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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee May 20, 2024

Asset Allocation Spotlight: The role of diversification in volatile markets.....2

- We believe a diversified allocation designed for a specific investment objective and risk tolerance can help investors accomplish goals more effectively than timing the market.
- Investors can utilize tactical guidance to adjust allocations based on near-term market dislocations, thereby leveraging the current market environment without completely exiting.

Equities: Hope springs eternal 4

- Chinese equities have rallied sharply on the back of hope that recent policy measures will result in sustained outperformance.
- We believe market expectations are running well ahead of reality and that investors should use the recent strength to trim exposure to Chinese and Emerging Market equities.

Fixed Income: Fed to begin tapering balance-sheet reduction in June 5

- In an effort to reduce the risk of volatility in the funding markets, the Federal Reserve (Fed) announced plans to begin tapering the pace of decline of its balance sheet starting in June.
- The Fed could become a marginal buyer of U.S. Treasuries in the upcoming months as a result, which could also help put a ceiling on intermediate- and long-term yields.

Real Assets: U.S. Treasury volatility coincides with elevated gold demand ...6

- Volatility in U.S. Treasuries has been a factor that correlates with driving persistent global central-bank purchases of gold.
- We expect central-bank demand to play an important role in supporting higher gold prices in 2024 as it now accounts for 23% of global demand.

Alternatives: Private capital recovering as macro environment evolves 7

- Private capital returns continued to recover through the end of 2023, and both the Direct Lending and Infrastructure strategies were bright spots.
- We believe a gradual rebound in initial public offering (IPO) and merger and acquisition activities as well as clarity on the future interest rate path should bode well for a continued recovery in private markets.

Current tactical guidance 8

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Asset Allocation Spotlight

Veronica Willis
Global Investment Strategist

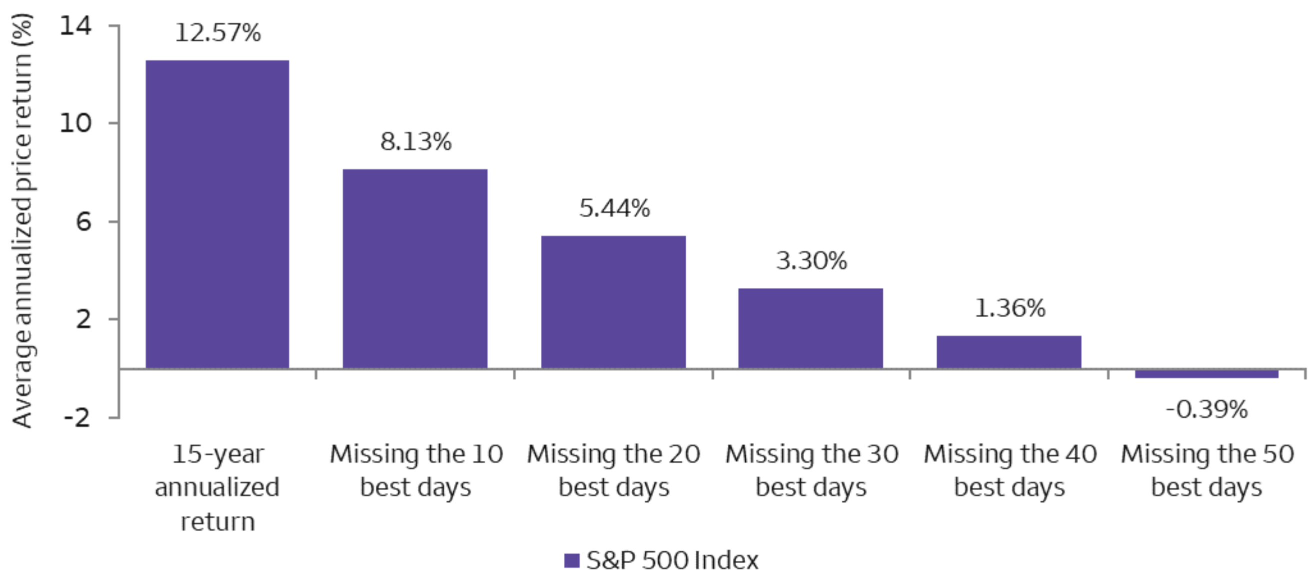
The role of diversification in volatile markets

