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**Investment Institute**

# Investment Strategy

**Weekly guidance from our Investment Strategy Committee** **February 26, 2024**


## Real Assets Spotlight: Long-term impacts of a pause in LNG export approvals ........ 2

- Over the past 10 years, the U.S. has emerged as one of the world's largest exporters of liquified natural gas (LNG), and one of the world's largest producers of dry natural gas.
- Recently, however, the U.S. decided to pause additional LNG export permits. Should the pause continue beyond the next few years, we would expect to see higher and more volatile global natural gas prices.

## Equities: Stock rally turns equity risk premiums negative ........ 4

- Recently, the equity risk premium (ERP) hit lows last seen during the dot-com bubble.
- While certainly not a timing mechanism, such a low ERP is yet another indicator that stocks are expensive — especially relative to bonds.

## Fixed Income: Scratching the surface on municipal bonds........ 5

- Municipal bond yields appear expensive in comparison to Treasuries, but that does not capture the full thesis of why we are favorable on U.S. Municipal Bonds.
- Taxable-equivalent yields, particularly for investors in higher income brackets, along with supply and demand imbalances, still provide an attractive opportunity in municipal bonds.

## Alternatives: Merger and acquisition activity rebounds as confidence improves ........ 6

- The recent rise in merger and acquisition (M&A) activity may indicate that corporate leaders' outlooks on the economy are improving, providing more confidence to engage in strategic transactions.
- Our current unfavorable guidance on the Merger Arbitrage strategy may transition to neutral as we continue to see further evidence of an improving M&A landscape that includes higher volumes of activity, potentially lower interest rates, and a more favorable regulatory environment.

## Current tactical guidance ........ 7


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# Real Assets Spotlight

**John LaForge**
Head of Real Asset Strategy

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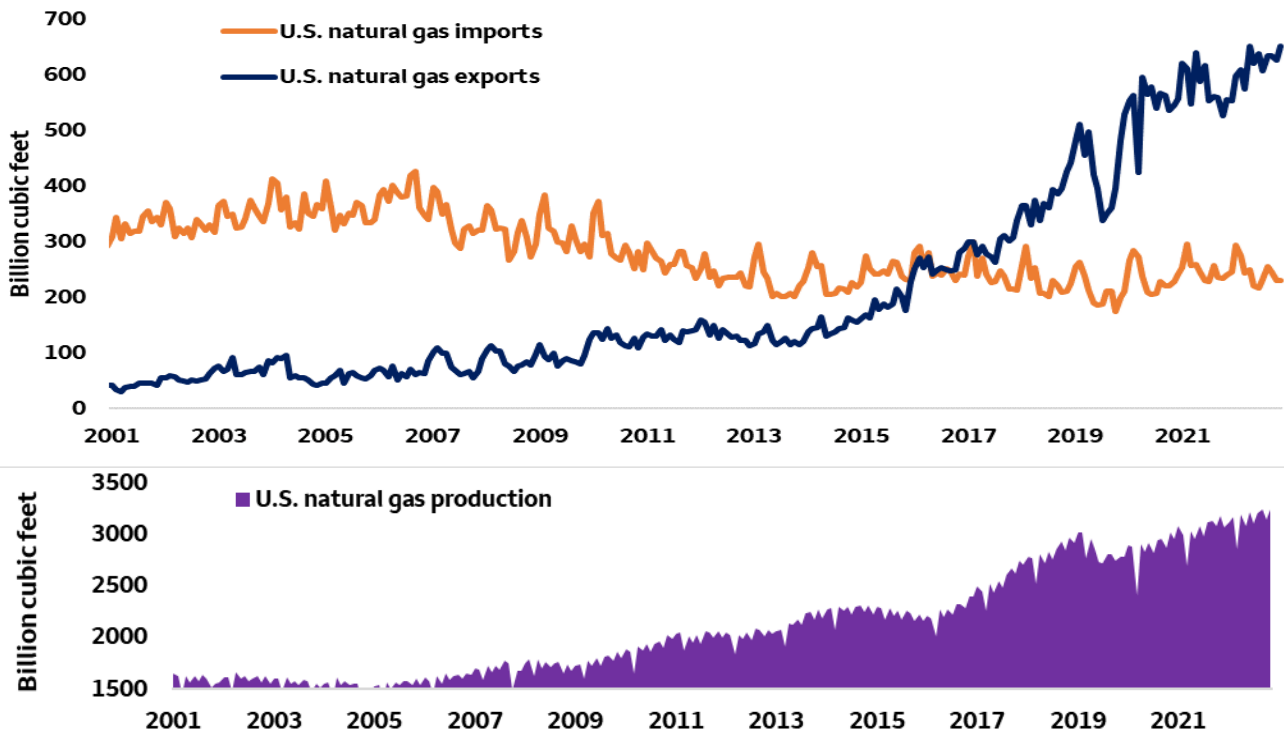
## Long-term impacts of a pause in LNG export approvals

