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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **January 23, 2023**

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- Most sectors are currently priced at a valuation level typically seen at major market bottoms.
- The higher inflation and higher interest rate environment may limit valuation's upside potential and be more constructive for defensive, low-valuation, and high-quality stocks and sectors.

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- High-quality fixed income, including U.S. Treasury securities, remains a key diversifier of portfolio risk.
- The debt ceiling has been reached, but we expect legislators to increase the limit before the Treasury exhausts its extraordinary measures.

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- Gold started 2022 strong but faded under the pressure of Federal Reserve rate hikes and a U.S. dollar reaching 20-year highs.
- Gold has started 2023 strong too, but unlike 2022, may continue to move higher as rate hikes near their end.

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- Rising interest rates are leading to an increase of companies struggling to meet debt service payments, as defined as those no longer able to generate sufficient earnings or cash flow to cover their ongoing interest expense.
- We maintain our favorable guidance on Distressed Credit strategies. The growth in credit markets, loosening underwriting standards, rising interest rates, and a looming recession may lead to growing opportunities.

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Equities spotlight

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Global Portfolio and Investment Strategist

Austin Pickle, CFA
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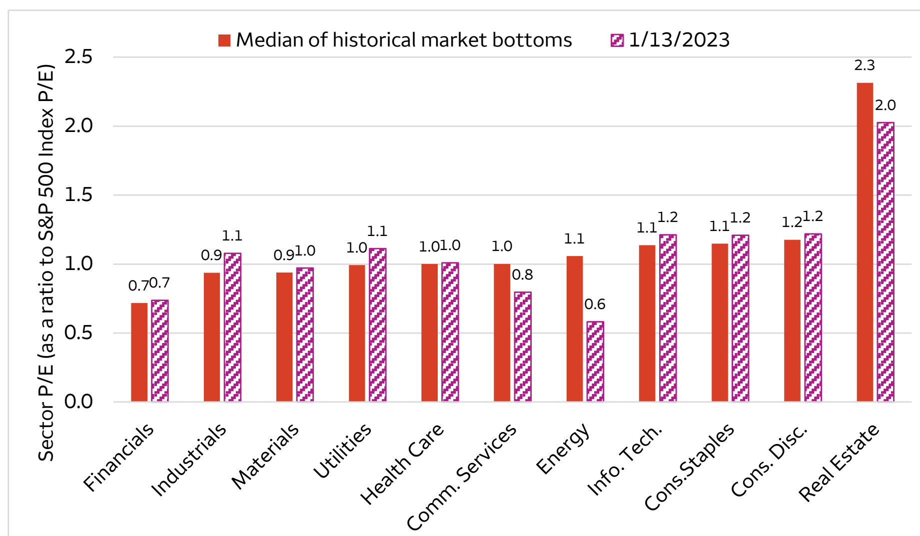
Stock valuation: What is the path forward?

Since the start of the current bear market in January 2022, stock market prices have largely been driven by a contraction in valuation. As of January 13, 2023, the price of the S&P 500 Index has declined by 17% since the start of last year on the back of a 21% price-to-earnings (P/E) multiple contraction. However, there are significant dispersions among sectors. For example, the Health Care sector's P/E multiple has barely experienced a material decline and is currently holding at the pre-bear-market level. On the other hand, the valuations of technology-related sectors, including Information Technology, Communication Services, and Consumer Discretionary have contracted by more than 30% since the start of 2022.

Looking across the past six major market lows between 1998 and 2021, cyclical sectors, including Industrials, Financials and Materials, had generally experienced valuation contractions at a level more significant than the broader S&P 500 Index. This was driven by investors shying away from areas that are more negatively impacted by economic downturns. As a result, based on the forward 12-month P/E multiple, cyclical sectors were priced below the S&P 500 Index at major market bottoms (that is, the below-1.0 relative valuations shown in Chart 1). On the contrary, defensive sectors (such as Consumer Staples) as well as high-growth sectors, including Information Technology and Consumer Discretionary, were typically more favored. They enjoyed a higher relative valuation at market bottom in the past.

Chart 1 also indicates that 7 out of the 11 sectors' relative valuations have currently reached or declined below their historical market bottom level. This may mean that investors are currently pricing these sectors to a market bottom condition. However, despite recent losses in price, the Information Technology sector may be an exception and is still expensive by historical standard.

Chart 1. S&P 500 sectors' relative valuation now and at historical market bottoms



Sources: Wells Fargo Investment Institute and Bloomberg. As of January 13, 2023. Relative valuation is calculated as the ratio of forward 12-month sector P/E multiple to S&P 500 Index's multiple. Sectors are sorted based on median relative valuation levels from low to high. Comm. Services = Communication Services. Cons. Staples = Consumer Staples. Cons. Disc. = Consumer Discretionary.

