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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **January 30, 2023**

Spotlight: Labor takes center stage in this year's economic outlook 2

- A tight labor market is a double-edged sword for this year's economic outlook, supporting household income growth and spending, but contributing to high inflation and credit tightening by the Federal Reserve.
- Wage pressure in a tight labor market favors those firms whose margins are insulated by productivity growth or by pricing power bolstered by strong productivity gains, a high intellectual property content, or through imposing barriers to entry and economies of scale.

Equities: Fourth-quarter earnings contraction?..4

- After growing by nearly 5% in the third quarter of 2022, Bloomberg consensus expects S&P 500 Index earnings to have declined in the fourth quarter of 2022.
- In this weakening earnings environment, we suggest focusing on high-quality companies with consistent earnings growth, low debt levels, and high return on equity.

Fixed Income: Will March see the last rate rise from the Fed?......................5

- The U.S. inflation rate has been falling back rapidly, but at 6.5% in December it still stands a full two percentage points above the top of the Federal Reserve's (Fed's) current target range of 4.25% - 4.50%.
- History may suggest that the federal funds rate should exceed inflation before the Fed will pause. It remains uncertain whether March will mark the last rate increase, as the market expects.

Real Assets: What is Urals crude oil, and who's buying? 6

- There are over 150 different blends of crude oil, one of which is Russia's export grade crude oil, called Urals.
- Despite sanctions on Russia, countries such as China, India, and Turkey continue to purchase Russian crude oil.

Alternatives: Private equity activity decelerates..7

- Private equity deal activity and exit volumes slowed significantly in 2022 versus the prior year, as the industry adjusts to declining valuations amid rising economic and geopolitical uncertainty.
- Given our longer-term cyclical outlook, we remain constructive on private markets in general and believe investors will be well-served to consider long-term allocations to Small/Mid Cap Buyout and Growth Equity strategies.

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Spotlight

Gary Schlossberg
Global Strategist

Jennifer Timmerman
Investment Strategy Analyst

Labor takes center stage in this year's economic outlook

A tight labor market at the center of this year's growth and inflation outlook is shaping the economic cycle in two important ways. Job growth has delayed the onset of a recession by supporting income and spending growth despite the squeeze on inflation-adjusted wages. The flip side to a vibrant labor market, however, is a worker shortage that has sent the December unemployment rate to a 50-year low, one reason why labor-intensive services prices are currently inflation's hot spot. Elevated inflation has encouraged the Federal Reserve to stay the course on credit tightening, posing the threat of an overshoot of rate hikes and a liquidity squeeze in the financial market.

Wage inflation still near a 40-year high and accompanied by inadequate productivity growth is a threat to corporate margins and profitability — particularly in labor-intensive services industries, the dominant sector of the U.S. economy. Elevated costs encouraging a move by firms to low-cost manufacturing centers have been at the heart of globalization roiling U.S. manufacturing in recent decades.

However, 12-month wage inflation has bucked low unemployment in falling from 6.7% to 6.1% between August and December. One reason is that lower union representation and fewer cost-of-living agreements have made wages more sensitive to price inflation than they were in the 1970s and early 1980s. Slowing inflation also is easing pressure on workers' inflation-adjusted incomes, down 0.3% in the year to December from a peak 2.6% drop in March 2022. That likely is easing worker demands for catch-up wage increases. Lastly, the labor market is beginning to soften, judging from slowing job growth, recent small-business surveys, and a five-month decline in leading-edge temp-worker employment.

Living with a tight labor market

Still, we believe U.S. labor supply will remain tight for two reasons. Aftershocks from the pandemic have sidelined close to 3 million workers directly and indirectly, according to the Census Bureau's Pulse Survey in December 2022. Second, the growing number of retirees in an aging population has slowed labor-force growth from an average 1.2% a year in the 1980s to just 0.7% annually in the decade before the pandemic, with further declines a near certainty. Added kindling for more aggressive bargaining comes from labor's historically low share of national income, stuck at less than 53% of total income in recent years, according to the chart on page 3, from more than 57% in the decade to 1980. That is a difference of more than $1.1 trillion, or nearly $8,900 per household in today's dollars.

Businesses may deal with higher-cost labor by boosting productivity through management innovations, enhanced worker training, or investment in robotics, artificial intelligence (AI), and in other labor-saving software and equipment. Robotics in the past five years has doubled from the previous five, boosted, in part, by worker shortages during the pandemic. Another option is to accommodate higher labor costs by moving up the value-added ladder, a shift facilitated by the recent tilt toward industrial policy in foreign trade strategy favoring technology and renewable energy equipment.

