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Investment Strategy

Weekly guidance from our Investment Strategy Committee **May 13, 2024**

Equities Spotlight: S&P 500 pullback may provide a rebalancing opportunity 2

- After reaching a record high on March 28, 2024, the S&P 500 Index hit a soft patch in April, falling 5.5% peak to trough.
- While there could be additional volatility through the election season, this appears to be a garden variety pullback that provides a great opportunity to rebalance portfolios.

Fixed Income: Historic length of the yield curve inversion 4

- The current yield curve inversion (10-year minus 2-year U.S. Treasury) is the longest on record and we see no signs of it reverting in the near term.
- While this inversion remains, we believe investors should continue to take advantage of higher yields available on ultra-short and short-term fixed-income investments.

Real Assets: Central banks now account for 23% of global gold demand 5

- Central banks purchased large volumes of gold in the first quarter of 2024, accounting for 23% of total gold demand.
- We expect central banks will continue to buy gold, even at these historically high levels for the foreseeable future.

Alternatives: Systematic Macro off to strong start 6

- Systematic Macro strategies started 2024 very strong, returning nearly 10% through April as momentum carried most equity markets and select commodities higher.
- The hedge fund category has offered diversification benefits over time and has often performed well during challenging market environments.

Current tactical guidance 7

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Equities Spotlight

Chris Haverland, CFA
Global Equity Strategist

S&P 500 pullback may provide a rebalancing opportunity

After reaching a record high on March 28, 2024, the S&P 500 Index hit a soft patch in April. Peak to trough the index fell 5.5%, which was the first drop greater than 5% since October 2023. Sticky inflation readings and the lower probability of multiple Federal Reserve (Fed) interest-rate cuts this year led to higher long-term rates. We believe this ultimately weighed on equity prices, especially areas that are more rate-sensitive (think U.S. Small Cap Equities). While the index remains in an uptrend and has bounced from oversold conditions, equities remain in a corrective phase that we think could linger until the path of inflation and Fed rate cuts becomes clearer.

Modest pullbacks of 5% – 10% are typically called "garden variety," as they are commonplace in equity market investing. In fact, since 1928, the S&P 500 Index has averaged 3 – 4 of these kinds of downdrafts per year. It often has been a way for equity markets to reign in excessive optimism and create better balance between prices and fundamentals. Although some pullbacks turn into full blown corrections (down 10% – 20%), the majority stay on the modest side and end after a month or two, on average.

Table 1. S&P 500 Index declines since 1928

	Pullback (5% decline)	Correction (10% decline)	Bear market (20% decline)
Number of occurrences	329	103	27
Average occurrences per year	3.4	1.1	0.3
Average duration (days)	35	99	289

Sources: Wells Fargo Investment Institute, Ned Davis Research, and Bloomberg. Data from January 3, 1928 to May 3, 2024.

Presidential election years have historically been volatile for equities, especially in the second quarter and leading up to the election.[1] Our view is that the S&P 500 Index could be range-bound until the election. Year to date, we have seen a range of roughly 4700 – 5300 and, we think that may hold for some time. It is possible we see a 10% correction this year (they happen on average once per year), but another bear market (down 20%) is unlikely without a recession.

Can earnings take the baton?

Earnings have barely grown for the S&P 500 Index over the past two years, while prices have reached record highs. That means multiples have expanded on optimism around an economic and earnings recovery. It is now time for profits to catch up with prices, and our view is that earnings can take the baton from valuations as the key driver of returns in 2024 and 2025.

Our outlook for positive economic growth and elevated inflation should benefit large companies with pricing power and unit sales growth. We see margins improving modestly on greater efficiencies and cost cutting initiatives. Specifically, we expect S&P 500 Index earnings per share (EPS) to rise from $240 in 2024 to $260 in

