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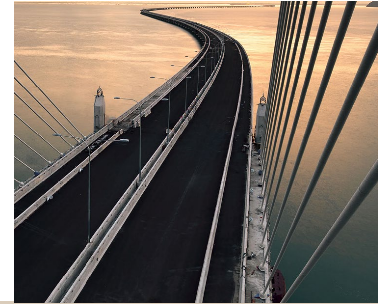

Investment Strategy

Weekly guidance from our Investment Strategy Committee **April 1, 2024**

Economic Spotlight: Don't be fooled by the economy's slow-motion slowdown........2

- While we acknowledge resilient aspects of the economic landscape, we remain wary of their staying power.
- For now, we prefer investors avoid putting all their eggs in one basket and stick with our more defensively positioned asset allocation guidance geared toward our expectation for a temporary soft patch in economic activity.

Equities: AI-focused data center buildout may benefit Semiconductors ..4

- Following the successful rollout of ChatGPT in November 2022, the adoption of generative artificial intelligence (AI) and cloud computing has helped drive higher levels of demand for data centers.
- Although we maintain a neutral view on the Semiconductors sub-sector, we continue to see potential long-term investment opportunities for companies exposed to the highly compute-intensive nature of AI-focused data centers.

Fixed Income: Triple-B rated corporate bonds trade tight to single-As.....5

- The additional yield that triple-B rated corporate bonds currently trade relative to single-A rated bonds is much lower than the historic average.
- Given that single-A credit metrics have slipped below historic averages while triple-B credit metrics remain strong, we believe some discretion among single-A credit is warranted.

Real Assets: Modest REIT growth metrics reflect ongoing headwinds 6

- While real estate investment trusts (REITs) broadly generated a reasonable same-store net operating income increase, growth in funds from operations (FFO) moderated from recent quarters.
- We recommend investors considering REITs focus on data center and industrial REITs given positive long-term demand drivers.

Alternatives: Venture capital deepening artificial intelligence focus 7

- Venture capital established its focus in AI before 2018 and has deepened dealmaking in AI in 2023.
- We believe qualified long-term investors interested in the transformative potential of emerging technology may want to consider the opportunity to invest in early-stage startups.

Current tactical guidance........8

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Economic Spotlight

Jennifer Timmerman
Investment Strategy Analyst

Don't be fooled by the economy's slow-motion slowdown

With springtime in full bloom, we find the U.S. economy reflecting a paradox observed in nature this time of year: A mixed bag of economic data over the past several weeks has included some "spring flowers" on the surface, but not without periodic "showers" dampening the mood. Only time will tell exactly what this season yields, in terms of economic activity, but we do see sufficient storm clouds gathering on the horizon to suggest a shallow economic slowdown in the months ahead.

Sorting through the data

As risk assets have ascended to record highs and the job market has been relatively tight, it can be easy to dismiss seemingly minor patches of sour data. And while we acknowledge resilient aspects of the economic landscape, we remain wary of their staying power. Framing our macroeconomic outlook are two crucial themes:

- Fading post-pandemic supports — In our view, fading post-pandemic supports soon may be leaving the economy to its own, late-cycle devices. We believe key tailwinds related to rapid disinflation — supporting real (inflation-adjusted) incomes and restraining interest rates — are likely in the rearview mirror as supply chains, oil, and other commodity markets rebalance (perhaps slightly firming inflation into 2025). Pent-up demand for certain goods and services seems to be losing steam, as evidenced by softening retail sales and personal spending data. Still in doubt is the extent of labor-market rebalancing from catch-up hiring in the aftermath of the pandemic. Job growth's true strength has been tough to surmise, muddled by diverging employment measures. Even the more robust non-farm payrolls data has been concentrated in less economically sensitive health care and government hiring. And, softening around the edges is becoming increasingly apparent from broadening layoffs, reduced temporary hiring, and job openings, along with a low quits rate signaling worker caution.