In last week's Investment Strategy Report, we discussed a recent decision by the U.S. to pause liquified natural gas (LNG) export permit approvals. Over the short term, we are not expecting to see impacts to global supplies or prices for LNG or dry natural gas. However, no timeline has been given by the Department of Energy for the duration of the pause. Should the permit approval ban remain in place beyond a few years, we would expect to see higher and more volatile global natural gas prices.

Natural gas has become big business in the U.S. over the past two decades. This can be seen from multiple angles in the chart below. The bottom panel highlights U.S. natural gas production, which has nearly doubled since the turn of the century. The jump in production was sparked by breakthroughs in energy extraction, such as hydraulic fracturing and horizontal drilling, often called the Shale Revolution. Production eventually became so abundant that the U.S. turned to exporting it as LNG.

LNG, for those unfamiliar with the term, is essentially frozen natural gas. Freezing the gas makes it easier and more efficient to export via ship. Prior to the Shale Revolution, LNG was not a term heard often in the U.S., as the country had been a net importer of natural gas for years. That started to change in earnest in 2011, however, with the U.S.'s first large LNG export facility approval at Sabine Pass, Louisiana. More approvals would soon follow, and by 2016 the U.S. officially flipped from being a net importer of natural gas, to a net exporter. This can be seen in the top panel of the chart below, where the two lines cross.

**U.S. natural gas trade versus production**




Sources: Energy Information Administration and Wells Fargo Investment Institute. Monthly data is from January 2001 – October 2023.

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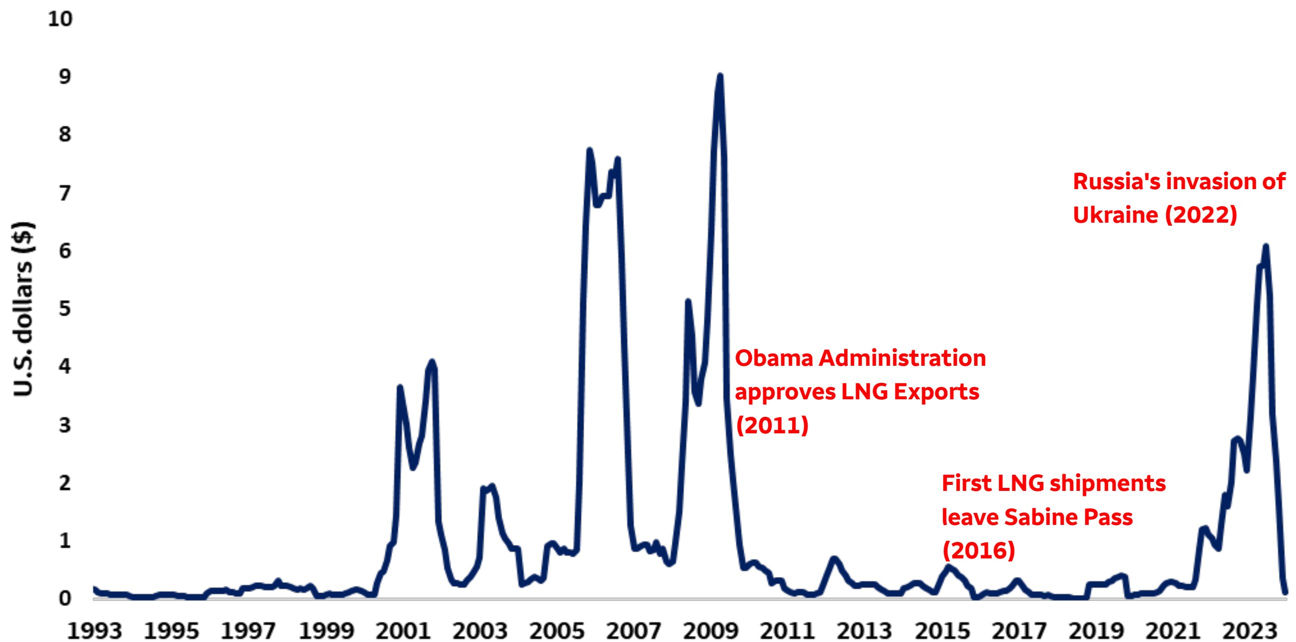
Strong demand for U.S. LNG, understandably, has fueled the need for more supply and record levels of U.S. natural gas production. Since 2011, U.S. LNG exports have grown at an average annual rate of 22%, and natural gas production by 4.4%. Given this context, the recent decision to pause additional U.S. LNG export permit approvals could be a critical for demand and production, depending on how long it lasts. In our view, the longer the pause, the more likely the decision will be felt by U.S. energy companies.