1. S&P 500 performance during presidential election years. Source: Bloomberg.

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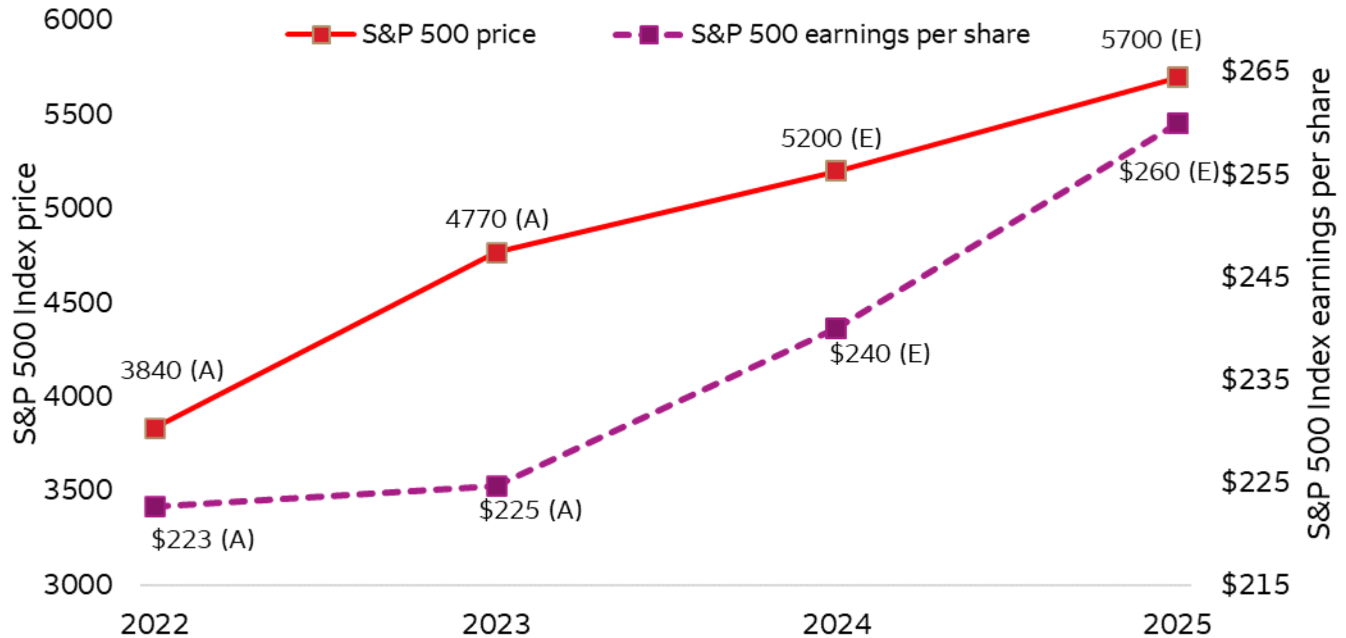
2025. Smaller companies, however, may continue to struggle as they are more reliant on tight and expensive bank credit and generally have more trouble passing on cost increases. We continue to favor U.S. Large Cap Equities over U.S. Small Cap Equities.

Chart 1. S&P 500 Index price and earnings per share



Sources: Wells Fargo Investment Institute and Bloomberg as of May 6, 2024. (A) = actual data which was provided by Bloomberg; (E) = estimates which were provided by Wells Fargo Investment Institute. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change. **Past performance is not a guarantee of future results.**

Stock market pullbacks can be viewed as an opportunity for investors to rebalance portfolios and deploy excess cash. Fundamentals are unchanged over the past month, with S&P 500 Index Bloomberg consensus earnings expectations stable to slightly higher. Valuations have been lowered, with forward price-to-earnings multiples receding close to the 5-year historical average. In addition, we are not seeing the warning signs of a deeper market sell-off — such as credit spreads surging. Although the lows may not be in place yet, and volatility likely will remain elevated over the near term, we prefer investors take advantage of weakness by adding to high-quality U.S. Large Cap Equities and within this space, the Energy, Health Care, Industrials, and Materials sectors.