- Transition to easier financial conditions — Unusually accommodative financial conditions, tied to rapid disinflation and an early reprieve from elevated interest rates, has been a key factor cushioning — and delaying — an economic slowdown this cycle. The recent rally in risk assets, increase in financing activity, and ample market liquidity all suggest the economic bite from real interest rates is not inordinately high at current levels. Chart 1 illustrates this point, as it compares a median measure of financial stress[1] over the past seven economic cycles with the current level. Historically, financial conditions have tightened heading into an economic downturn, but the unusually early break in inflation this cycle has alleviated this pressure point. The chart's vertical axis represents the economic-cycle peak separating growth from recession in past cycles and, in this cycle, the inflection point we envision around mid-year that we believe may bring a more sustained loss of economic momentum. Of course past performance is not a guarantee of future results.

1. Financial stress is a composite of financial risk, credit availability, and leverage. Three-month moving average data.

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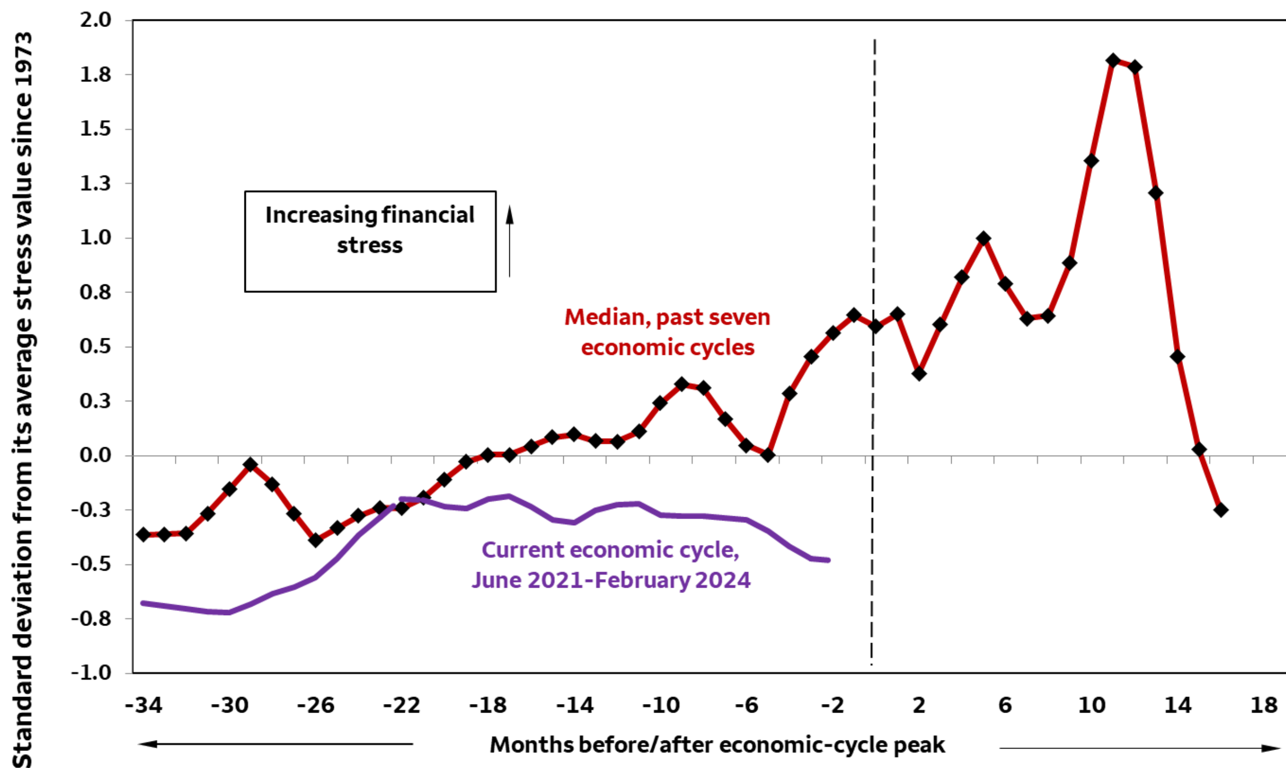
Chart 1. This economic cycle cushioned by unusually accommodative financial conditions



Sources: Wells Fargo Investment Institute and Federal Reserve Bank of Chicago. Monthly data as of March 12, 2024. Standard deviation is a measure of volatility. Financial stress is a composite of financial risk, credit availability, and leverage. Three-month moving average data. Month zero is assumed to be the inflection point for a more sustained loss of economic momentum beginning mid-2024.