Another potential consequence of the pause, should it last longer than a few years, could be increased natural gas price volatility. Past natural gas price volatility is illustrated in the chart below. Notice that prior to the U.S.'s first LNG export approval in 2011, prices had frequent bouts of high volatility. The volatility profile has changed dramatically since then, thanks to the persistent and projectable demand from LNG exporters.

We would also note that there are five large export projects are currently in the pipeline, expected to nearly double U.S. LNG export capacity by 2027. However early indications suggest they will not be impacted by the permit pause.

**12-month variance in natural gas prices**




Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data is from January 1993 – December 2023

The bottom line is that the U.S. recently decided to pause LNG export permit approvals. Over the short term, we are not expecting to see much in the way of impacts to global supplies or prices for LNG or dry natural gas. No timeline has been given by the Department of Energy for the duration of the pause, however. Should the permit approval ban remain in place beyond a few years, we would expect to see higher and more volatile global natural gas prices, long term.

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# Equities

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

**Austin Pickle, CFA**
Investment Strategy Analyst

## Stock rally turns equity risk premiums negative

Recently, the U.S. equity risk premium hit lows last seen during the dot-com bubble (1998-2000). What does this mean, and what are the investment implications?

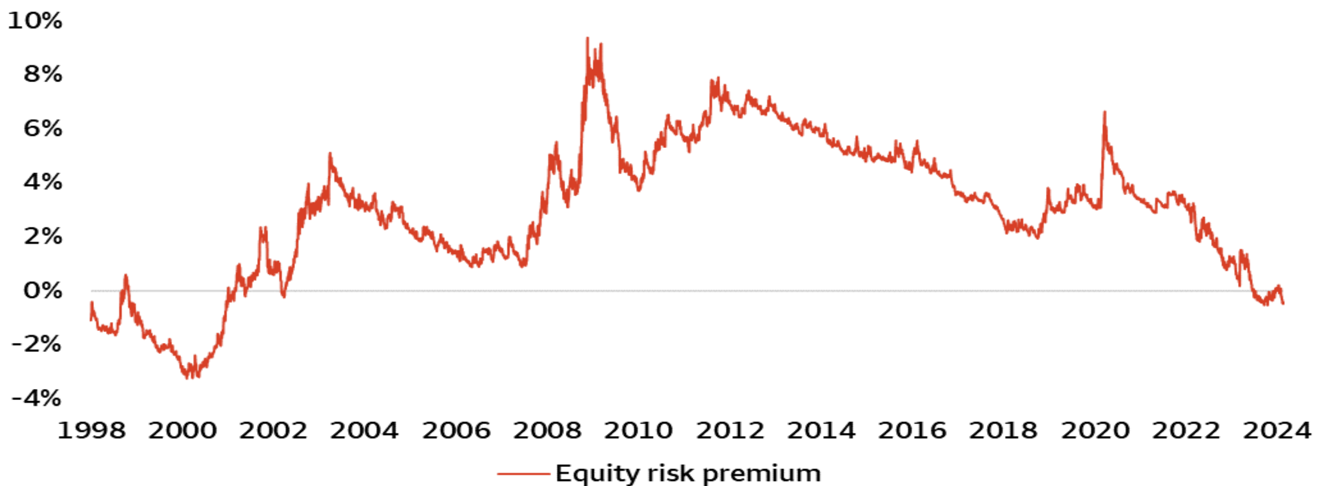
For those unfamiliar, the equity risk premium (ERP) is calculated by taking an equity earnings yield and subtracting a bond yield — that is, it measures the amount of additional return offered by equities compared to perceived lower-risk alternatives. The earnings yield is earnings divided by price, or the reciprocal of the well-known price-to-earnings ratio. The ERP is a way to measure whether stocks are cheap or expensive relative to bonds. With the S&P 500 Index near all-time highs, the ERP has dipped into negative territory (see chart). In other words, stocks appear expensive at the moment.

This contrasts with the last time the S&P 500 Index hit a record high in January 2022, when the ERP was at a significantly more attractive 3%. At that time, short-term rates were near zero, the two-year Treasury yield was roughly 0.7%, and even the 10-year Treasury yielded less than 2%. Today, with money market rates above 5% and 10-year Treasury yields above 4.25%, we believe fixed income offers a reasonable alternative to equities.