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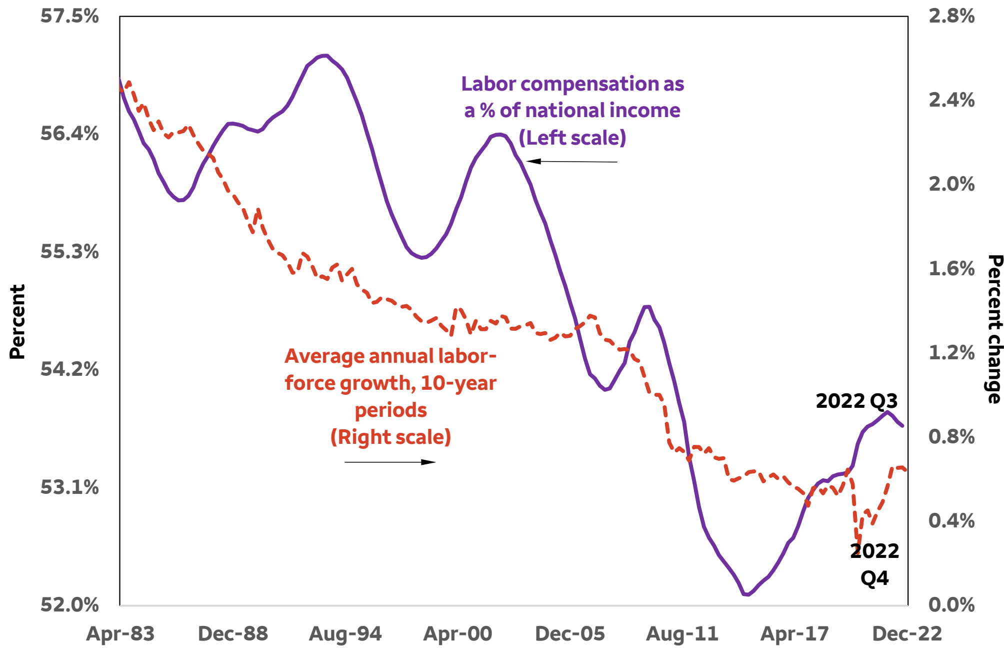
Is U.S. labor primed for a bigger piece of the national income pie?



Sources: U.S. Commerce Department and U.S. Department of Labor. Data as of January 5, 2023.

Investment implications: Pricing power by any means

Labor-saving investment for most firms is a long-term solution to elevated labor costs. For now, investment strategy will favor those firms with the pricing power to maintain margins in the face of elevated costs. We look to several bellwethers of pricing power. For example, the managed health care industry benefits from demand inelasticity, or insensitivity, to changes in price. Pricing power in a growing number of industries, notably technology, steel, and aluminum are insulated by government subsidies or trade barriers as part of the tilt toward industrial policy. Industry products with a high intellectual property content, like technology's enterprise software and robotics, attract a stable following by improving customer productivity and, in some cases, because of high switching costs. And highly concentrated industries, like industrial gases, benefit by providing a key input to manufacturing from economies of scale and from other barriers to entry by upstart firms. Apart from steel and aluminum, all these sub-industries carry a favorable rating by Wells Fargo Investment Institute, as of January 18, 2023.

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Equities

Chris Haverland, CFA
Global Equity Strategist

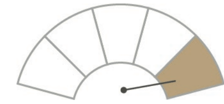
Fourth-quarter earnings contraction?

After growing by nearly 5% in the third quarter of 2022, Bloomberg consensus expects S&P 500 Index earnings to have fallen 2% – 3% in the fourth quarter. Early results have been mixed and if the growth rate remains negative, it would be the first down quarter in over two years. Revenue growth is expected to be modestly positive, but it likely will be the first time in the past eight quarters that the S&P 500 index has not experienced double-digit sales growth.

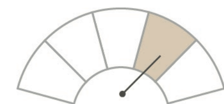
The Energy and Industrials sectors should lead the way, with Energy earnings expected to rise by more than 50%. While Energy sector earnings continue to impress, it is masking underlying weakness in other sectors. Excluding the Energy sector, overall S&P 500 Index earnings are expected to be even further in the red. Most of the S&P 500 Index is forecasted to show flat to declining earnings, led by weakness in Materials and Communication Services (see chart below).