U.S. Large Cap Equities have continued to move higher over the past year, albeit with periodic pullbacks, as the economy has remained robust and inflation showed signs of easing. However, economic data has started to show signs of a moderate slowdown while inflation has remained stickier than market participants expected at the start of the year. And expectations based on the futures market for Federal Reserve (Fed) rate cuts have fallen from nearly seven at the start of the year to between one and two as of May 14, 2024. At the same time, the yield on cash, represented by Treasury bills, and ultra short-term fixed-income instruments have pushed higher, to levels not seen in years.

This market environment has contributed to a somewhat divergent scenario. One type of investor has likely remained in or moved into cash and cash alternatives to leverage higher yields. Meanwhile, another investor may have attempted to time the market, with the goal of participating mostly on the up days and missing pullbacks altogether. The first type of investor is inclined to be risk averse or sees little cost benefit to being invested and taking on the potential for increased downside volatility. The second type of investor is probably more willing to take on additional risk in an effort to achieve higher returns.

We believe that a third approach — that is, using diversification — can be a better strategy, especially for longer-term investors seeking capital preservation or growth. While the yield on cash is elevated now, we do not expect this to persist indefinitely. Keeping a large amount of cash on the sidelines can lead to a drag on portfolios, especially over the long term as cash has historically not been able to keep up with other assets. Additionally, our expectations for growth in other assets exceed our longer-term expectations for cash.

Chart 1. Missing the best days can have a negative impact on performance



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data: May 14, 2009 through May 13, 2024 for the S&P 500 Index. Best days are calculated using daily returns. For illustrative purposes only. An index is unmanaged and not available for direct investment. A price index is not a total return index and does not include the reinvestment of dividends. **Past performance is no guarantee of future results.**

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For investors who are seeking growth, market timing may be tempting. In practice, however, timing the market is often futile as the market's best and worst days have frequently occurred back-to-back during times of market volatility. These periods have historically coincided with bear markets and economic slowdowns, when investors may be most prone to exiting the market.[1] Missing just a few of the best days can have an adverse effect on overall returns compared to a buy-and-hold strategy.

We believe employing a diversified allocation that is designed for a specific risk tolerance and investment objective can help investors accomplish their goals more effectively versus attempting to time the market. A diversified allocation can be less susceptible to asset-class or sector-specific risks as losses in one asset class may be offset by gains in others. Diversification can help investors weather market volatility and maintain relatively stable performance over time. Additionally, diversified allocations have done well at delivering competitive risk-adjusted returns while providing reduced downside participation compared to an equity-only allocation. And while cash has preserved capital during downside events, it has not been able to keep up over time.

Table 1. Asset class and allocation performance over the past 15 years

Index/allocation	Cash**	Moderate Income	Moderate Growth & Income	Moderate Growth	U.S. Large Cap Equities^
Annualized total return (%)	0.98	5.48	8.19	10.09	14.78
Standard deviation (%)	0.44	5.96	9.34	13.06	14.68
Sharpe ratio	--	0.75	0.77	0.72	0.82
Average drawdown (%)	0.00	-3.57	-6.01	-8.69	-9.02

Sources: © Morningstar Direct, All Rights Reserved* and Wells Fargo Investment Institute. Data as of May 13, 2024. Analysis uses total return data from May 12, 2009 to May 13, 2024. **: Cash represented by the Bloomberg U.S. Treasury Bills (1-3 Month) Index. ^: U.S. Large Cap Equities represented by the S&P 500 Index. Performance results for Moderate Income, Moderate Growth & Income and Moderate Growth are calculated using blended index returns and are for illustrative purposes only. Moderate Income, Moderate Growth & Income, and Moderate Growth allocations are dynamic and change as needed with adjustments to the strategic allocations. Index returns do not represent investment performance or the results of actual trading. Index returns reflect general market results; assume the reinvestment of dividends and other distributions; and do not reflect deductions for fees, expenses, or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** [See end of report for blended index compositions of the Moderate Income, Moderate Growth & Income, Moderate Growth, risks, and index definitions.]

