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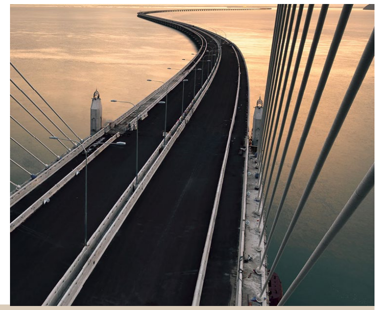
Investment Strategy



Weekly guidance from our Investment Strategy Committee **March 18, 2024**

Equities Spotlight

"Learn from yesterday, live for today, hope for tomorrow. The important thing is not to stop questioning." — Albert Einstein

Austin Pickle, CFA
Investment Strategy Analyst

Developed Market Equities appear cheap. And?

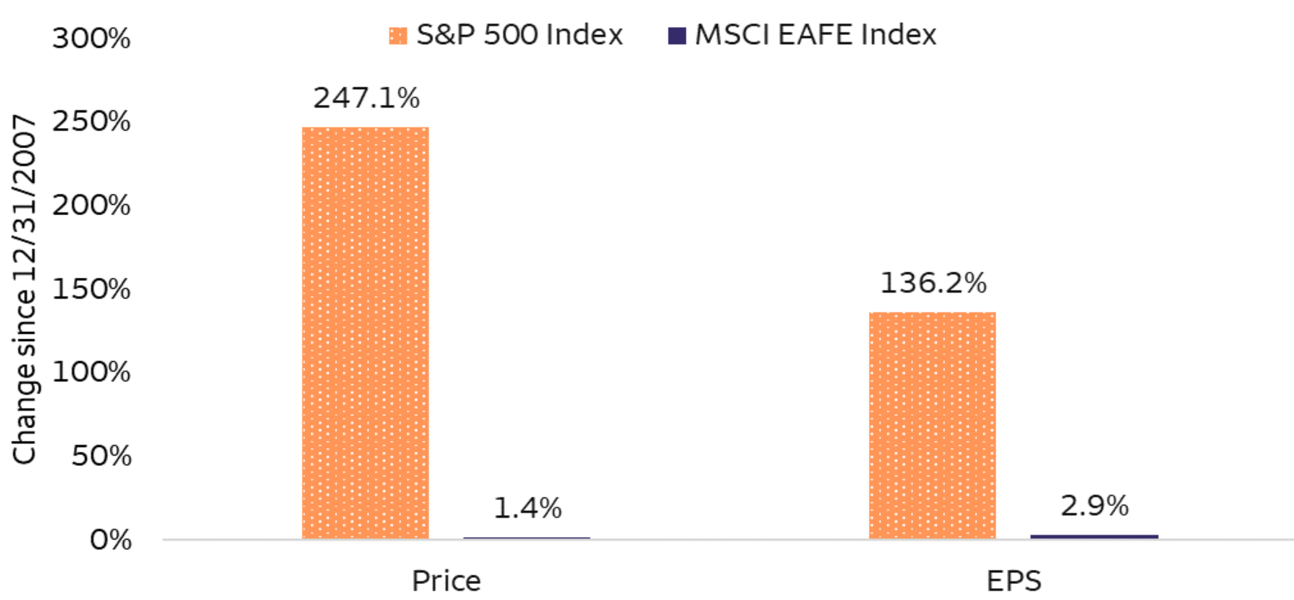
The bullish Developed Market ex-U.S. equities (DM) arguments we have heard center around valuations. Whether we look at absolute or relative valuation metrics, DM appears cheap. An asset class with a price less than 15 times its consensus forward next 12 months' earnings may look appealing, especially to investors wary of paying over a 21 times forward earnings (P/E, or price-to-earnings) valuation for the S&P 500 Index. We would caution investors from relying solely on valuations for a bullish investment thesis, though. The problem with doing so is twofold: some assets appear cheap for a reason, and cheap assets can always get cheaper.

