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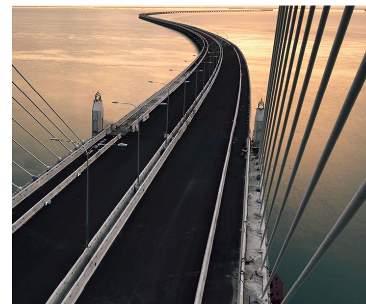

Investment Strategy

Weekly guidance from our Investment Strategy Committee **April 8, 2024**

Fixed Income Spotlight: Liquidity remains despite the Fed's best attempts to remove it 2

- Ample financial market liquidity remains, although we are expecting some notable reduction in the coming weeks.
- We believe there are investment opportunities for both long-term and more tactically oriented investors.

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- The Energy sector has outperformed the S&P 500 Index since our recent upgrade, due to a brightening outlook for energy commodity prices.
- We believe the backdrop remains favorable and investors should add exposure on pullbacks.

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- Russia's crude oil production is down 7% since the war in Ukraine began in February of 2022, and we suspect that production could still slide further.
- As sanctions continue to bite into Russian oil exports, we're expecting to see more volatile global petroleum prices in 2024.

Alternatives: Secondaries defy lackluster fundraising environment 6

- While fundraising across most private capital categories declined significantly in 2023, Secondary strategies defied the trend and rose over 65% year over year.
- Secondary markets offer several potential advantages, including pricing discounts, a shortened path to achieving positive returns, and a shorter lifespan (relative to primary fund positions).

Current tactical guidance 7

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Fixed Income Spotlight

Tony Miano
Investment Strategy Analyst

Liquidity remains despite the Fed's best attempts to remove it

By the spring of 2022, total assets on the Federal Reserve's (Fed's) balance sheet peaked at just shy of a record nine trillion dollars[1] as a result of stimulus efforts from the pandemic. The Fed has already started reversing these efforts through quantitative tightening (QT), removing almost 1.5 trillion dollars from its balance sheet. In simple terms, QT normally works in the following way: 1) The Fed has bonds in its portfolio (balance sheet), once those bonds come to maturity the Fed simply does not reinvest the proceeds; 2) by not reinvesting these bonds, the Fed decreases bank reserves — commonly known as "liquidity". However, something different is happening now. The Fed's bond holdings are down but only about half of this supposed tightening has impacted bank reserves, or "liquidity".

Why has market liquidity managed to be so resilient? A simple answer is that money is just moving from one bucket to another, and excess reserves are not being fully drained. Money market funds have been stepping up by purchasing excess bonds and draining the Reverse Repurchase Agreement (RRP) facility.

A more complex answer lies with the Fed and Treasury, through both their Bank Term Funding Program (BTFP) and more directly through the RRP facility and the Treasury's General Account (TGA). BTFP was created following the collapse of Silicon Valley Bank and allowed financial institutions to pledge their Treasuries to the Fed at par value, providing a source of liquidity. The RRP facility functions similarly and allows institutions to essentially make short-term loans to the Fed through the agreed upon sale and repurchase of a security. Banks may place excess liquidity in the RRP facility and in Fall of 2022 the RRP facility represented more than two trillion dollars in excess cash from financial institutions. Cash has also flowed out of the TGA, providing liquidity that exceeded QT over the past 18 months.

Our cup runneth over … but for how long?

While liquidity has remained ample, there may be some bumps in the road over the coming weeks. As seen in the chart on the following page, the RRP facility has come down quite a bit since QT began. Similarly, the BTFP expired in March and repayments have already begun. On top of that, April generally represents a time for decreasing liquidity in the market as a result of tax season. Add those factors together and we may see liquidity flow out of the market over the coming weeks as efforts to remove liquidity continue.

1. FRED Economic Data, St. Louis Federal Reserve, "Assets: total assets (less eliminations from consolidation)", March 26, 2024.