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Remaining diversified and utilizing a periodic rebalancing[2] strategy to maintain the desired allocation has proven to be a useful tool for weathering market volatility and uncertainties. Additionally, diversification can be a useful tool for capital preservation while also providing fuel for growth, which may help investors stay disciplined in their investment strategy. Investors can also utilize tactical guidance to adjust allocations based on near-term market dislocations as a way to leverage the current market environment without completely exiting. Given the current macroeconomic environment, we remain somewhat cautious. In fixed income, we favor U.S. Short Term Taxable Fixed Income over U.S. Intermediate Term, U.S. Long Term, and High Yield Fixed Income. In equites, we favor U.S. over international equities and Developed Markets ex-U.S. Equities over Emerging Market Equities. We also favor quality, recommending U.S. Large Cap Equities over U.S. Mid and Small Cap Equities at this point in the economic cycle.

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1. For more information, please see our Special Report titled "The perils of trying to time volatile markets", February 29, 2024.
2. Rebalancing involves periodically reviewing the current asset allocation of the portfolio and making adjustments to bring it back in line with the target allocation. This typically involves selling some assets that have become overweighted and buying assets that are underweighted based on the target allocation.

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Equities

Sameer Samana
Senior Global Market Strategist

Hope springs eternal

The MSCI China Index is up 28.07% (in U.S. dollars) from its late-January lows through May 13, 2024, driven by authorities' policy measures to help support the economy and financial markets. After initial skepticism, investors appear to have warmed up to the idea that Chinese equities might finally be making a sustainable turn. Unfortunately, we believe investors are at best premature and at worst falling for another false dawn.

The true nature of the issue lies in the fact that Chinese consumers remain very cautious due to a combination of economic slowing and concerns about the property market. In the absence of a consumer rebound, China has turned to the old playbook of export-driven growth alongside a quickly developing Information Technology sector. Therein lies another facet of the problem — much of the world no longer needs China's excess capacity, and trade protectionism has continued to intensify. And while China's Information Technology sector is meaningful in size, the U.S. and other Western nations are working to impede China's technological advancements.

This combination of factors suggests that China's recovery should eventually fade and does not even account for future risks, such as further increases in tariffs and the possibility of increased diplomatic and economic strains with the U.S. and its allies. We believe investors should steer clear of Chinese equities and use the recent strength to reduce exposure to Emerging Market Equities, in line with our unfavorable guidance. The chart below suggests the MSCI China Index may find support at the 50- and 200-day moving averages (7.20), on a pullback.

MSCI China Index moving toward short-term uptrend

Sources: Bloomberg and Wells Fargo Investment Institute. Daily data from May 13, 2021 through May 13, 2024. MXCN = MSCI China 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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Fixed Income