Cheap for a reason

So why is DM cheap? It hasn't always been. For much of the 2000s, our DM benchmark, the MSCI EAFE Index, generally traded with a P/E around or even above that of the S&P 500 Index. The rationale as to why the DM P/E has derated to below 70% of the S&P 500 includes factors such as index composition (the MSCI EAFE Index is tilted more toward cyclical value sectors and away from the high P/E growth sectors), macroeconomic, demographic, and structural differences, as well as sustained depreciation of developed market currencies against the U.S. dollar. But we can help simplify the discussion by boiling all the factors down to the main building block of equity returns: earnings growth, or the lack thereof, in the case of DM.

Chart 1 illustrates that since 2007, DM earnings growth has been nearly nonexistent while S&P 500 Index earnings has grown substantially. As a result, the S&P 500 Index has experienced impressive price gains while DM prices have languished for 17 years.

Chart 1. DM earnings and price growth since 2007 has been nonexistent

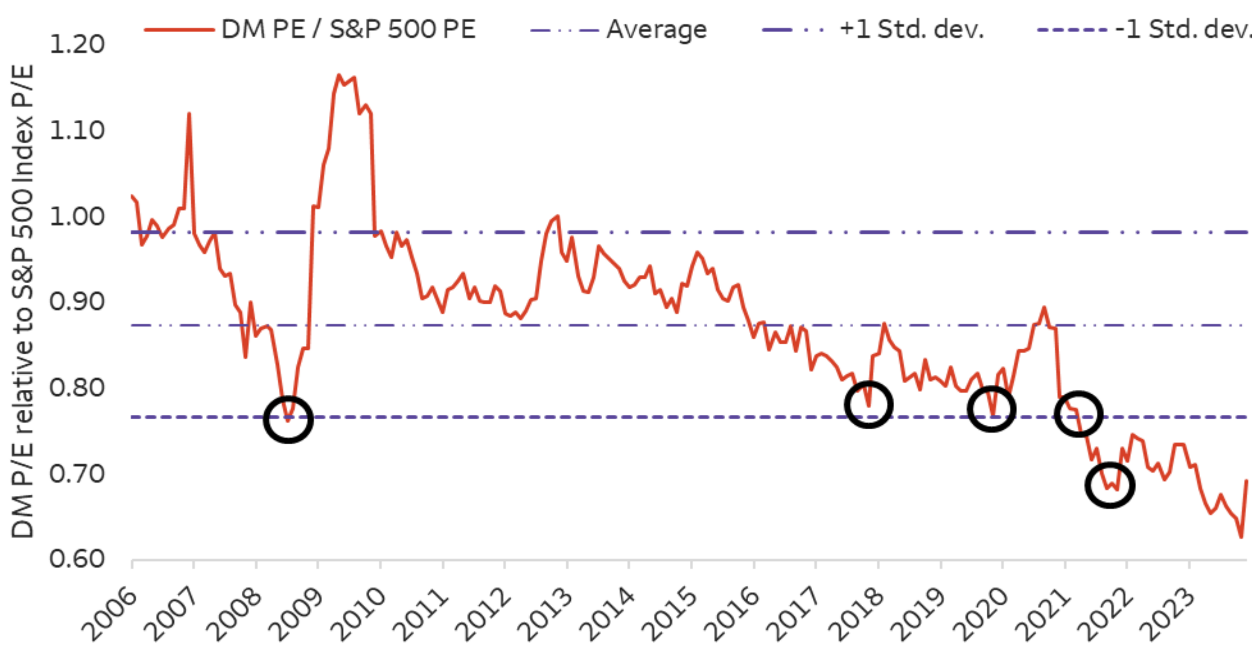


Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data: December 31, 2007 – February 29, 2024. EPS is trailing 12-month earnings per share. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment.