On the hunt for clarity

Ultimately, we believe a gradual economic slowdown should prevail, likely stemming from the combination of several catalysts. These include decelerating real income growth, an unusually low household savings rate, rising credit card delinquency rates (particularly among lower-income earners), weak consumer sentiment, and the cumulative, lagged effect of higher interest rates and tightened bank credit on housing activity, and their impact on household and small-business credit quality.

However, abnormally low financial stress — unless it turns higher due to some unforeseen risk event — should serve as a shock absorber, potentially preventing a sharper economic pullback. And market expectations for a near-term Federal Reserve (Fed) pivot to interest rate cuts are helping cement historically low financial stress and feeding into our expectation for a shallow slowdown.

Investment implications

Once this pivot point occurs as we expect — and markets gain more clarity on the future path of inflation and interest rates — we anticipate opportunities to dial up risk in portfolios. For now, we prefer investors avoid putting all their eggs in one basket and stick with our more defensively positioned asset allocation guidance geared toward our expectation for a temporary soft patch in economic activity. This means prioritizing quality and liquidity in equities and fixed income, along with broad exposure to a basket of commodities.

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Equities

Amit Chanda
Equity Sector Analyst, Information Technology

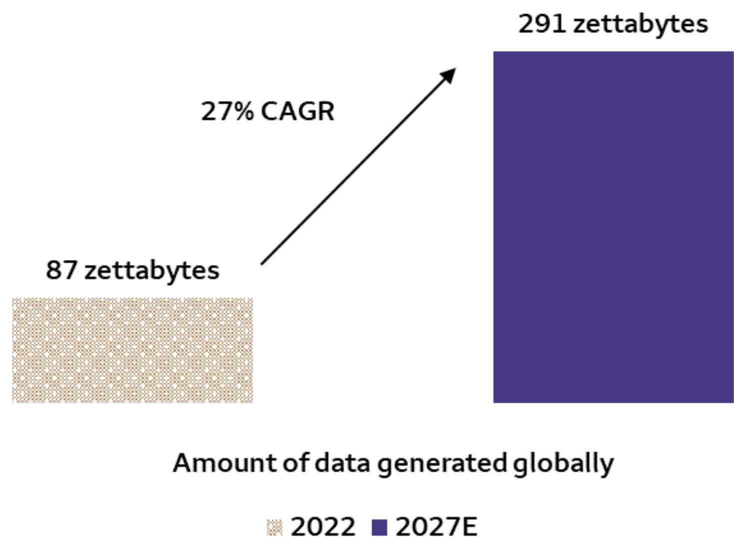
AI-focused data center buildout may benefit Semiconductors

Following the successful rollout of ChatGPT in November 2022, there has been a rapid adoption of generative AI, the Internet of Things, and autonomous driving as well as the ongoing adoption of cloud computing. These factors and, more broadly, the digital transformation of the economy have contributed to an abundance of data generated by enterprises and consumers. This in turn has driven a unique set of demands on the modern data center (see chart).

Popular generative-AI based large language models, including ChatGPT-4, are trained on massive amounts of existing text and images from the worldwide web. Data centers represent the critical foundation of storing, managing, and analyzing information. If data analytics and data-intensive generative AI large language models gain traction in the marketplace as we expect, we believe this should help support future demand for AI-focused data centers. Further, AI-focused data centers are highly resource intensive — the compute-intensive nature of these workloads requires an increased amount of power.

From a high level, we expect the Information Technology and Communication Services sectors may benefit from increasing levels of data center demand. Although we maintain a neutral view on these sectors as well as the Semiconductors sub-sector, we see long-term investment opportunities for companies exposed to the highly compute-intensive nature of AI-focused data centers. We believe leading Graphics Processing Unit (GPU) chip suppliers may potentially be positioned to benefit from the proliferation of AI and high-density rack servers in modern data centers, and we also expect leading semiconductor companies may benefit from supporting the networking and silicon storage needs of data centers.