Luis Alvarado
Global Fixed Income Strategist

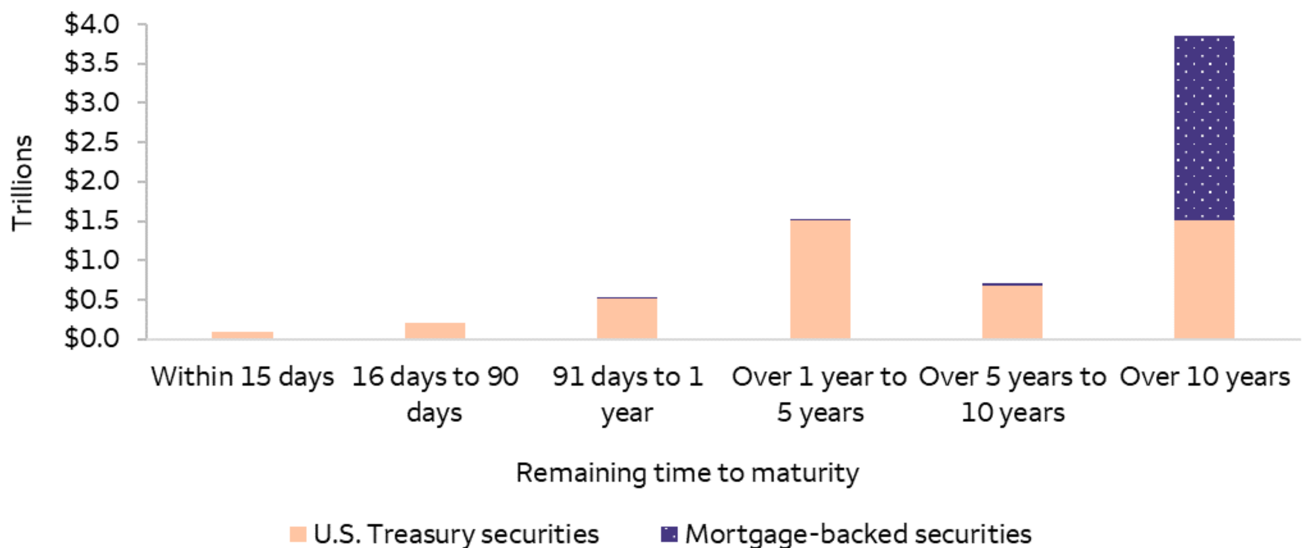
Fed to begin tapering balance-sheet reduction in June

Back in May of 2022, the Fed announced that it would begin reducing its balance sheet, which peaked in April of 2022 at more than $8.5 trillion due to all its post-pandemic stimulus efforts. Two years later, the Fed has already managed to reduce its balance sheet to $6.9 trillion[3]. Although it will continue to shrink its balance sheet, we learned the following at the May 1 policy meeting:

> *"Beginning in June, the Committee will slow the pace of decline of its securities holdings by reducing the monthly redemption cap on Treasury securities from $60 billion to $25 billion. The Committee will maintain the monthly redemption cap on agency debt and agency mortgage-backed securities at $35 billion and will reinvest any principal payments in excess of this cap into Treasury securities."*

In our view, the Fed is being cautious, attempting to reduce the risk of volatility in the funding markets and a recurrence of events similar to those of September 2019 (when overnight money market rates inclined sharply, accompanied by significant volatility). For now, bank reserves remain ample, and the overnight reverse repo (or RRP: reverse repurchase agreement) facility is still a source of liquidity. Furthermore, because of the large increase in federal debt issuance, the Fed's holdings as a percent of the entire Treasury market have fallen below 17% after peaking near 30% in 2022 — this allows the Fed to use balance sheet expansion down the road if needed. The Fed could become a marginal buyer of U.S. Treasuries in the upcoming months as a result, which could also help put a ceiling on intermediate- and long-term yields.

Maturity distribution inside the Fed's balance sheet



Sources: Wells Fargo Investment Institute. Data as of May 8, 2024. Federal Reserve statistical release, table H.4.1 – Maturity distribution of securities, loans and selected other assets and liabilities.