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Fixed Income

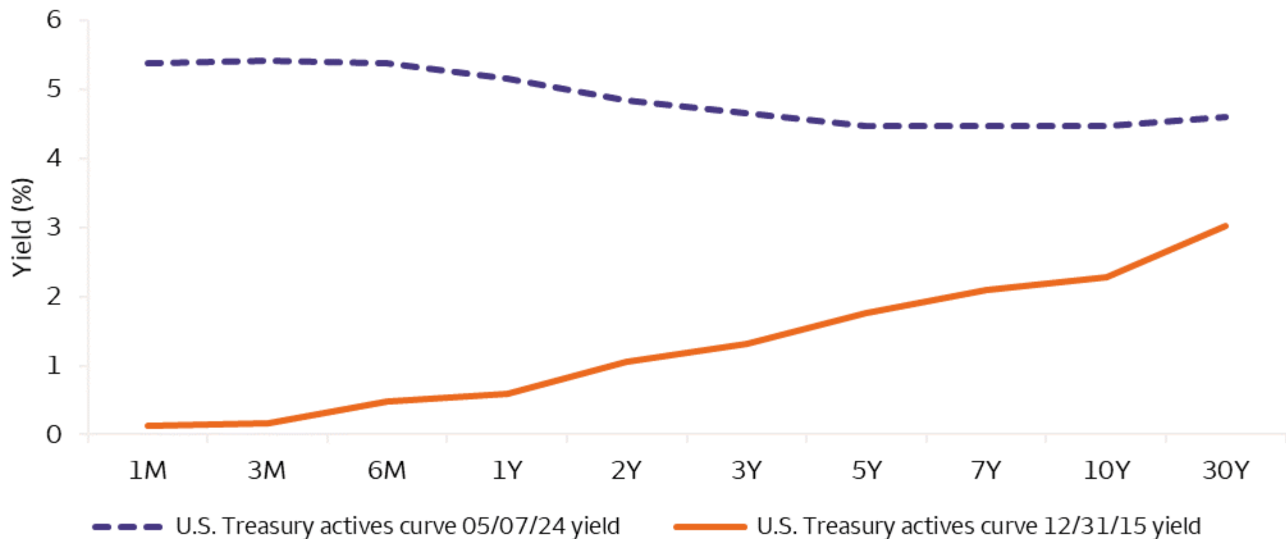
Tony Miano, CFA
Investment Strategy Analyst

Historic length of the yield curve inversion

In March, the current yield curve inversion (10-year minus 2-year U.S. Treasury yield) became the longest on record, and we believe this dynamic is unlikely to reverse course in the near term. U.S. Treasury yield curve inversions are not the historical norm, so when they occur, they are often viewed as a signal of underlying problems in the economy. Inversions are therefore associated with volatility by investors.

The chart below compares an upward sloping (steepening) yield curve (as of December 31, 2015) with the current yield curve (inverted). In an upward sloping yield curve, investors receive a higher yield (term premium) for longer-term bonds versus short-term securities. In an inversion, the opposite occurs. Obviously, investors getting paid more for shorter-term investments seems counterintuitive, and as a result, inversions are rare and usually limited in length.

Current inverted yield curve vs. yield curve as of year-end 2015



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of May 7, 2024.

Historically, the yield curve tended to un-invert as short-term rates moved lower, being largely influenced by Fed interest-rate cuts. In our view, rate cuts may not occur until later in the year, so we may add considerably more time to this record inversion. Yield curve inversions go beyond just being a signal of stress and can actually add stress to the market by causing capital dislocations. For example, institutions, such as banks, may need to borrow money by paying a higher interest rate over the short-term, compared with a lower longer-term rate at which they may lend.

With unusually high interest rates on the short end of the yield curve, we believe investors should consider investments on the short end. We remain most favorable on U.S. ultra-short and short-term taxable fixed income as a means to pick up extra yield potential as we wait for the yield curve to un-invert.

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Real Assets

Mason Mendez
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John LaForge
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Central banks now account for 23% of global gold demand