Like any valuation metric, the ERP is not a timing tool. There is nothing to say that the ERP could not dip further into negative territory, which has not happened to the S&P 500 Index since the late 1990s (see chart). To be sure, we are not suggesting that today is a replay of those times, only that we favor being selective to look for value. Put another way, we favor holding Information Technology (IT) and Communications Services equities at market weight but would not overweight sectors that already look expensive. We expect more attractive entry points to present themselves.

At least for now, with the fixed income yields where they are, investors may consider fixed income options with reasonably attractive premiums.

**Equity risk premium at levels last seen during the dot-com bubble**




Sources: Bloomberg and Wells Fargo Investment Institute. Equity risk premium represents S&P 500 Index earnings yield minus two-year Treasury yield. Daily data: January 1, 1998 – February 20, 2024. Earnings yield is calculated as the trailing 12-month earnings per share divided by the current price.

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# Fixed Income

**Tony Miano**
Investment Strategy Analyst

## Scratching the surface on municipal bonds

Municipal bond yields have struggled to keep up with Treasury yields in the current interest rate environment. Municipal-to-Treasury yield ratios (MTYR) for 10- and 30-year municipals are well below 20-year averages, indicating investors are receiving lower-than-average yields relative to Treasuries. Current MTYR may make municipals seem unattractive given how expensive valuations are relative to history, but we still believe they present a good entry point for certain investors.

Focusing solely on the quoted yield ignores a key portion of what makes municipals attractive — favorable tax treatment. Municipals may be exempt from taxation on the federal, state, and local level while Treasuries are federally taxable. For investors in high-income tax brackets or investors who have concerns about tax rates in the future, municipals may be more attractive than quoted yields initially indicate. The below table demonstrates that adjusting municipal yields for their favorable tax treatment results in higher yields for investors in the highest tax bracket and may even exceed that of long-term Treasuries.

**Taxable equivalent yield versus corporate and Treasury yields at various tenors**

| | 1 year | 3 year | 5 year | 7 year | 10 year | 20 year | 30 year |
|---|---|---|---|---|---|---|---|
| Treasury yields | 4.98% | 4.43% | 4.29% | 4.31% | 4.30% | 4.38% | 4.45% |
| A-rated TEY municipal yields | 5.11% | 4.59% | 4.31% | 4.28% | 4.43% | 5.86% | 6.41% |
| A-rated corporate yields | 5.29% | 4.86% | 4.87% | 5.00% | 5.20% | 5.50% | 5.42% |
| **Highest-yielding asset class at 37% tax bracket** | **A-rated corporate** | **A-rated corporate** | **A-rated corporate** | **A-rated corporate** | **A-rated corporate** | **A-rated TEY municipal** | **A-rated TEY municipal** |

Source: Bloomberg. Data as of February 20, 2024. Taxable-equivalent yields (TEYs) are calculated by dividing yield by 1 minus federal income tax bracket and is intended to adjust municipal yields for their tax benefits. Municipal bonds are represented by the Bloomberg US General Obligation A+ A A- Index.

We also believe municipal market dynamics are favorable. Bloomberg Intelligence reports that assets under management in municipal separately managed accounts (SMAs) has grown from 3% to an almost 25% market share, attracting nearly $1 trillion over the past decade.[1] Growing interest in tax-efficient vehicles like SMAs and exchange-traded funds may provide a demand tailwind for municipals in a market already focused on tax consequences. Supply and demand for municipals remains mismatched, and we believe this will be beneficial. We remain favorable on U.S. Municipal Bonds, particularly in the 11- to 16-year portion of the curve, where we believe investors can find additional yield.

1. Bloomberg Intelligence, “Three keys for 2024: US Municipal Market,” November 28, 2023.

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# Alternatives

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Global Alternative Investment Strategist