3. Data is as of May 8, 2024

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Real Assets

Mason Mendez
Investment Strategy Analyst

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Head of Real Asset Strategy

U.S. Treasury volatility coincides with elevated gold demand

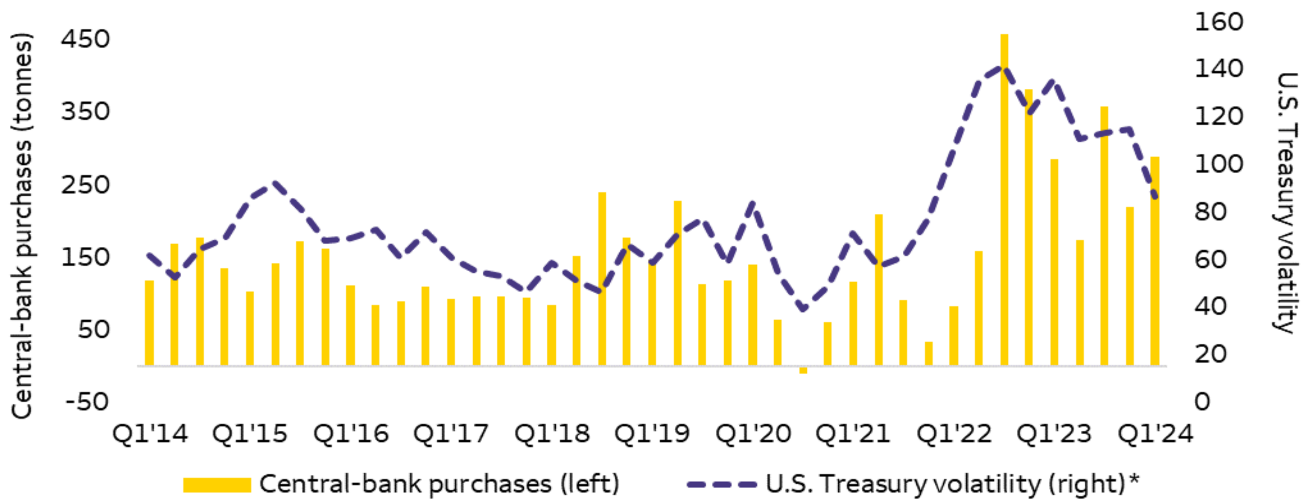
Gold continues to be one of the strongest commodities in 2024, now up 14% year to date (through May 14, 2024). In last week's Investment Strategy Report (May 13), we highlighted the main driver of this strength — persistent purchases by global central banks. Today, we expand on a potential reason why global central banks have been adding gold reserves — U.S. Treasury volatility.

Two of a central bank's many roles are promoting stability in domestic prices and in the currency, and these goals are typically achieved partly through the management of different reserve assets. The most preferred assets are often those that are stable, liquid, and have low volatility. These qualities, along with the backing of the U.S. economy, have made U.S. Treasuries a preferred asset and dominant portfolio holding of most central banks.

While U.S. Treasuries remain a preferred asset of global central banks in 2024, increased volatility in U.S. Treasuries since 2022 has coincided with the asset-mix decisions of some central banks. As demonstrated in the chart below, central banks' gold purchases ramped up alongside U.S. Treasury volatility starting in 2022. From a central bank's perspective, we believe that these central bank policy makers may expect that adding other reserve assets such as gold can help lower the portfolio's volatility.

Overall, if U.S. Treasury prices continue to show volatility through significant up and down price movements, we suspect that global central banks may continue to add gold to their portfolios over the coming years. The main reason is that at a time of elevated global debt levels, gold remains one of the rare reserve assets that is not the liability of another government. We believe gold also has plenty of room to grow throughout 2024 and 2025, as it remains a small percentage of most central bank's reserve asset mixes. We remain favorable on Precious Metals and expect gold prices to be supported between $2,300 – $2,400 per troy ounce in 2024, and move higher between $2,400 - $2,500 per troy ounce in 2025.

Central banks' gold purchases coincide with U.S. Treasury volatility



Sources: World Gold Council, Bloomberg, Wells Fargo Investment Institute. *U.S. Treasury volatility represented by Bank of America MOVE Index. Q = quarter. Quarterly data is from Q1 2014 – Q1 2024. Central bank data is collected by the World Gold Council and represent purchases from all central banks - globally. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Alternatives