Cheap can always get cheaper

Examples of the numerous occasions over the past 17 years where seemingly rock-bottom valuations we used as an argument to buy into DM are represented by circles in the below chart. 2008, 2018, 2020, 2021, and 2022 all saw relative valuations approach or break through generationally cheap levels. Yet, DM has considerably underperformed from each and every one of those points through now. This is yet another example of how valuations have generally been terrible market timing tools. In this case, the cheap kept getting cheaper.

Chart 2. Cheap valuations have not led to outperformance



Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data: March 31, 2006 – February 29, 2024. DM is represented by MSCI EAFE Index. P/E is next 12 months price to earnings ratio. Standard deviation (Std. dev.) is a statistical measure of the volatility of a portfolio's returns. The higher the standard deviation, the greater volatility has been. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment.

Our view

Valuations are just one piece of the investing puzzle. Adding to an asset class based on cheapness alone is not a sound strategy. We need to see a catalyst for outperformance before upgrading DM further. A U.S. dollar bear market akin to the early 2000s or late 1980s, a substantial rebound in global growth and trade, a shift in sentiment, and an improved technical profile all could spark a DM run. Alas, we currently don't see these conditions developing. Yes, the U.S. dollar has likely peaked this cycle; however we do not see the conditions for substantial weakness. Many areas of DM are struggling with slowing growth or even outright recessions and the world's trade engine, China, is out of gear. Sentiment continues to wallow as earnings expectations keep getting revised lower. And while DM returns have perked up recently (up 6.0% versus the S&P 500's 4.6% over the past month, as of March 13, 2024), the many head fakes, where DM starts to outperform over a short period before resuming its long term downtrend, over the past 17 years of DM underperformance weigh heavily on our minds.

For now, we are comfortable at neutral — which is a full allocation — as cheap valuations and poor market sentiment reduce downside risk and lower the bar for positive surprises while a lack of sustained tailwinds on the horizon will likely mute DM's outsized return potential, in our view. Within DM, we are neutral the Europe region and favorable the Pacific region relative to the broader DM benchmark.

Fixed Income

Brian Rehling, CFA
Head of Global Fixed Income Strategy

Little drama as the Fed meets

The Federal Reserve (Fed) meets this week, and there is hardly any doubt about the outcome: the Fed will most likely leave rates unchanged when its meeting concludes on March 20, 2024. Despite the lack of expected policy actions at the Fed's upcoming meeting, investors will get a look at a new summary of economic projections. Our current expectation is for three rate cuts before year-end, with the first cut at the conclusion of the Federal Open Market Committee meeting on June 12, 2024. Current market expectations are mostly in line with our expectation of three rate cuts; this is down dramatically from the six plus rate cuts markets expected several months ago.

While the Fed is unlikely to commit to any action or non-action at future meetings, we anticipate that the summary of economic projections will suggest that the Fed is preparing the market for a rate cut at its June meeting. We look for Fed Chair Jerome Powell to stress that any future Fed moves remain data dependent, but as we get closer to early summer, inflation data would need to meaningfully disappoint to change the timing of the Fed's first rate cut.

As we await Fed developments, short-term maturities are our current maturity preference for investment-grade fixed-income investors. Should we experience rising inflation expectations, we could begin to see long-term rates test the mid or even upper 4% area. While this is not our base case expectation, if such a move were to happen, we may use the opportunity to add to long-term maturities as our conviction remains that the Fed will achieve its 2% inflation goal in the long run.