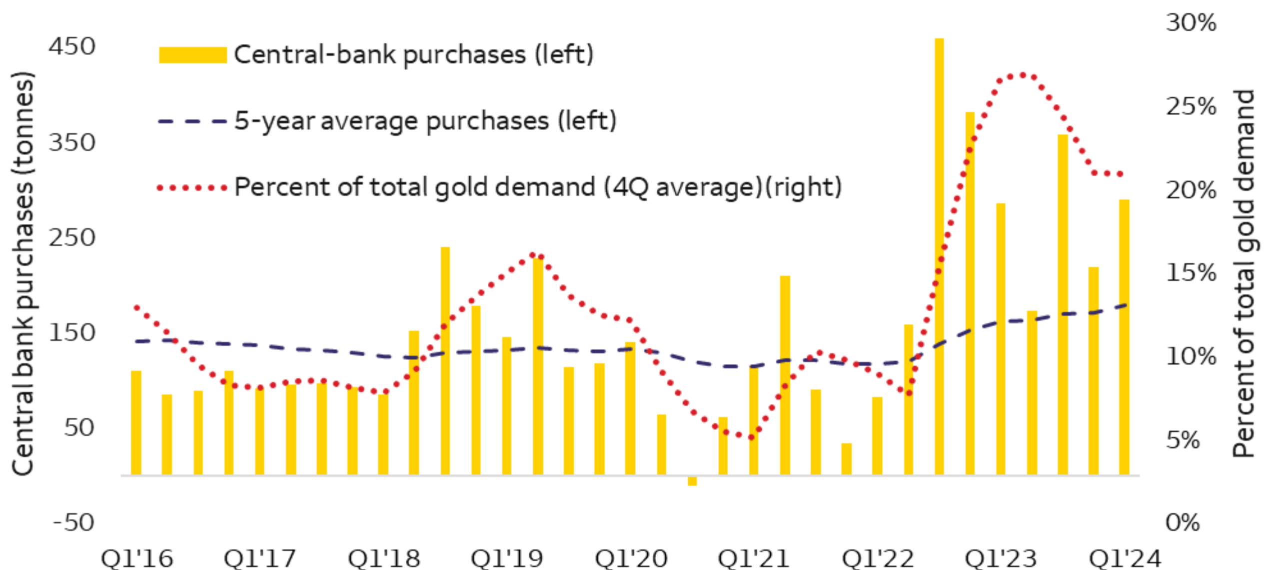
Gold has had a tremendous year, up 11.7% year-to-date.[2] Even more impressively, it has closed at new all-time highs on 16 different days.

A key driver of gold's performance has been persistent, and historically elevated, purchases by central banks. In fact, since 2022, central banks have become a dominant force driving global gold demand. Over the past two years, the percentage of gold demand coming from central banks has more than doubled from 9% to 21%, based on a four-quarter average (see chart). Looking at just the raw data in the first quarter of 2024, without averaging, central banks accounted for an impressive 23% of global demand.[3]

Emerging market central banks have been the main buyers, especially China. This is because gold is that rare reserve asset with no counterparty risk, unlike other reserve assets, such as U.S. Treasury yields. With debt levels of many countries on the rise, to historic levels in some cases, counterparty risk has become a growing concern for central banks. Holding gold is one way a central bank can protect its reserves from being devalued by another nation's debt.

The bottom line is that persistent central-bank gold buying continues to support global gold prices. Emerging market central banks, especially, have been buying gold to diversify their reserves and protect against a strong U.S. dollar. We suspect that this trend in central bank gold buying will continue for the foreseeable future, supporting our 2024 target range of $2,300 – $2,400 per troy ounce, and 2025 target range of $2,400 – $2,500 per troy ounce.

Central bank purchases of gold



Sources: World Gold Council and Wells Fargo Investment Institute. Quarterly data is from Q1 2016 – Q1 2024.

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2. Data calculated Q1 2022 - Q1 2024.
3. Data from the World Gold Council and Wells Fargo Investment Institute.

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Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

