to fluctuate more than other fixed income securities. TIPS have special tax consequences, generating phantom income on the "inflation compensation" component of the principal. A holder of TIPS may be required to report this income annually although no income related to "inflation compensation" is received until maturity. 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.

Investing in gold, silver or other precious metals involves special risk considerations such as severe price fluctuations and adverse economic and regulatory developments affecting the sector or industry.

The Energy sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather 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.

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

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.

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.

An index is unmanaged and not available for direct investment.

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