Growth of worldwide data growth forecast



Sources: Vertiv 2023 Investor Conference and Wells Fargo Investment Institute. Data as of November 29, 2023. CAGR = compound annual growth rate. E = estimated. A zettabyte is a unit of measurement used in the technology industry to describe digital storage capacity. Forecasts, estimates, and projections are not guaranteed and are based on certain assumptions and views of market and economic conditions which are subject to change.

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Fixed Income

Eric M. Jasso, CFA
Lead Retail Fixed Income Analyst

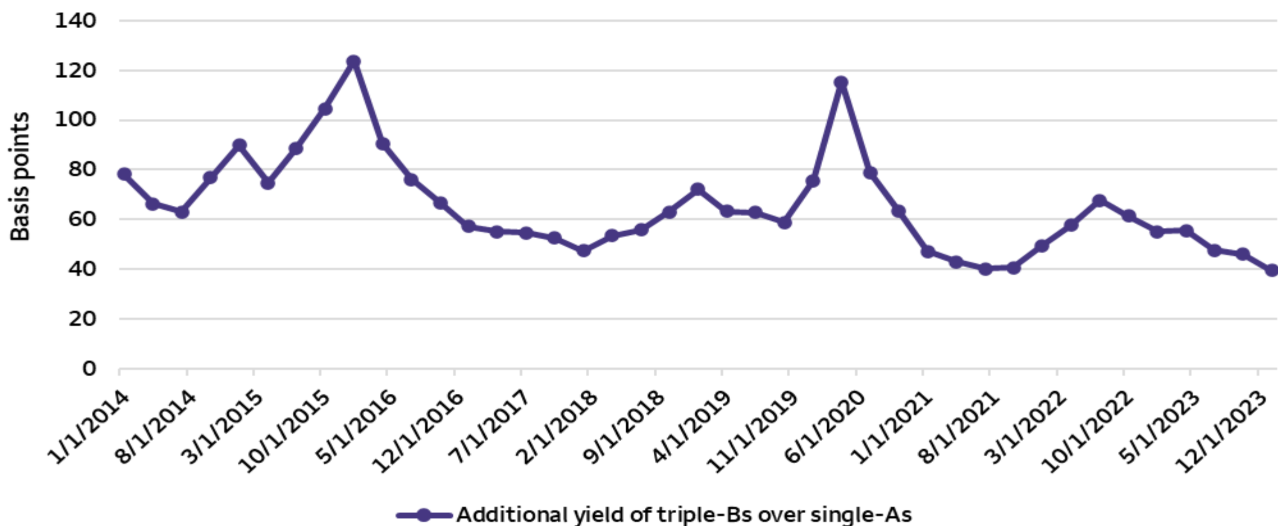
Triple-B rated corporate bonds trade tight to single-As

Over the past 10 years, triple-B corporate bonds have yielded on average 66 basis points (100 basis points equals 1% (bps)) above single-A corporate bonds[2] owing to modestly higher business and financial risk; however that difference has declined to one of the lowest measures on record (40 bps) as of March 22,2024. Although some of that could be attributed to a broader risk-on sentiment, we believe that converging fundamentals among the two rating tiers justifies at least some of that spread compression.

As of fourth-quarter 2023 reporting, single-A corporate bonds have seen their interest coverage slip roughly 21% below their 10-year average while net leverage has risen about 20% higher[3]. Credit deterioration over the past year has been concentrated among the basic industrials and consumer non-cyclical sectors, while other sectors saw only slight declines. In our view, this may signal that the substantial financial cushion built through the pandemic is no longer a tailwind, and some discretion among single-As is warranted.

Triple-B corporate bonds have remained strong, with net leverage and coverage ratios just 4% below the 10-year average and only the basic industrials sector showing substantial deterioration over the past year[3]. Further, the only sectors with metrics currently materially below their historic sector averages, communications and technology, also have the highest consensus earnings growth expectations for 2024. Most notably, the gap between key credit metrics for triple-Bs and single-As is now the narrowest that it has been since 2014. In our view, this convergence justifies some of the compression between triple-Bs and single-As and signals that investors should exercise increasing discretion when selecting investment-grade credits.