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

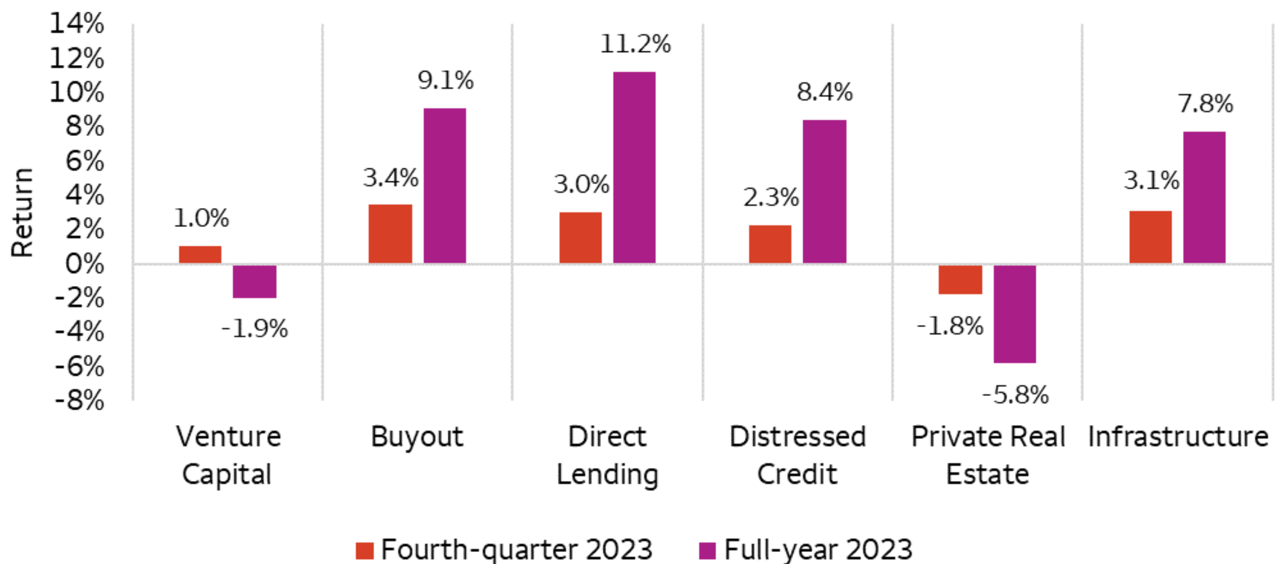
Private capital recovering as macro environment evolves

After subdued performance in 2022, private capital returns continued to recover through the end of 2023. Thus far, the recovery has been moderate relative to long-term averages as a challenging exit environment and the high cost of capital weighed on fund distributions and valuation growth. However, private capital cash flows turned positive in December, benefiting from a pause in interest-rate hikes and higher public-market prices.

On a strategy level, Direct Lending and Infrastructure were bright spots for private capital in 2023 as both generated higher returns relative to long-term trends (see chart below). Direct lenders' floating-rate loans were more immune to interest-rate changes and benefited from the higher-for-longer rate environment. Meanwhile, more stable yields from private infrastructure investments continued to showcase the Infrastructure strategy's countercyclical and inflation-hedging potential.

Relative to Venture Capital, Buyout strategies have recovered substantially as they have benefited from stabilizing interest rates, resilient company growth, and more realistic valuations. On the other hand, the Venture Capital strategy struggled to navigate the elevated interest-rate environment and a largely closed initial public offering (IPO) market. Finally, Private Real Estate registered a negative fourth quarter and year as stress remained high in the office and residential sectors. Commercial real estate transaction activity was sluggish, owing to higher interest rates and wide bid-ask spreads. Going forward, we believe a gradual rebound in IPO and merger and acquisition activities as well as clarity on the future path of interest rates should bode well for a continued recovery in private markets.

Select private capital strategies recovered in 2023 while others continued to lag



Sources: Wells Fargo Investment Institute and Burgiss. Data as of December 31, 2023. Fourth-quarter 2023 returns are preliminary. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** [See end of report for index definitions.]

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 20, 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 and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.

Diversification does not guarantee profit or protect against loss in declining markets.