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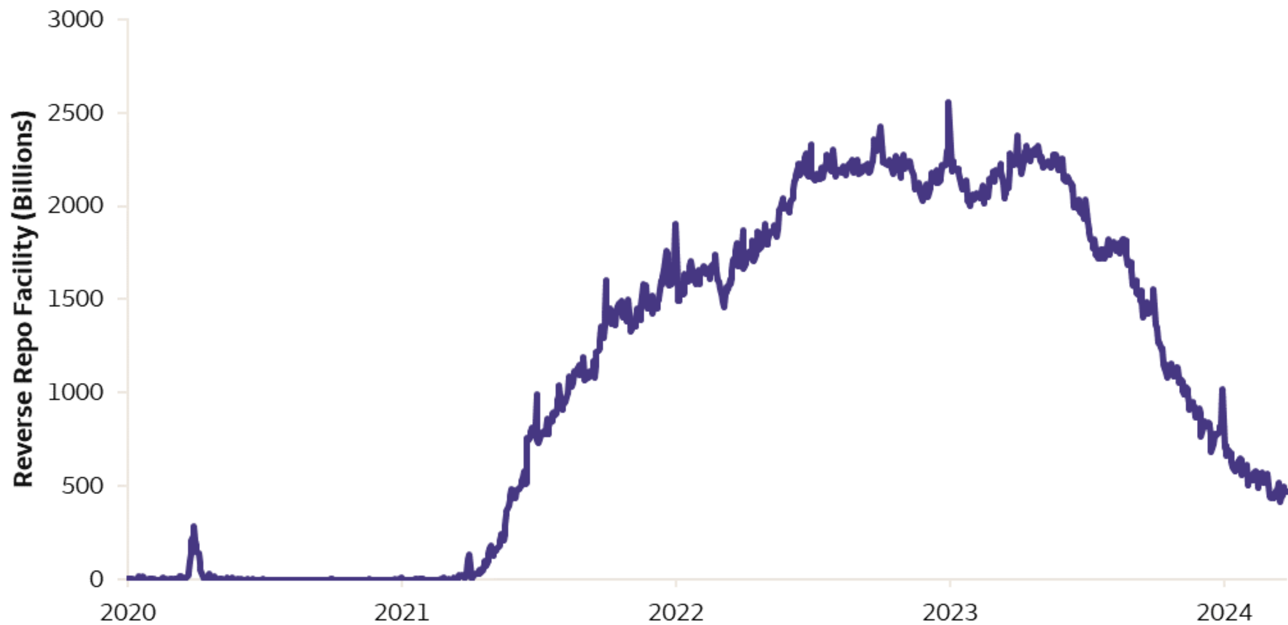
Chart 1: Overnight reverse repurchase agreements (RRP Facility)



Sources: Wells Fargo Investment Institute and FRED Economic Data, St. Louis Federal Reserve, "Overnight Reverse Repurchase Agreements: Treasury securities sold by Federal Reserve in the Temporary Open Market Operations". Data as of March 27, 2024. In billions of U.S. dollars, not seasonally adjusted.

While liquidity may continue to be removed from the market in the short term, we believe the outlook for the remainder of 2024 is bright. The liquidity drain from tax season shouldn't last much longer than the second quarter and, more importantly, the Fed has signaled its intention to scale back QT in the coming months. While the RRP has fallen significantly, it still holds a moderate war chest of nearly $500 billion in potential additional liquidity. Also, while we believe that the market may still be too sanguine on Fed rate cuts for 2024 and 2025, we do believe that some form of cuts are coming in 2024, which may also be supportive to liquidity. Taken in concert with lessening QT and further policymaker actions from the TGA to support liquidity into the election, this may allow ample liquidity later in the year.

Positioning for continued liquidity

We believe there are potential opportunities for long-term investors in this environment. Now may be a good time to check to see that the share of the portfolio allocated to equities and fixed income align with the original goals of the portfolio. It is likely in some portfolios that the equity allocation may exceed the target percentage, and, if so, we favor rebalancing, which means taking some profits in equities and reallocating to fixed income, to raise that allocation to its target share.

For shorter-term investment horizons, we believe there are tactical opportunities over the coming months. The potential near-term volatility from less market liquidity, and our outlook for a broader equity rally and potential opportunities in long-term fixed income, orient our preferences defensively in the coming months. We continue to favor quality. That means for new cash or maturing securities we favor short-term over longer maturities, and investment-grade securities over non-investment grade. In equities, we prefer U.S. over international markets and, in the U.S., large-cap over mid- and small-cap equities.

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Equities

Sameer Samana
Senior Global Market Strategist

Energy takes the baton

Since our upgrade on January 9, the Energy sector is up 14.61% through March 28, compared to the S&P 500 Index's +10.47%. This outperformance is due to energy commodity price appreciation brought about by economic, monetary, and supply- and demand-related factors. The U.S. economy remains on solid footing despite the Fed's significant rate increases. Meanwhile, Chinese authorities seems to have done enough via a patchwork of initiatives to put a floor under their economy. The U.S. and China are the world's two largest consumers of oil.

With respect to monetary policy, the Fed has continued to talk about interest rate cuts despite inflation remaining elevated. Other central banks around the world either already have or are also expected to start rate-cutting cycles. The prospect of lower interest rates should further support economic growth both in the U.S. and around the world.