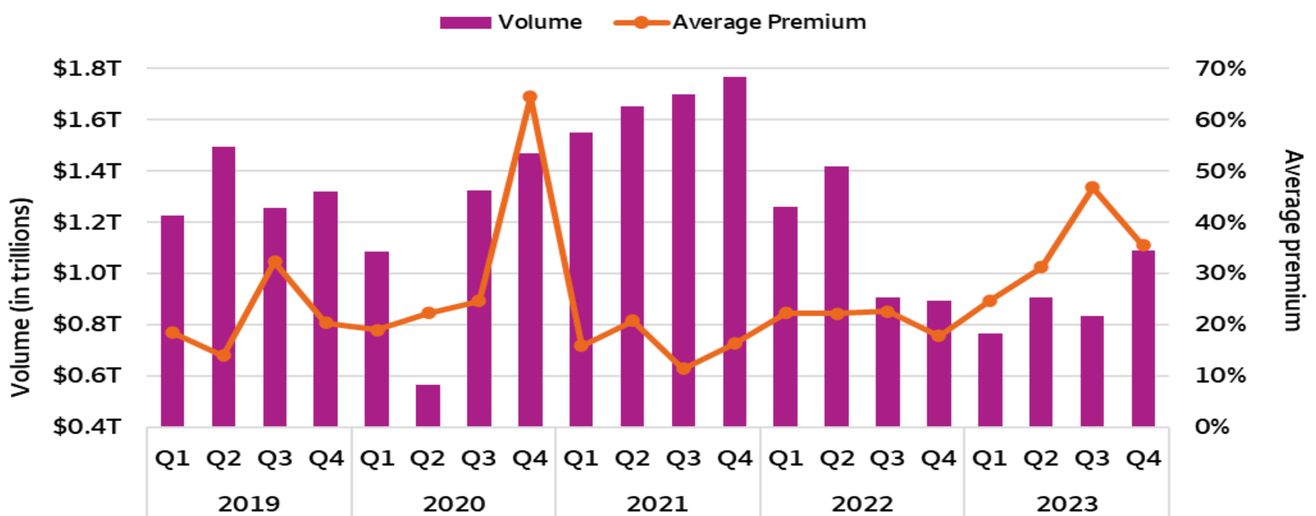
## Merger and acquisition activity rebounds as confidence improves

While global merger and acquisition activity in 2023 remained well below annual totals in recent years, the fourth quarter of 2023 offered signs of life as markets rebounded alongside the growing narrative of a Federal Reserve (Fed) pivot. Quarterly volumes have been rangebound near the $800 – $900 billion mark since the third quarter of 2022 yet rose significantly in the fourth quarter of 2023, registering near $1.1 trillion. The trend of rising deal volumes may reflect the market's growing optimism that a meaningful economic pullback can be avoided. Moreover, the average premium (or spread between buyer bids and current market prices) of announced deals narrowed in the fourth quarter, in part reflecting corporate leaders' growing confidence in future economic prospects.

While increased regulatory scrutiny of acquisitions led to greater delays in early 2023, the recent string of successful legal challenges may also pave the way for faster deal closings in the coming quarters. Furthermore, anticipated interest rate cuts in 2024 may bolster activity as lower financing costs may improve deal fundamentals for potential acquirers. Yet, the mixed inflationary signals may delay any meaningful reduction in interest rates until the Fed gains greater confidence that inflation is moving sustainably down to its 2% goal.

Should we witness further improvements in the environment for deals, we likely will become more constructive on the Merger Arbitrage strategy. Higher volumes of activity, potentially lower interest rates, and a more conducive regulatory environment would bode well for Merger Arbitrage over the coming year. Our current unfavorable guidance may transition to neutral should we see further evidence of an improving landscape. In our view, the key factor to await is a lower interest rate environment.

**Merger and acquisition deal volumes increasing, spreads narrowing**




Sources: Bloomberg and Wells Fargo Investment Institute. Data shown is from January 1, 2019, to December 31, 2023. Data as of December 31, 2023. All data is quarterly. T = trillion. Volume = the aggregate value of all announced deals on a global basis, which include pending, proposed, completed, withdrawn, and terminated deal status. Average premium = the average premium of all announced deals on a global basis that includes all pending, proposed, terminated, completed, and withdrawn deal status.

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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# Tactical guidance*

## Cash Alternatives and Fixed Income

| Most Unfavorable | Unfavorable | Neutral | Favorable | Most Favorable |
|---|---|---|---|---|
| | High Yield Taxable Fixed Income | Cash Alternatives<br>Developed Market Ex-U.S. Fixed Income<br>Emerging Market Fixed Income<br>U.S. Long Term Taxable Fixed Income<br>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<br>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<br>Hedge Funds—Equity Hedge<br>Private Equity<br>Private Debt | Hedge Funds—Relative Value<br>Hedge Funds—Macro | |

Source: Wells Fargo Investment Institute, February 26, 2024. *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.

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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. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. 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. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

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.

Merger arbitrage involves investing in event driven situations such as reorganizations, spin-offs, mergers, and bankruptcies, and involves the risks that the proposed opportunities in which the fund may invest may not materialized as planned or may be renegotiated or terminated which can result in losses to the fund.

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.

**Bloomberg General Obligation Bond Index** is an index that represents average market-weighted performance of general obligations securities that have been issued in the last five years with maturities greater than one year.

**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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