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. Investing in **gold or other precious metals** involves special risk considerations such as severe price fluctuations and adverse economic and regulatory developments affecting the sector or industry. **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

Moderate Income: 2% Bloomberg U.S. Treasury Bills (1–3 Month) Index, 60% Bloomberg U.S. Aggregate Bond Index, 4% Bloomberg U.S. Corporate High Yield Bond Index, 5% J.P. Morgan EMBI Global, 16% S&P 500 Index, 5% Russell Midcap Index, 2% Russell 2000 Index, 4% MSCI EAFE Index, 2% Bloomberg Commodity Index.

Moderate Growth & Income: 2% Bloomberg U.S. Treasury Bills (1–3 Month) Index, 30% Bloomberg U.S. Aggregate Bond Index, 6% Bloomberg U.S. Corporate High Yield Bond Index, 5% J.P. Morgan EMBI Global, 24% S&P 500 Index, 10% Russell Midcap Index, 6% Russell 2000 Index, 8% MSCI EAFE Index, 5% MSCI Emerging Markets Index, 4% Bloomberg Commodity Index.

Moderate Growth: 2% Bloomberg U.S. Treasury Bills (1–3 Month) Index, 8% Bloomberg U.S. Aggregate Bond Index, 3% Bloomberg U.S. Corporate High Yield Bond Index, 31% S&P 500 Index, 14% Russell Midcap Index, 10% Russell 2000 Index, 15% MSCI EAFE Index, 12% MSCI Emerging Markets Index, 5% Bloomberg Commodity Index.

Bank of America MOVE Index is considered a proxy for term premiums of U.S. Treasury bonds (i.e., the yield spread between long-term and short-term bonds).

Bloomberg Commodity Index is calculated on an excess return basis and reflects commodity futures price movements. The index rebalances annually, weighted two-thirds by trading volume and one-third by world production, and weight-caps are applied at the commodity, sector, and group level for diversification.

Bloomberg U.S. Treasury Bills (1-3 Month) Index is representative of money markets.

Bloomberg U.S. Aggregate Bond Index is composed of the Bloomberg U.S. Government/Credit Index and the Bloomberg U.S. Mortgage-Backed Securities Index and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities.

Bloomberg U.S. Corporate High Yield Bond Index covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market. J.P. Morgan EMBI Global (USD) is a U.S. dollar-denominated, investible, market cap-weighted index representing a broad universe of emerging market sovereign and quasi-sovereign debt.

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Burgiss venture capital index is based on the pool of venture capital funds sourced by Burgiss and is asset weighted. The index is calculated using cash flow and valuation histories of the underlying funds within Burgiss manager universe. The underlying funds are classified by Burgiss private capital classification system and the cash flow data is sourced from institutional investors around the world.

Burgiss buyout index is based on the pool of buyout funds sourced by Burgiss and is asset weighted.

Burgiss direct lending index is based on the pool of senior private debt funds sourced by Burgiss and is asset weighted.

Burgiss distressed credit index is based on the pool of private debt distressed funds sourced by Burgiss and is asset weighted.

Burgis private real estate index is based on the pool of private real estate funds sourced by Burgiss and is asset weighted.

Burgiss infrastructure index is based on the pool of infrastructure funds sourced by Burgiss and is asset weighted.

J.P. Morgan EMBI Global (USD) is a U.S. dollar-denominated, investible, market cap-weighted index representing a broad universe of emerging market sovereign and quasi-sovereign debt. MSCI EAFE Index is a free-float-adjusted market-capitalization-weighted index designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

MSCI China Index captures large and mid-cap representation across China H shares, B shares, Red Chips and P Chips. With 140 constituents, the index covers about 85% of the China equity universe.

MSCI EAFE Index capture large- and mid-cap representation across developed market countries (excluding the U.S. and Canada) around the world.

MSCI Emerging Markets Index is a free-float-adjusted market-capitalization-weighted index designed to measure equity market performance of emerging markets.

Russell Midcap Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index.

Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

S&P 500 Index is a market capitalization-weighted index composed of 500 stocks generally considered representative of the U.S. stock market.

An index is unmanaged and not available for direct investment.

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