Real Assets

Mason Mendez
Investment Strategy Analyst

John LaForge
Head of Real Asset Strategy

Update on the growth of spot-based bitcoin ETFs

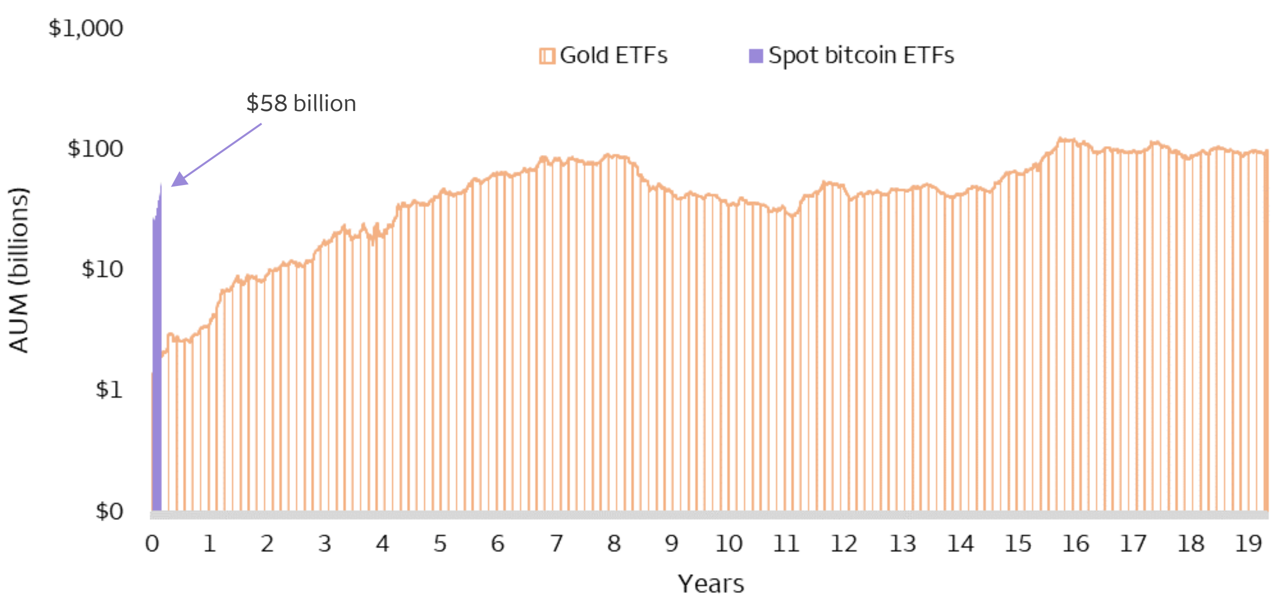
On January 10, 2024, the U.S. Securities and Exchange Commission (SEC) approved 11 spot-based bitcoin exchange-traded funds (ETFs). While ETF approvals do not normally make headlines, these did. The reason is that spot-based ETFs give investors direct exposure to the price of bitcoin without the complexities of managing bitcoin ownership directly. The ETFs have continued to make headlines since, due to investor interest. Now, 63 days later, the total assets under management (AUM) of these 11 new ETFs has reached a staggering $58 billion.

To reach $58 billion in assets for any asset class is an impressive feat. One way to see this is through the lens of gold, which went through a similar 'easier way to invest' transition a decade ago. Prior to 2004, gold was a cumbersome asset for traditional investors with its extra costs for storage and insurance, and its physical complexities. This changed with the launch of the first spot-based gold products in late 2004. In the first 30 days of trading, spot-based gold products attracted $1.2 billion, which was a record at the time. And five years later, AUM had grown to more than $50 billion.

The growth in AUM for spot-based gold ETFs, however, pales in comparison to what we have witnessed with bitcoin in 2024. In their first 30 days, the recently approved spot-based bitcoin ETFs attracted a whopping $30.6 billion. Just as staggering, it took only 57 days for these ETFs to cross $50 billion in AUM — a feat that took spot-based gold ETFs more than five years.

The bottom line is that spot-based bitcoin ETFs have enjoyed impressive inflows since their approval in January. If asset flows continue at their current rate, total AUM could soon surpass those of spot-based gold ETFs.

Spot bitcoin ETFs vs. gold ETFs by AUM



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of March 12, 2024. Log scale.

Alternatives

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

Private markets improve accessibility and liquidity potential for qualified investors

The number of semi-liquid private capital funds has doubled to over 500 from 2019 to 2023 (see chart below). Semi-liquid funds, also known as open-ended funds, perpetual capital, and evergreen funds, loosely refer to newer private capital fund structures tailored to qualified investors. Based on Preqin's estimate, semi-liquid funds now represent at least $350 billion in assets.