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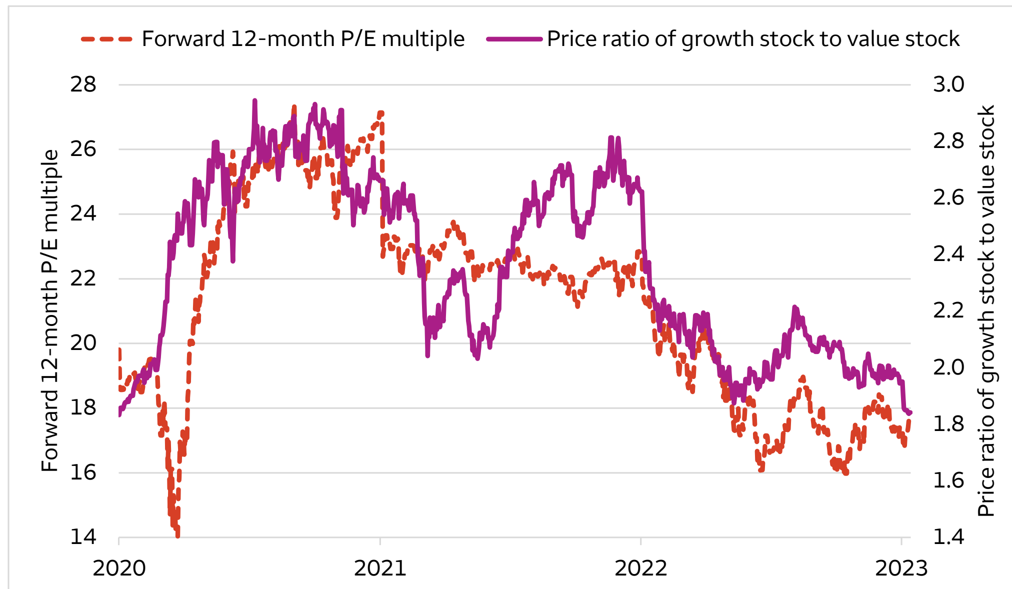
We also believe the interest rate and inflation environment are important factors for valuation levels. Higher inflation and interest rates can limit valuation's upside potential. In such periods, investors may desire a higher level of earnings yield and price return from stocks to offset the impact of higher inflation, as well as to compensate for the higher yield from bonds. For example, in the 10 years from 1976 to 1985 when inflation and interest rates were elevated, the average trailing 12-month P/E ratio of the S&P 500 Index was 10x, whereas the P/E multiple averaged 18x during the low-rate and low-inflation 10-year period prior to the COVID-19 pandemic.

Given the uncertainties in inflation and interest rate policy, we believe valuation may continue to be an important driver for stock return dispersions. As shown in Chart 2, the valuation multiple has a 0.8 correlation to the relative performance between growth and value stocks since the onset of the pandemic. In the backdrop of higher interest rates and lower valuations, high-dividend-yielding, profitable, and high-asset companies are sought after more so than expensive, growth-oriented sectors. As we approach the upcoming recession, we continue to favor defensive, high-quality, and U.S.-based equity asset classes and sectors whose valuations are likely to prove resilient as growth slows.

Chart 2. The P/E multiple has shown a high correlation to the price ratio of growth and value stocks



Sources: Wells Fargo Investment Institute and Bloomberg. Daily data: January 1, 2020 – January 13, 2023. Price ratio of growth to value stocks is calculated as the price ratio of S&P 500 Pure Growth Index to S&P 500 Pure Value Index. Please see page 7 for index definitions. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Fixed Income

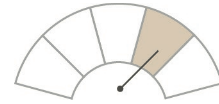
Not the time to fret over debt ceiling

The U.S. has hit the debt ceiling. The debt ceiling restricts the Treasury's ability to borrow but does not hinder Congress's ability to enact spending legislation. As the Treasury has done in the past, it will undertake extraordinary measures to avoid breaching the debt ceiling and should allow the government the ability to continue paying its bills until at least mid-summer. Once extraordinary measures have been exhausted, the Treasury is faced with not paying bills legislators have already authorized.

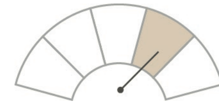
The debt ceiling has been used for political brinkmanship in the past and, given the current political discourse in Washington, we expect that increasing the debt ceiling will once again become a contentious issue for politicians. While the risks of a political miscalculation are higher than in the past, it is unlikely that either party will want to be responsible for a U.S. government default. At some point, politicians will pass an increase to the debt ceiling just as they have over 75 times since 1960 — we expect this increase will occur before the U.S. government is unable to pay its bills.