Lastly, the Organization of Petroleum Exporting Countries, along with Russia, have been curtailing oil production. Some of this has been offset by record production in the U.S., but that is expected to slow. This means that supply will likely fail to keep up with demand over time, putting a solid floor under energy commodity prices. We believe this bodes well for the sector, since underlying commodity prices are typically the most important determinant of performance. Cheap valuations, strong balance sheets, and a resolute focus on profitability and returning cash to shareholders are additional positives. The chart below suggests the S&P 500 Energy Index may find support at the 50-day (661) and 200-day (656) moving averages, on a pullback.

S&P 500 Energy Index with moving averages

Sources: Bloomberg and Wells Fargo Investment Institute. Daily data from April 1, 2021, through April 1, 2024. S5ENRS = S&P 500 Energy Index. SMAVG (50) = 50-day simple moving average. SMAVG (200) = 200-day simple moving average. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Real Assets

Mason Mendez
Investment Strategy Analyst

John Laforge
Head of Real Asset Strategy

Russian crude oil flying under the radar

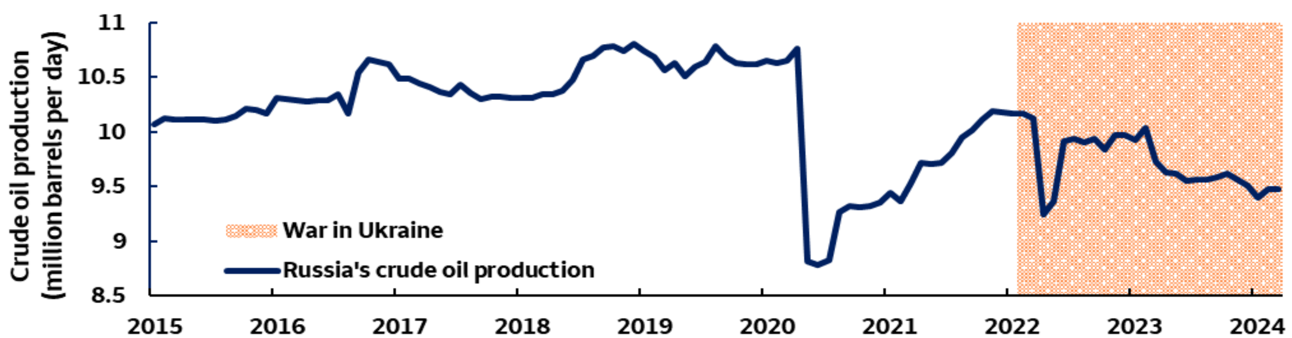
It has been a little over two years since the war in Ukraine began, and international sanctions were first imposed on Russia's oil industry. Initially, to the surprise of many, there was still a healthy appetite for Russian oil — primarily from China and India. Now two years into the war, though, it is getting more difficult for countries to deal with Russia. Sanctions on everything from insurance on the crude oil being transported, to the tankers themselves, have tightened, making voyages riskier. This has ultimately resulted in lower Russian oil production, as it gets harder to find export markets for Russian oil.

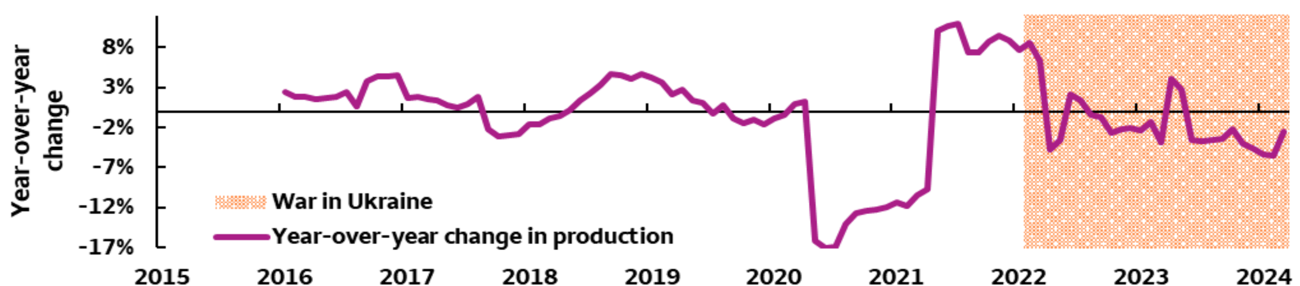
Russia's crude oil production has been shrinking since February of 2023, and is down roughly 7% since the beginning of the war through March 31. This can be seen in the chart below. It is also clear that Russian oil production is continuing to deteriorate.

In recent weeks, Ukrainian drones struck Russian refineries, which we suspect could cause production to slide further as the refineries shut down for repair. In addition to the possibility of lower production, we suspect that reduced refinery activity could lead to supply issues and higher price volatility for petroleum products, such as gasoline and diesel. In fact, Russia has already implemented a six-month ban on its gasoline exports, in a bid to avoid a domestic shortage.

