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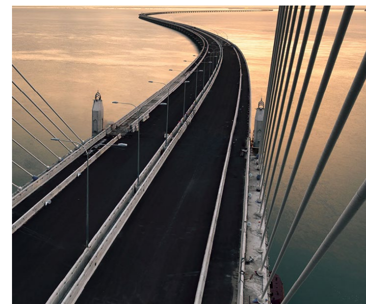

Weekly guidance from our Investment Strategy Committee **March 10, 2025**

Fixed Income Spotlight: Emerging-market bonds continued to gain momentum 2

- The decline of U.S. Treasury yields, and a retracing of the U.S. dollar, has supported U.S.-dollar-denominated and local-currency emerging market (EM) sovereign debt so far this year.
- In our view, the yield differential of EM bonds (compared to U.S. Treasuries) may provide local currency resilience and, potentially, a cushion against capital losses if interest rates resume their move higher or if credit spreads widen.

Equities: Earnings grow for the sixth consecutive quarter 4

- It was a strong fourth-quarter earnings season, with S&P 500 Index revenue growing 6% and profits surging 14%.
- Our view is that earnings growth will be the key driver of returns in 2025. Our sector guidance tilts toward cyclical and growth-oriented areas, with favorable ratings on the Communication Services, Energy, Financials, and Industrials sectors.

Real Assets: "Drill, baby, drill?" Don't count on it 5

- Companies are not planning to spend the money necessary to substantially increase oil production.
- As the year progresses, we believe that a measured U.S. and OPEC+ (Organization of the Petroleum Exporting Countries and their allies) supply response alongside an uptick in demand and sentiment will drive prices higher by year end.

Alternatives: Venture capital remains artificial intelligence-focused 6

- With record dealmaking and soaring valuations, venture capital in artificial-intelligence (AI) startups was a bright spot in 2024.
- Although AI-related venture-capital investments are still in their early stages with significant capital likely needed, we believe they can benefit from expectations for technology's rapid growth as well as its long-term transformative potential.

Current tactical guidance 7

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Fixed Income Spotlight

Luis Alvarado
Global Fixed Income Strategist

Emerging-market (EM) bonds continued to gain momentum

We believe that EM sovereign bonds will likely continue to display positive performance in the first half of 2025, both U.S.-dollar- and local-currency-denominated[1], following positive calendar-year returns for EM bonds in dollars in both 2023 and 2024. However, most of the support may come on the back of our expectations for: additional interest-rate cuts by the Federal Reserve (Fed); falling U.S. Treasury yields; and, to some extent, from further U.S. dollar weakening relative to key EM currencies. Therefore, we maintain a neutral view on EM bonds as we believe all these positive factors will most likely fade as we step into the second half of 2025.

The EM bond Index in U.S. dollars has enjoyed the recent tailwind of declining U.S. Treasury yields, which we believe may continue over the next two quarters, in line with expectation for moderating U.S. economic growth and the potential for further interest-rate cuts from the Fed. But there are risks, especially if U.S. Treasury yields resume their move higher for example, in the event that inflation surprises to the upside. Second, local-currency EM debt may present the U.S.-dollar-based investor with better performance in the first half of the year, especially if the Fed decides to implement additional interest-rate cuts. However, if cuts are delayed or don't come to fruition, the longer-term impact of tariffs will likely cause the U.S. dollar to strengthen further, eventually hurting local currency EM bonds.

We do not expect U.S. credit spreads to widen much further from current levels and, in that context, it would be reasonable to expect EM sovereign spreads to remain range-bound and contained below historical averages. However, if spreads were to widen against a bigger concern of a U.S. recession, this move would likely be partially offset by lower U.S. Treasury yields. Still, the current starting yield for the dollar-denominated EM bond Index (between 7% and 7.5%), which broadly reflect the income component of the total return, may provide a cushion against possible capital losses.

Proactive central banks and a larger rate cushion

Chart 1 illustrates support for the outperformance of EM currencies and debt and EM debt's resilience in recent years. Many EM central banks began to raise policy interest rates in mid-2020, whereas many developed-market (DM) central banks began playing catch-up in early 2022. Although many DM and EM central banks started cutting rates in 2024, the higher rates across (local currency) EM yield curves historically have given EM central banks policy flexibility in tackling both inflation and economic downturns. We believe the wider yield differential may provide both local currency resiliency and a potentially larger cushion against capital losses if interest rates were to rise.

[1] Emerging Market Fixed Income in U.S. dollars is proxied by the J.P. Morgan Emerging Markets Bond Index (EMBI Global) and Emerging Market Fixed Income in local currency is proxied by the J.P. Morgan Government Bond Index-Emerging Markets Global Diversified.