We suggest fixed income investors not make any meaningful adjustment to their portfolios currently due to the debt ceiling. If a debt ceiling solution is not apparent as the deadline approaches, we expect market volatility will increase, boosting risk-off assets. High-quality fixed income has tended to be one of the better-performing asset classes during periods of uncertainty. We do not think that the market will discount most U.S. Treasury securities. Those Treasuries maturing on or near the deadline could be negatively impacted, but longer maturity yields are likely to move lower under such conditions.

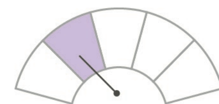
Brian Rehling, CFA
Head of Global Fixed Income Strategy



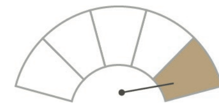
Favorable
U.S. Taxable Investment Grade Fixed Income



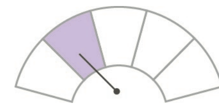
Favorable
U.S. Short Term Taxable Fixed Income



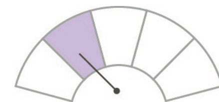
Unfavorable
U.S. Intermediate Term Taxable Fixed Income



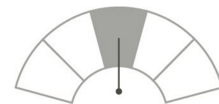
Most favorable
U.S. Long Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



Unfavorable
Developed Market Ex.-U.S. Fixed Income



Neutral
Emerging Market Fixed Income

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Real Assets

John LaForge
Head of Real Asset Strategy

Mason Mendez
Investment Strategy Analyst

Favorable
Commodities

Neutral
Private Real Estate

"If speaking is silver, then listening is gold." — Turkish proverb

Gold – It may be different this time

2022 was a tough year for gold with persistent rate hikes from the Federal Reserve (Fed), and a U.S. dollar that ascended to a 20-year high. In 2023, we entered the year neutral on Precious Metals versus other commodity sectors, but that does not necessarily mean that we were expecting poor performance. Our year-end 2023 gold target range, as an example, remains $1900 – $2000 per ounce. Should we gain confidence that rate hikes are near their end, and the U.S. dollar stays range bound, we may even raise our target range.

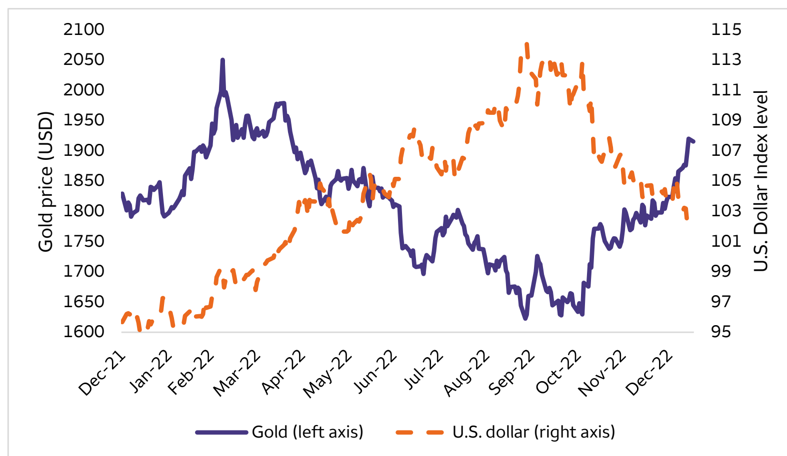
Gold started out strong in 2022, up 12% through March, but faded once the Fed started raising rates to combat inflation. The rate hikes eventually led to U.S. dollar strength, and both factors emerged as potent headwinds for the yellow metal. Historically speaking, it is common to see gold weakness in response to rising real interest rates and a strong U.S. dollar. We suspect that there are two main reasons for this:

1.) Gold is globally priced in U.S. dollars, but most gold demand takes place outside the U.S. A rising U.S. dollar means that most other currencies are becoming relatively weaker, which hurts the purchasing power of non-U.S. buyers. This dynamic often leads to lower overall global gold demand.

2.) Gold is a non-interest-bearing asset. As interest rates rise, gold becomes less attractive to institutional buyers who can buy Treasury securities and other interest-bearing assets.

The bottom line for 2023 is that gold prices have started the year strong, like in 2022 (see chart). We suspect that gold may end 2023 on a more positive note, though. We may even need to increase our year-end 2023 target range should the U.S. dollar remain range bound and we gain confidence that rate hikes are near their end.