Forward guidance will be key as many companies continue to deal with high input prices, a tight labor market, and a slowing global economy. After peaking in the second quarter of 2022, operating margins[1] are expected to have declined for the second consecutive quarter. We believe margins and overall earnings peaked in 2022 and will decline in 2023, before rebounding in 2024.

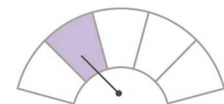
Looking forward, we expect earnings weakness in 2023 with an economic recession looming. In this environment, we suggest focusing on high-quality companies with consistent earnings growth, low debt levels, and high return on equity.



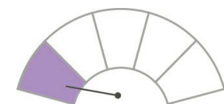
Most favorable
U.S. Large Cap Equities



Favorable
U.S. Mid Cap Equities



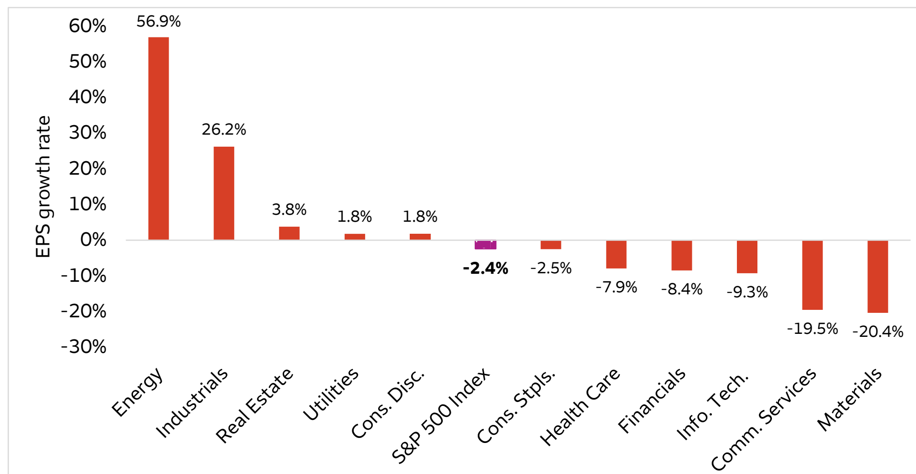
Unfavorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities

Unfavorable
Emerging Market Equities

S&P 500 Index fourth-quarter earnings per share growth estimates



Sources: Wells Fargo Investment Institute, Bloomberg as of January 23, 2023. EPS = earnings per share. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

1. Operating margins are operating income divided by revenue.

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Fixed Income

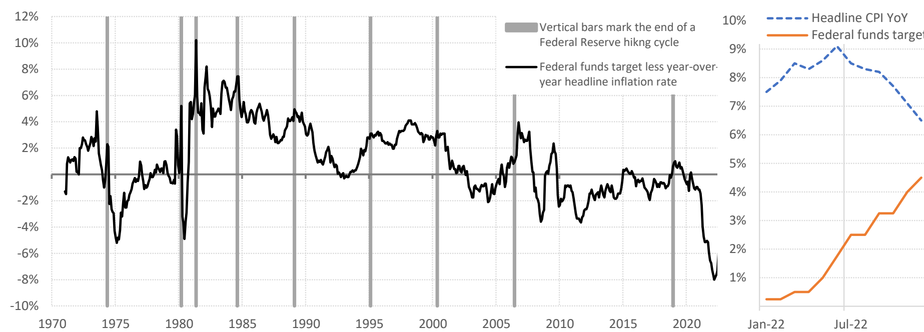
Will March see the last rate rise from the Fed?

The rate path implied by the federal funds futures contracts shows a peak in rates at around 4.90% early in 2023. This suggests a quarter-point hike from the Federal Reserve (Fed) this week, followed by another quarter point at the March 22 meeting, and then a pause. But will there be another quarter-point increase at the May 3 Federal Open Market Committee (FOMC) meeting — which would take the federal funds rate to the 5.00% – 5.25% level implied by the Fed's December dot plot?

One narrative arguing in favor of a third hike is the observation that the Fed has never yet ended a rate-rise cycle with the federal funds rate in negative territory in real terms (that is, below the annual headline inflation rate). The rate of headline inflation as of Dec. 31, 2022, is still two full percentage points above the top of the current federal funds range of 4.25% – 4.50%. By the March 22 Federal Reserve rate-setting meeting, headline inflation will almost certainly have fallen further, but will it have fallen below 5%?