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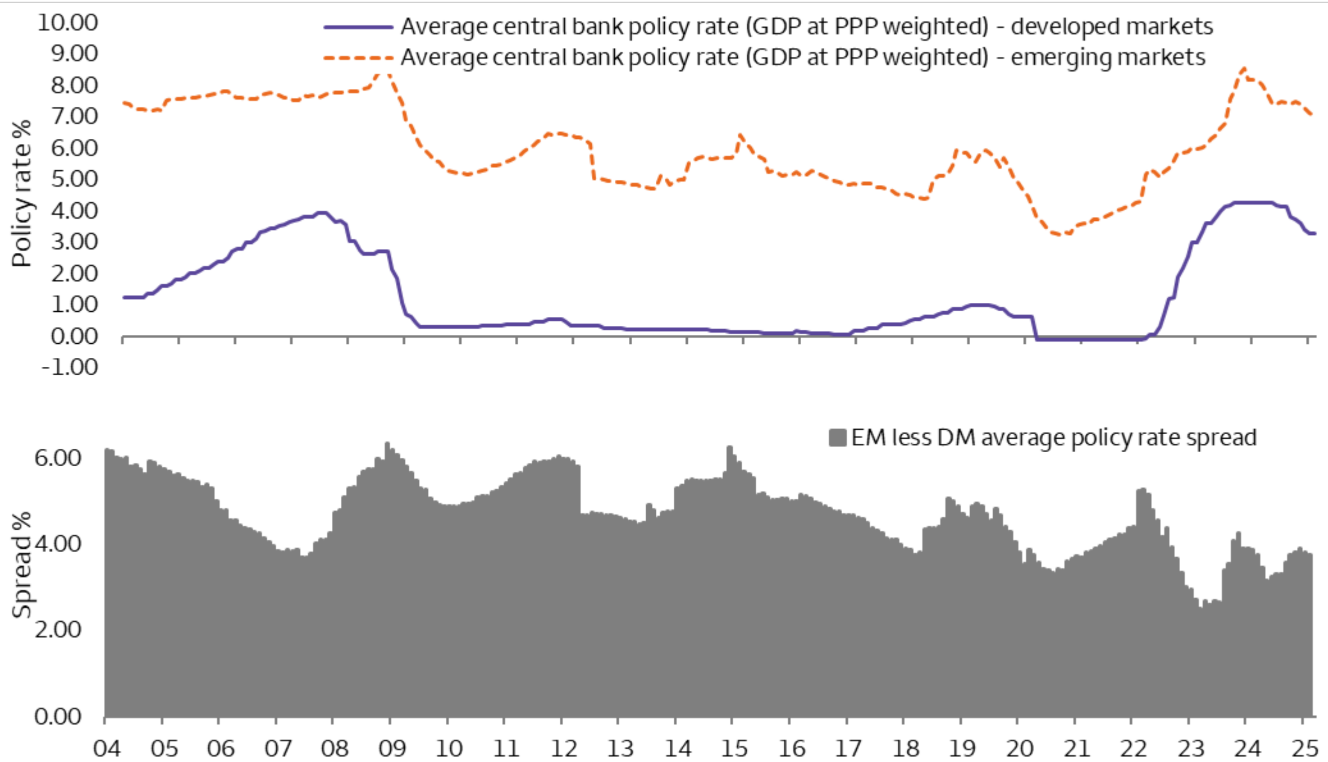
Chart 1. Emerging markets' average policy rate spread increasing



Sources: International Monetary Fund (IMF), Bloomberg, and Wells Fargo Investment Institute. Latest data as of Feb. 28, 2025. The Developed Markets (DM) series is a weighted average of 11 DM central bank policy rates, using gross domestic product (GDP) at purchasing power parity (PPP) as weights. The Emerging Markets (EM) series is a weighted average of 26 EM central bank policy rates, using GDP at PPP as weights. Purchasing power parity is the measurement of prices in different countries that uses the prices of specific goods to compare the absolute purchasing power of the countries' currencies.

Balancing duration and credit — Remain neutral for now

In short, U.S.-dollar-denominated EM sovereign index[2] yields are a more attractive proposition at the 7% – 7.5% levels seen currently. Seeking to balance duration (a measure of interest rate sensitivity) and credit risk, we currently remain neutral on this asset class. EM bonds may continue to display positive performance in the first half of 2025 given the markets expectation for additional Fed interest rate cuts. We foresee one more fed funds rate cut, at most, and even that is at risk if inflation ticks higher. Generally falling U.S. Treasury yields have attracted investors to EM dollar-denominated debt, but we don't expect the current worries about the U.S. economy to persist, and our view is for U.S. Treasury yields to generally move higher by year-end. The U.S. dollar has reversed lower against EM currencies in recent weeks, but we foresee a rebound, based on tariffs and firm U.S. economic growth. Therefore, caution ahead is warranted as we believe that the factors that have been benefitting EM bonds could reverse as we step into the second half of 2025.