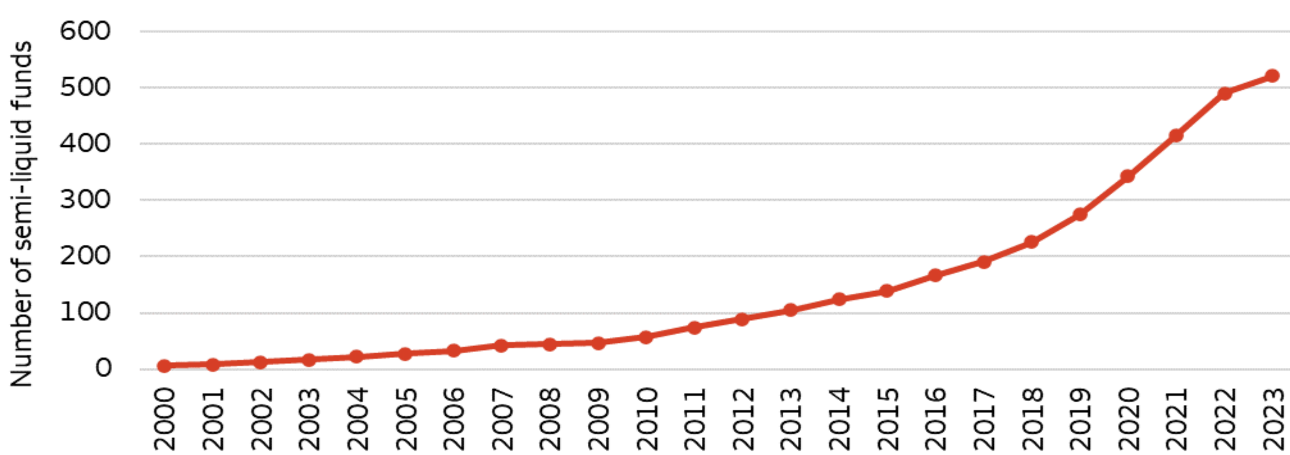
Semi-liquid funds offer greater accessibility and improved liquidity:

- *Periodic liquidity* — semi-liquid funds offer regular subscription and redemption periods, typically quarterly. As the name indicates, however, there is generally a limit to the redemption amount allowed each quarter and in extreme cases, fund managers may suspend redemptions.
- *Immediate capital deployment* — semi-liquid funds generally put capital to work straight away, and capital stays invested afterward, without a multi-year investment period and a finite holding period that is typical for conventional drawdown funds.
- *Simplified tax reporting* — many semi-liquid funds offer Form 1099. For U.S. investors, Form 1099 is simpler to complete compared with Schedule K-1 typically associated with private capital investments.
- *Lower minimum investment sizes* — typical ticket sizes are in the thousands to tens of thousands of dollars, rather than the millions or hundreds of thousands needed for conventional private capital funds.

So far, semi-liquid funds are available in certain core and buy-and-hold strategies, such as direct lending, core private real estate, and private equity fund of funds. Drawdown funds, on the other hand, continue to be a prevalent and flexible vehicle offered across both core and specialty strategies.

Both semi-liquid and drawdown fund options can be utilized to develop a diversified alternative allocation. As such, investors should consider not only the fund structure, but also investment merit and manager quality when it comes to fund selection.

The number of semi-liquid private capital funds through years



Sources: Wells Fargo Investment Institute and Preqin. Data as of December 31, 2023.

Tactical guidance*

Cash Alternatives and Fixed Income

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

Source: Wells Fargo Investment Institute, March 18 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.

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. 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.

Exchange Traded Funds seek investment results that, before expenses, generally correspond to the price and yield of a particular index. There is no assurance that the price and yield performance of the index can be fully matched. Exchange Traded Funds are subject to risks similar to those of stocks. Investment returns may fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost.

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

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.

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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