Gold versus U.S. dollar



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data is from December 31, 2021 to January 16, 2023. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Alternatives

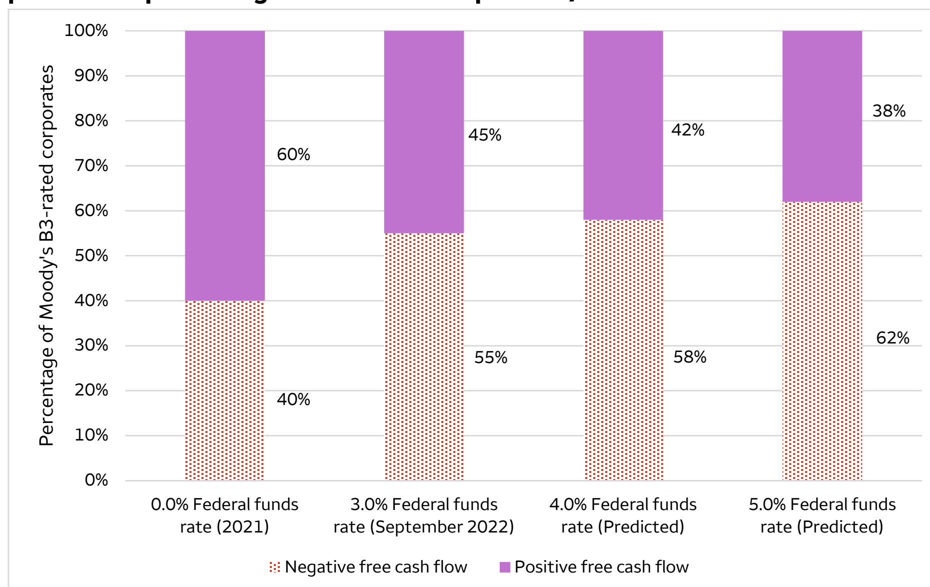
Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

Concerning trends in credit markets

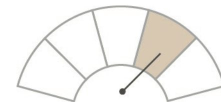
Credit markets have grown significantly over the past decade, with the U.S. and European high-yield bonds, leveraged loans, and direct lending markets growing from $1.7 trillion in 2008 to over $5.1 trillion at the end of 2022. The growth was in part due to the era of very low interest rates, ushered in by central banks around the globe since the Great Financial Crisis. However, the emergence of inflation has caused the Federal Reserve to initiate a series of interest rate hikes designed to lower inflation levels back to long-term targets. Yet, rising interest rates can take 6 to 12 months on average before the full effects of the monetary tightening are known.

The floating-rate nature of leveraged loans and direct loans can, to some extent, insulate investors from falling bond prices as the income they receive adjusts upward as rates rise. However, the pressures of rising debt service levels can become an increasingly heavy burden on those small-to-midsized businesses, that at some point overwhelms the borrower's ability to generate cash flow and earnings. As highlighted in the chart below, rising interest rates increasingly limit corporate borrowers' ability to meet debt payments. While interest rates remain low relative to historical standards, the rapid change in interest rates may well trigger the next distressed credit cycle in global credit markets as companies adjust to a new interest rate regime. The growth of the leveraged and direct loan markets, loosening underwriting standards, rising rates, and a looming recession may combine to create significant dislocations in credit markets and provide an ideal environment for Distressed Credit strategies to thrive.

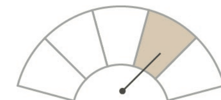
Rising level of firms with negative free cash flow as rates rise (free cash flow profile as a percentage of B3-rated corporates)



Sources: Wells Fargo Investment Institute, Marathon Asset Management LP, Moody's, Data as of 9/30/22. Free cash flow is the amount of cash a company has left over after it has paid all of its expenses, including investments.



Favorable
Hedge Funds – Relative Value



Favorable
Hedge Funds – Macro

Neutral
Hedge Funds – Event Driven

Neutral
Hedge Funds – Equity Hedge

Neutral
Private Equity

Neutral
Private Debt

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.

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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. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate. **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. Investing in gold or other precious metals involves special risk considerations such as severe price fluctuations and adverse economic and regulatory developments affecting the sector or industry.

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

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 Pure Growth Index is a style-concentrated index designed to track the performance of stocks that exhibit the strongest growth characteristics by using a style-attractiveness-weighting scheme.

S&P 500 Pure Value Index is a style-concentrated index designed to track the performance of stocks that exhibit the strongest value characteristics by using a style-attractiveness-weighting scheme.

U.S. Dollar Index measures the value of the U.S. dollar relative to majority of its most significant trading partners. This index is similar to other trade-weighted indexes, which also use the exchange rates from the same major currencies.

An index is unmanaged and not available for direct investment.

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