[2] Emerging Market Fixed Income in U.S. dollars is proxied by J.P. Morgan Emerging Markets Bond Index.

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Equities

Chris Haverland, CFA
Global Equity Strategist

Earnings grow for the sixth consecutive quarter

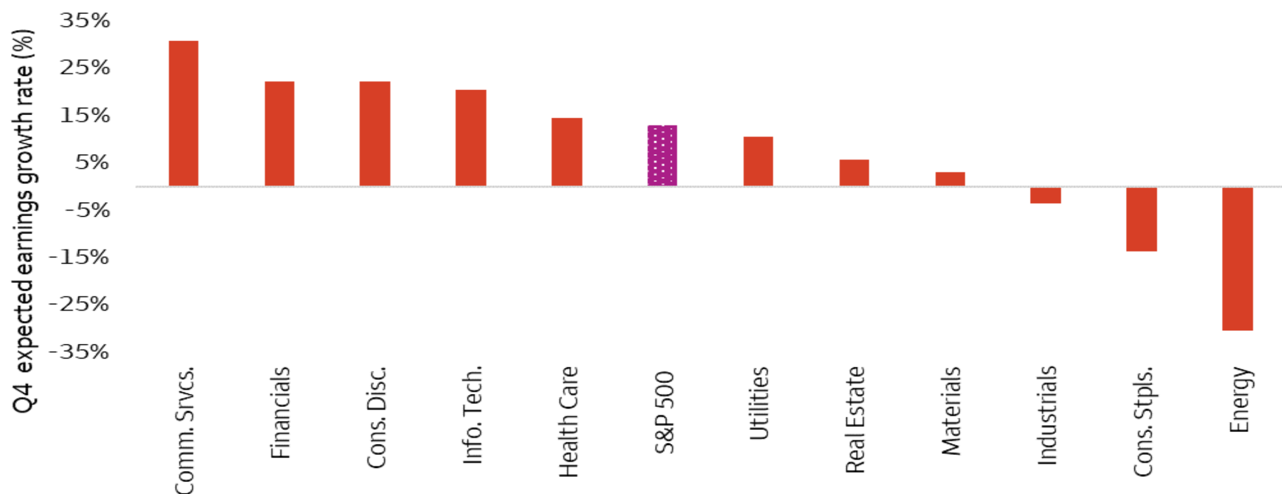
Fourth-quarter earnings season is coming to a close, and profits for the S&P 500 Index are on track to increase by 14% year over year (YOY), well ahead of the Bloomberg consensus expectation of 7.3%. The earnings beat rate (companies reporting earnings above consensus expectations) is around 75%. Revenue grew by almost 6%, and margins increased from the fourth quarter of 2023.

Eight of 11 S&P 500 sectors posted positive earnings growth with the Communications Services, Financials, Consumer Discretionary, and Information Technology sectors leading the way. The Energy sector was the biggest laggard as earnings plunged 30% YOY. Lower oil prices drove the decline. The so-called Magnificent Seven[3] stocks continued to be responsible for much of the earnings growth in the Communication Services and Information Technology sectors. We expect these sectors to maintain leadership in 2025, but S&P 500 Index earnings growth should become more balanced as the year unfolds.

Forward guidance was mixed, and the number of tariff mentions rose on quarterly conference calls. Bloomberg consensus estimates have been revised lower in recent weeks, with 2025 growth expectations now near 10%. We believe solid economic growth will drive company sales while deregulation, continued cost control, and loosening credit conditions will support expanding profit margins in 2025.

Our view is that earnings growth will be the key driver of returns in 2025. That growth likely will be concentrated in cyclical and growth-oriented sectors. Our sector guidance tilts toward these areas, with favorable ratings on the Communication Services, Energy, Financials, and Industrials sectors.