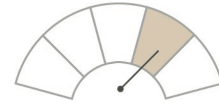
On the face of it, this seems unlikely. But this argument for a third quarter-point increase in May is not as straightforward as it may seem. For one thing, why headline consumer price inflation when the Fed's preferred measure is known to be the core Personal Consumption Expenditure deflator, currently 4.4%, so a significantly lower hurdle to clear to achieve positive "real" rates? Secondly, even if the federal funds rate is not positive in real terms by March, it might be so by May, even without a third hike. And thirdly, history is not an iron rule, and the rise of inflation in 2021 – 2022 was unprecedented in recent decades, so the speed of the fallback in 2023 may well be, too. The best we can say is that, while the next two quarter-point hikes seem extremely likely, a third (or more, for that matter) will remain, for now, data-dependent.

The Fed has never stopped hiking with a negative real funds rate

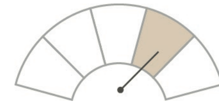


Sources: Bloomberg and Wells Fargo Investment Institute. For the left chart, monthly data from Jan 31, 1971 to Dec. 31, 2022. For the right chart, monthly data from Jan. 31, 2022 – Dec. 31, 2022. CPI = Consumer Price Index. YoY = year-over-year.

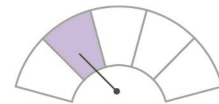
Peter Wilson
Global Fixed Income Strategist



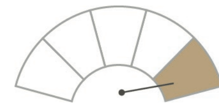
Favorable
U.S. Taxable Investment Grade Fixed Income



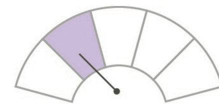
Favorable
U.S. Short Term Taxable Fixed Income



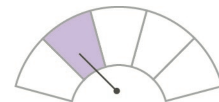
Unfavorable
U.S. Intermediate Term Taxable Fixed Income



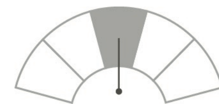
Most favorable
U.S. Long Term Taxable Fixed Income



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

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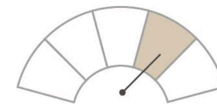
Investment Strategy Analyst



Favorable
Commodities

Neutral
Private Real Estate

"We aren't addicted to oil, but our cars are." —James Woolsey

What is Urals crude oil, and who's buying?

When discussing oil, we frequently mention West Texas Intermediate (WTI) crude and Brent because they are the two most actively traded global benchmark prices. In reality, though, there are over 150 different mixtures of crude oil, including Russia's primary export grade crude oil — Urals crude.

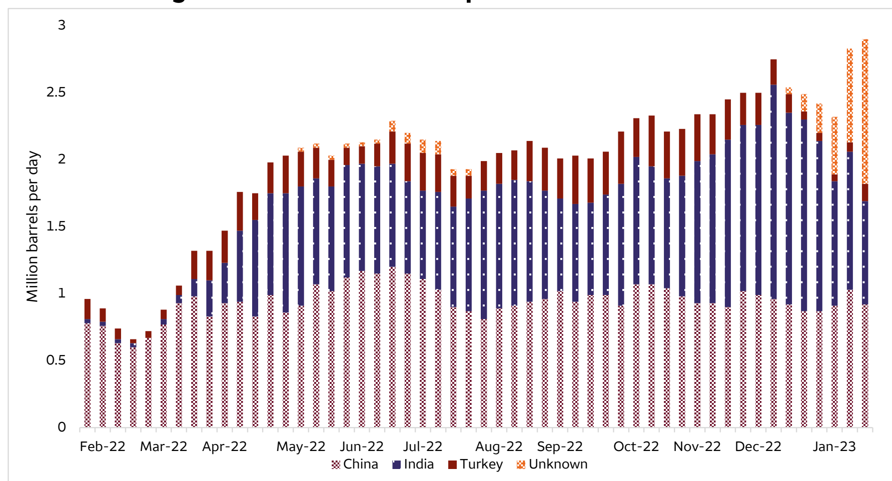
Prior to the Russia-Ukraine war, Europe was the largest buyer of Russian oil, accounting for 53% of Russian crude exports in 2021. Demand for Urals crude, though, would soon drop as the European Union moved to ban Russian oil imports and G7 nations[2] planned future price caps. Urals crude prices have since traded at steep discounts to WTI and Brent; today 27% lower than WTI, and 32% lower than Brent crude, as of Jan. 20, 2023.

As bad as steep discounts in Urals oil sounds, they did attract extra buying from key emerging markets. The largest additional purchases came from China, India, and Turkey. Notably, India increased its purchases of Russian crude from less than 300,000 barrels per day prior to the war, to a peak of 1.43 million barrels per day in December 2022 (see chart).