Spread between triple-Bs and single-As declining



Sources: Federal Reserve Economic Data and Wells Fargo Investment Institute. Data as of March 22, 2024. BBB Premium refers to the quarterly average of the gap between the ICE BofA Single-A US Corporate Index Option-Adjusted Spread, Percent, Quarterly, Not Seasonally Adjusted and the ICE BofA BBB US Corporate Index Option-Adjusted Spread, Percent, Quarterly, Not Seasonally Adjusted.100 basis points equals 1%. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

2. BBB Premium refers to the quarterly average of the gap between the ICE BofA Single-A US Corporate Index Option-Adjusted Spread, Percent, Quarterly, Not Seasonally Adjusted and the ICE BofA BBB US Corporate Index Option-Adjusted Spread, Percent, Quarterly, Not Seasonally Adjusted.
3. Bloomberg Data, Q4 (fourth quarter) 2023. Reporting as of March 22, 2024.

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Real Assets

John Sheehan, CFA
Equity Sector Analyst, Real Estate

Modest REIT growth metrics reflect ongoing headwinds

U.S. REITs (as measured by the FTSE Nareit All Equity REITs Index) have returned -4.12% year to date through March 25 as a conglomeration of challenges — namely still-elevated rates, higher interest expenses, and tough year-over-year comparisons — have pressured performance. Looking back to the fourth quarter, we see evidence of these challenges in multiple data points: growth in funds from operations (FFO), growth in net operating income (NOI), and earnings guidance.[4]

In the fourth quarter of 2023, the REIT industry generated year-over-year FFO-per-share growth of 1.1%[5], up from the third quarter's 0.5%. We see this modest growth as a result of a challenging comparison quarter, higher interest costs, and moderating rent growth. Also, for the fourth quarter, year-over-year NOI growth from same-store portfolios (seen as a good indicator of internal growth) came in at 3.6%, which we see as relatively attractive despite slight moderation from recent quarters. To put these numbers in perspective, it is worth noting that we believe REITs faced challenging year-over-year comparisons — in the fourth quarter of 2022, REITs generated an 8.2% growth rate in FFO per share (likely reflecting an ongoing economic recovery as business operating restrictions mandated by the pandemic were lifted) and a 6.4% increase in same-store NOI.

In conjunction with their fourth-quarter 2023 earnings, the majority of REITs we closely monitor also provided their initial 2024 earnings guidance — in general, we view the initial 2024 guidance from most REITs as appropriately conservative given near-term uncertainty over future Fed policy actions and moderating U.S. economic growth. While we remain unfavorable on the Real Estate equity sector and neutral on Private Real Estate, we recommend investors considering REITs focus on data center and industrial REITs given positive long-term demand drivers.

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4. All data provided by the National Association of Real Estate Investment Trusts (Nareit) as of March 25, 2024.
5. All data as measured by the FTSE Nareit All Equity REITs Index.

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Alternatives

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

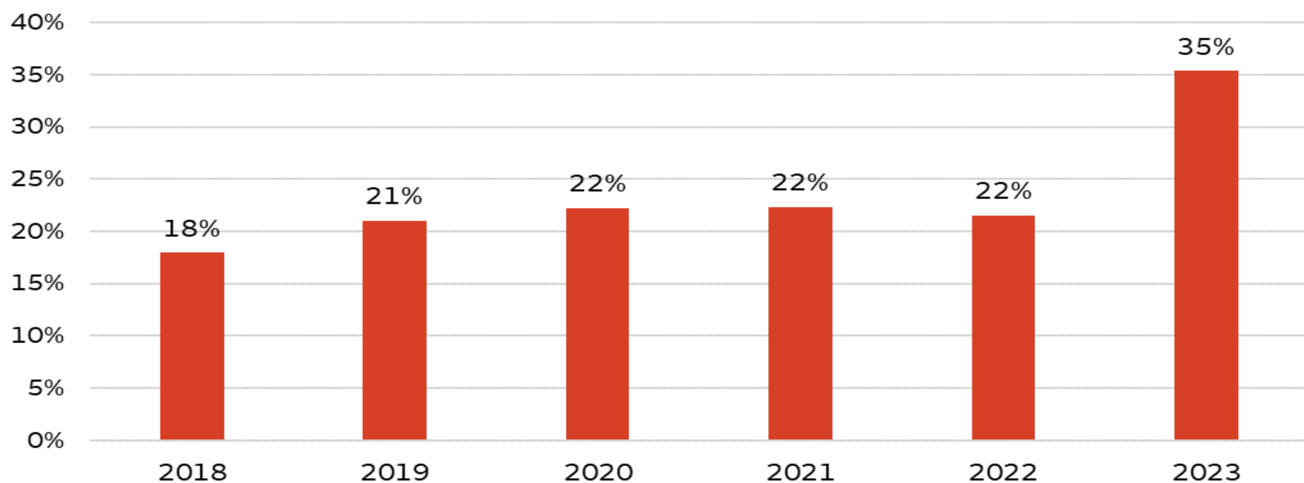
Venture capital deepening artificial intelligence focus