Strong S&P 500 Index earnings growth in the fourth quarter



Sources: Bloomberg and Wells Fargo Investment Institute. Earnings-per-share (EPS) growth measures the earnings growth of the S&P 500 Index and each of its sectors, as of March 4, 2025, versus fourth-quarter 2024 EPS. Q4 = fourth quarter. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

3. The Magnificent Seven refers to Apple, Microsoft, Nvidia, Meta, Alphabet (Google), Amazon, and Tesla.

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Real Assets

"Before anything else, preparation is the key to success." — Alexander Graham Bell

Austin Pickle, CFA
Investment Strategy Analyst

"Drill, baby, drill?" Don't count on it

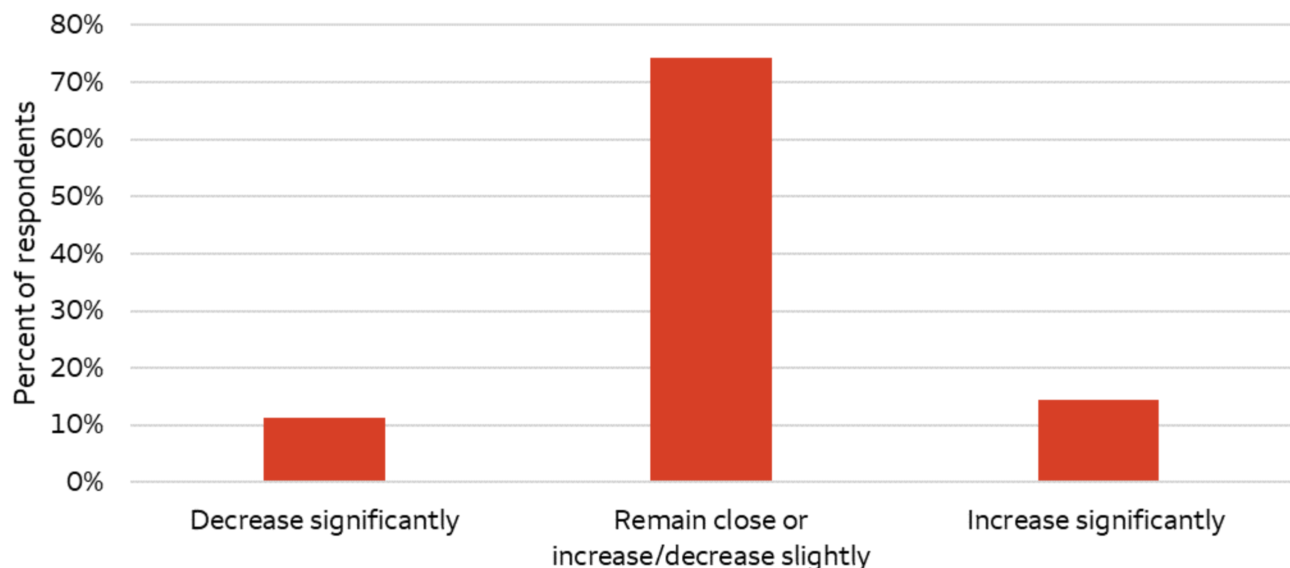
"Drill baby drill" has been a slogan of the Trump administration summarizing a desire for U.S. companies to pump more oil and bring down prices. While the new administration can reduce frictions within the oil industry regarding regulations, permitting, and acreage access, we suspect that U.S. companies will continue exercising capital discipline and will not significantly increase oil production. Recent responses from oil companies support this view as well.

Each quarter, the Federal Reserve Bank of Dallas (Dallas Fed) surveys the energy industry. Of the roughly 130 oil and gas companies that responded to the December Dallas Fed survey, only 14% indicated they would significantly increase capital spending relative to 2024 (see chart below). Interestingly, not one large exploration and production (E&P) firm selected that response. Additionally, a March 2024 Dallas Fed survey stated that $64 per barrel was the average West Texas Intermediate (WTI) oil price E&P companies needed to profitably drill a new oil well.

What does this mean? Companies are not planning to spend the money necessary to substantially increase oil production. Also, a string of soft economic data and OPEC+'s announced plans to revive some halted production suggests WTI prices may close in on that $64 per barrel, where companies are more likely to curtail output than to expand it.

We suspect that supply and demand concerns may weigh on oil prices in the immediate term but also that prices are unlikely to drop significantly below recent lows. As the year progresses, we believe that a measured U.S. and OPEC+ supply response alongside an uptick in demand and sentiment will drive prices higher by year end.

Oil companies' expectation for capital spending in 2025 versus 2024



Sources: Federal Reserve Bank of Dallas and Wells Fargo Investment Institute. Executives from 85 exploration and production firms and 47 oil and gas support services firms answered this question during the survey collection period, December 11, 2024 – December 19, 2024.