Overall, though, the extra emerging market buying has not been enough to offset the damage from sanctions, price caps, and lost buying from the west. One recent report on Jan. 11, 2023, from the Centre for Research on Energy and Clean Air, concluded that Russia's oil profits fell 17% in December 2022.

As we enter 2023, we suspect that Russia's oil profits should remain squeezed, as long as it continues to wage war in Ukraine. This is a critical point for a country that relies heavily on profits from oil, and other fossil fuels, for its federal budget.

4-week average of seaborne crude shipments from Russia to select countries



Sources: Bloomberg and Wells Fargo Investment Institute. Weekly data is from January 28, 2022 – January 20, 2023.

2. Group of 7 (G7) is an organization made up of seven large developed economies that meet annually to coordinate global economic policy.

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Alternatives

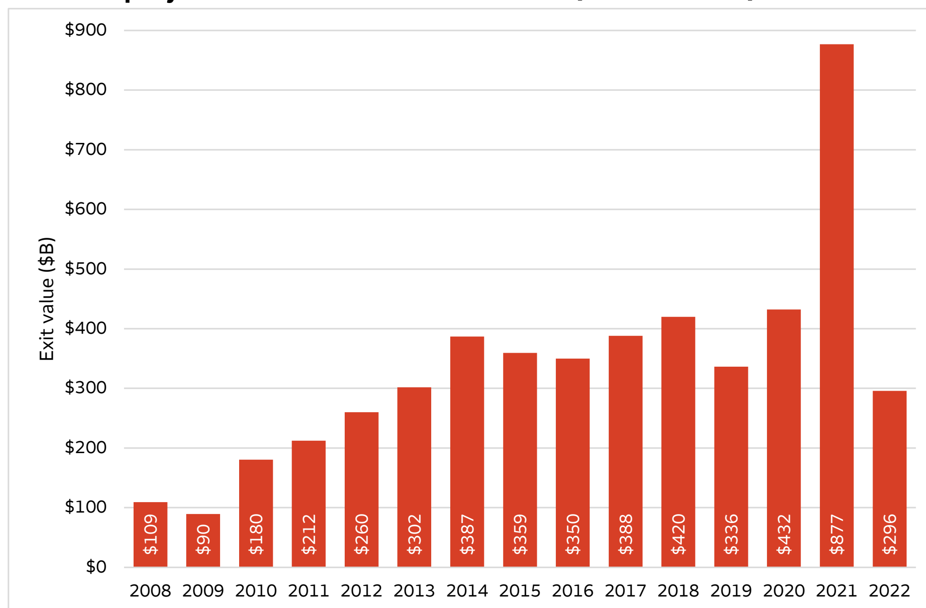
Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

Private equity activity decelerates

The booming private equity market reached a peak in 2021 as rising deal activity and an active initial public offering (IPO) market created a frenzy of firms anxious to launch new funds and capitalize on the favorable environment. However, as the equity and bond markets began their descent in early 2022, persistent inflation levels prompted the Federal Reserve to increase interest rates. Private equity firms began to adjust to weakening economic conditions and higher financing costs.

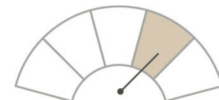
Although private equity deal activity started 2022 strong, volumes declined through the second half of the year and finished significantly lower than in 2021. The largest sector in recent years, Information Technology, was also responsible for the largest decline. Peaking in the second quarter, volumes declined by 46% in the second half of the year. Similarly, the exit environment for private firms deteriorated as the IPO market faded after several years of robust activity. As highlighted in the chart below, exit volumes declined in 2022 by approximately 66% from the elevated levels in 2021.

Private equity exit volumes on an annual basis (2008 to 2022)



Sources: Pitchbook and Wells Fargo Investment Institute. Data as of December 31, 2022.

The economic outlook remains challenging in 2023, and we expect further pressure on valuations in 2023 as private markets continue to adjust to the uncertain outlook. Although the industry faces several headwinds entering 2023, the downturn in private markets may provide opportunities to capitalize on lower valuations within select areas of the market. Given our longer-term cyclical outlook, we remain constructive on private markets in general and believe investors will be well served to consider long-term allocations to Small-Mid Buyout and Growth Equity strategies.



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. 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.

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.

Personal Consumption Expenditure (PCE) is a measure of inflation based on changes in personal consumption.

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.

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