As a crucial driver to innovation and emerging technology, venture capital investment has historically provided funding and support to early-stage, high-growth corporations that are not accessible through the public markets. For example, between 2018 and 2021, venture capital[6] committed about 20% of its yearly deal value to AI and machine learning (ML) startups (see chart). Notably, venture capital established this focus on AI and ML before widespread enthusiasm was seen in public markets.

The release of generative AI technologies like OpenAI's ChatGPT helped validate their potential transformational impacts over the long run and further fueled investor interest in AI and ML startups. As a result, in 2023, AI and ML's share of venture capital deals increased to 35%, totaling $90 billion across over 7000 deals (according to Pitchbook). Venture capital investment also broadened its participation across many AI areas, including foundational code development, data center establishment, industry-specific applications, as well as other nascent opportunities.

Our short-term view on venture capital investment remains neutral, as we continue to observe slow exit activities, including initial public offerings (IPOs), and expect further valuation adjustments in the broader venture capital market. However, we think qualified investors should consider venture capital as a long-term investment option. Specifically, qualified long-term investors, who are interested in the transformative potential of emerging technology, may want to consider the opportunity to invest in early-stage startups offered by venture capital funds. For venture capital investing, we also prefer developing a diversified allocation in an effort to achieve a more favorable balance between return and risk over the long-term.

AI & ML's share of venture capital deal value



Sources: Wells Fargo Investment Institute and Pitchbook. Data as of February 28, 2024. Venture capital universe is defined is as a type of private equity investment that focuses on startups and early-stage companies with long-term, high-growth potential. **Past performance is no 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.

6. Venture capital universe is defined as a type of private equity investment that focuses on startups and early-stage companies with long-term, high-growth potential.

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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 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, April 1, 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

Forecasts, estimates, and projections are not guaranteed and are based on certain assumptions and views of market and economic conditions which are subject to change.

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. Other risks associated with investing in listed **REITs** include the use of leverage, unexpected reductions in common dividends, increases in property taxes, and the impact to listed REITs from new property development.

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. . Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market. . **Communication services** companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product

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

FTSE NAREIT All Equity REITs Index, a subset of the All REITs Index, is designed to track the performance of REITs representing equity interests in (as opposed to mortgages on) properties. It represents all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets, other than mortgages secured by real property that also meet minimum size and liquidity criteria.

FTSE NAREIT All REITs Index includes all REITs that are listed on NYSE, American Stock Exchange or NASDAQ. This includes mortgage REITs, Timber REITs, Infrastructure REITs, and Manufactured Housing REITs. It is the most expansive of all the FTSE REIT indices.

ICE BofA Single-A US Corporate Index is a subset of the ICE BofA US Corporate Master Index tracking the performance of US dollar denominated investment grade rated corporate debt publicly issued in the US domestic market. This subset includes all securities with a given investment grade rating A.

ICE BofA BBB US Corporate Index is a subset of the ICE BofA US Corporate Master Index tracking the performance of US dollar denominated investment grade rated corporate debt publicly issued in the US domestic market. This subset includes all securities with a given investment grade rating BBB.

ICE BofA Corporate Master Index is a statistical composite tracking the performance of the entire US corporate bond market over time. The index includes dollar-denominated investment grade corporate public debt issued in the US bond market.

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