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Alternatives

Chao Ma, PhD, CFA, FRM
Global Portfolio and Investment Strategist

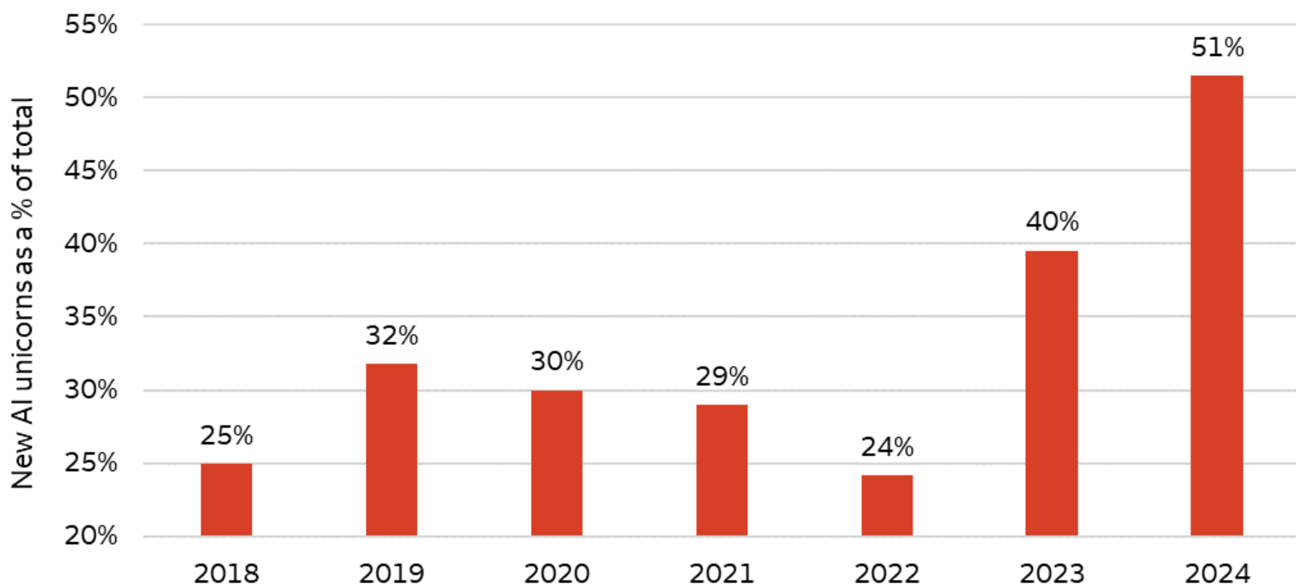
Venture capital remains artificial intelligence-focused

Venture capital investments in AI startups set a record in the fourth quarter of 2024, with deal values topping prior highs. According to Pitchbook, the strong quarter also brought the full-year figure to over $140 billion, boasting a 50% growth rate over the prior year. As a result, the AI sector accounted for 46% of venture capital's total deal value for the year and contributed 51% of newly minted unicorns[4] (see chart below). The vibrant activity level is also reflected in the wide variety of AI deals. For example, transaction deal values were equally split between early-stage companies and megadeals. AI deals also spanned across algorithm developments and industry-specific applications.

In 2024, leading AI-related startups received multiple funding rounds and saw rapid valuation growth, based on Pitchbook data. This contrasted with the challenging environment in the broad venture capital arena, where many startups struggled to complete even one funding round. The significant amount of AI-related strategic acquisitions also resulted in a decent bounce in exits for the AI sector in 2024.

Although the AI sector is still in its early stages and will likely require significant capital investment, we believe the stream of news showcasing its rapid growth, as well as AI's long-term transformative potential, should continue to fuel investors' interest. Additionally, given AI's growing importance to Venture Capital strategies, we also believe that the elevated activities in the AI sector should support the broader asset class's ongoing transition to a future recovery.

AI startups made up an increasing share of newly minted unicorns in 2023 and 2024



Sources: Wells Fargo Investment Institute and Pitchbook. Data as of December 31, 2024. Unicorns are defined as startup companies that received a valuation of $1 billion or more. **Past performance is not a guarantee of future results.**

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.

4. Unicorns are commonly defined as startup companies with a valuation of $1 billion or more.

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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, March 10, 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.

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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. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. 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. 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.

Sovereign debt is generally a riskier investment when it comes from a developing country and tends to be a less risky investment when it comes from a developed country. The stability of the issuing government is an important factor to consider, when assessing the risk of investing in sovereign debt, and sovereign credit ratings help investors weigh this risk.

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

Emerging Market Fixed Income (U.S. dollar). J.P. Morgan Emerging Markets Bond Index (EMBI Global) currently covers more than 60 emerging market countries. Included in the EMBI Global are U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

Emerging Market Fixed Income (Local Currency). J.P. Morgan Government Bond Index-Emerging Markets Global Diversified tracks the performance of bonds issued by emerging market governments and denominated in the local currency of the issuer.

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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