Overall, it appears that the effects of international sanctions and the ongoing war in Ukraine are chipping away at Russia's ability to boost oil production. We suspect that production could slow further in 2024, and with it, global oil prices could become more volatile. Slowing Russian oil production along with the effects of sanctions on exports is one of many reasons we remain favorable on the energy commodity sector, and expect higher oil prices by year-end. Our year-end 2024 price targets are $85 – $95 per barrel for West Texas Intermediate (WTI) and $90- $100 per barrel for Brent.

Decline in Russia's crude oil production





Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data is from January 2015 – March 2024. **Past performance is no guarantee of future results.**

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Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

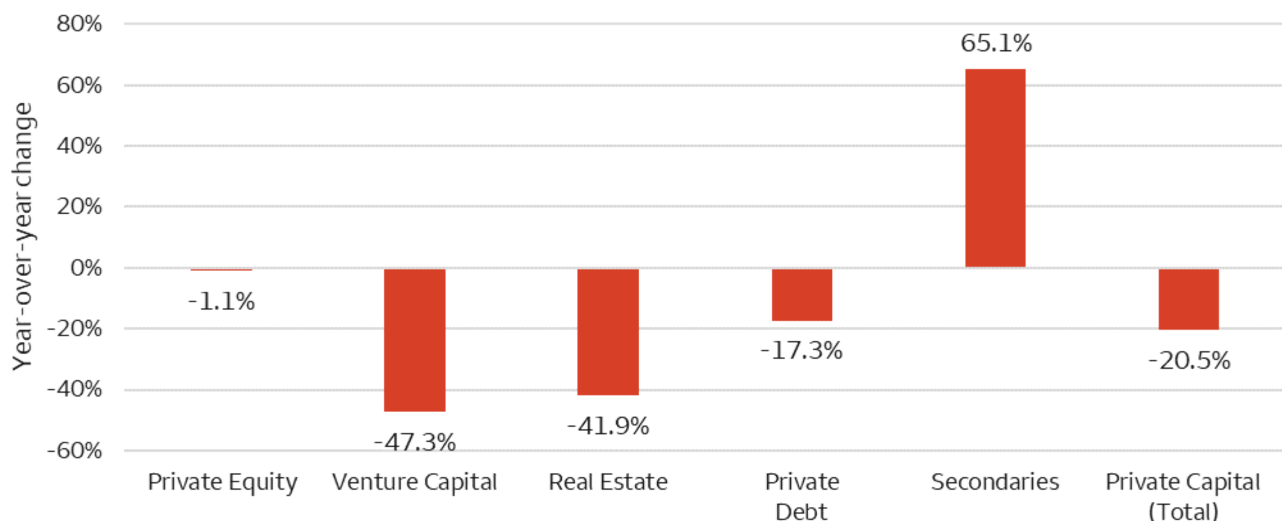
Secondaries defy lackluster fundraising environment

2023 fundraising across most private capital categories finished significantly lower than 2022 (-21% in total). While Venture Capital and Real Estate strategies both registered declines of over 40%+, Private Equity managed to rebound in the second half of 2023 and finished with a modest decline of only 1.1% year over year (see chart below). The second-half comeback was bolstered by a public equity market rally and the growing expectation of several Fed rate cuts in 2024, providing renewed investor confidence and optimism. Yet, the standout in 2023 fundraising activity was Secondary strategies, recording an increase of over 65% from the year prior. Several factors contributed to the robust fundraising environment for secondary strategies, including:

- Attractive secondary market valuations that provided opportunities for enhanced returns.
- A soft exit environment led many limited partners to use secondary markets as a liquidity solution.
- Increased use of general partner-led secondaries, also known as "continuation funds", which extend holding times for many high conviction assets.
- Increased use by institutional investors as a portfolio management tool to adjust portfolio allocations.
- Potentially quicker path to positive returns as funds offered on the secondary market are often more mature portfolios in the mid-to-later stages of their life cycle.

In addition to the recent increase, secondary market fundraising has grown considerably over the past decade as investors become more aware of its benefits. Secondary fundraising grew from just $14 billion in 2013 to over $78 billion in 2023 (Pitchbook). While this outsized growth may moderate, we remain constructive on secondary strategies as discounts remain attractive and traditional private equity exit routes remain challenged.

Secondary markets standout in 2023 fundraising growth



Sources: Wells Fargo Investment Institute and Pitchbook, as of December 31, 2023. Strategy categories include funds classified as private equity, venture capital, real estate, private debt, or secondary funds available in the Pitchbook database. Private Capital (total) category includes all the aforementioned categories, as well as real assets and fund of funds. **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.

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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 8, 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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Forecasts and targets are based on certain assumptions and on 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. **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. **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.

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

S&P 500 Energy Index comprises those companies included in the S&P 500 that are classified as members of the GICS® energy sector.

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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