Systematic Macro off to strong start

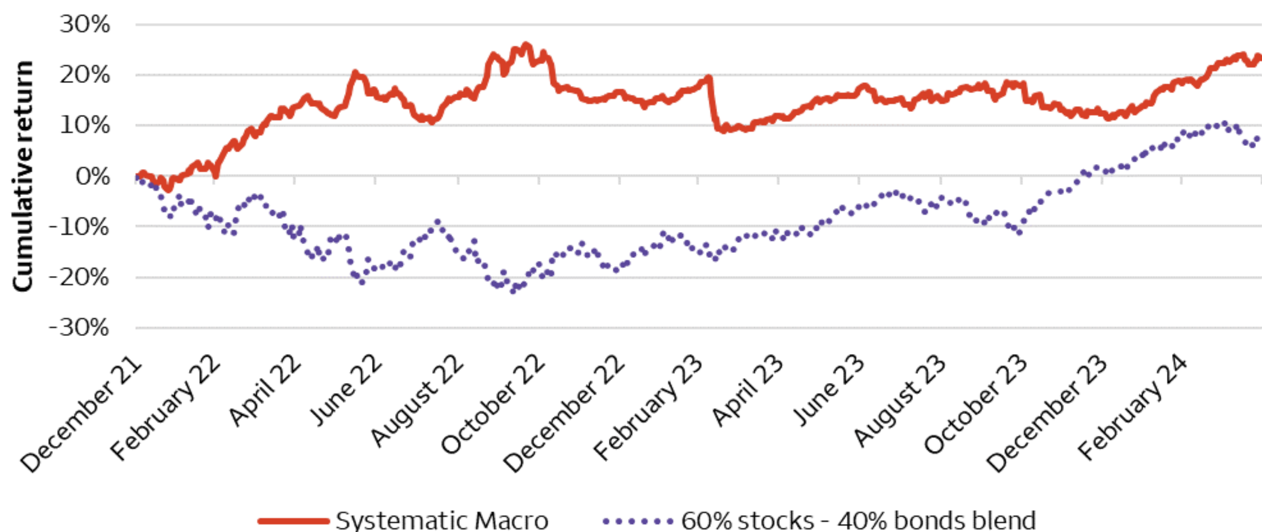
Systematic Macro strategies began 2024 strong as the HFRX Macro Systematic Diversified CTA Index posted a first-quarter return of 8.8%. The strategies attempt to capitalize on both positive and negative price trends across four major categories, including stocks, bonds, currencies, and commodities. The trend-following strategies generally perform well in environments characterized by sustained momentum in price trends (either upward or downward).

In the first quarter, the extreme rally in cocoa prices (125%+) was an outsized contributor to returns for many managers, as supply concerns in West Africa led to a spike in the price of the commodity. Additionally, the continued rally in many equity markets was a significant contributor to returns as long positions were maintained across U.S., European, and Japanese equity markets. Short Japanese yen positions also benefited as questions mounted on the willingness of the Bank of Japan to stem the tide of recent declines in their currency.

The performance of Systematic Macro strategies may frustrate investors in environments with frequent market reversals and a lack of enduring trends. Yet, their historical performance has offered low correlations with traditional long-only equity and fixed-income markets and has provided excellent diversification benefits, often performing well during challenging market environments (for example, 2022).

While we have maintained a favorable rating for the category, given the myriad of risks facing the economy and markets over the past two years, we anticipate a future downgrade as we receive confirmation that the economy has transitioned to the recovery phase. At that time, we instead expect to favor strategies with higher correlations to a broad economic recovery.

Cumulative return since 2022 of Systematic Macro strategies versus a blend of 60% stocks and 40% bonds



Source: Bloomberg. Data as of April 30, 2024. Systematic Macro strategies are represented by the HFRX Macro Systematic Diversified CTA Index. The 60/40 blend is built from a weighted average of the S&P 500 Total Return Index (60%) and Bloomberg U.S. Aggregate Total Return Index (40%). Performance is calculated from December 31, 2021, to April 30, 2024. **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, May 13, 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. **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.

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

An index is unmanaged and not available for direct investment.

Bloomberg US Aggregate Bond Index TR USD Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

HFRI Macro: Systematic Diversified CTA Index—Systematic Diversified strategies have investment processes typically as function of mathematical, algorithmic and technical models, with little or no influence of individuals over the portfolio positioning. Strategies which employ an investment process designed to identify opportunities in markets exhibiting trending or momentum characteristics across individual instruments or asset classes. Strategies typically employ quantitative process which focus on statistically robust or technical patterns in the return series of the asset, and typically focus on highly liquid instruments and maintain shorter holding periods than either discretionary or mean reverting strategies. Although some strategies seek to employ counter trend models, strategies benefit most from an environment characterized by persistent, discernable trending behavior. Systematic: Diversified strategies typically would expect to have no greater than 35% of portfolio in either dedicated currency or commodity exposures over a given market cycle.

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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