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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **May 23, 2022**

Equities spotlight: Equity valuation reset 2

- In 2022, equity market valuations have retreated in all equity asset classes, market capitalizations, and regions.
- The recent late-cycle contraction in price/earnings (P/E) multiples has reset valuations closer to long-term averages. As the cycle ages, we favor staying invested in reasonably priced, high-quality U.S. companies with consistent revenue and earnings growth.

Fixed Income: Financial conditions tighten quickly as Fed hikes rates.....4

- So far in May; U.S. financial conditions have already tightened at a faster pace than what investors experienced in the last Federal Reserve tightening cycle.
- Financial conditions have been historically indicative of future inflation trends, so their rapid tightening could eventually ease some of the stickiness and broadness of inflation pressures.

Real Assets: Pain-at-the-pump stories 5

- U.S. petroleum inventories remain near record lows.
- Price relief, if it comes, will likely be tied to an economic slowdown, in our opinion.

Alternatives: Credit concerns building, depth of cycle uncertain.................6

- Credit default swap spreads have increased meaningfully in recent weeks, highlighting a growing concern for future defaults in both high-yield and investment-grade credit.
- Though the current environment is challenging, it is too early to forecast a major default cycle, as many weaker companies refinanced debt and reduced leverage last year. We still prefer Long/Short Credit over Distressed Debt investing.

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Equities spotlight

"To be prepared is half the victory." — Miguel de Cervantes

Chris Haverland, CFA
Global Equity Strategist

Austin Pickle, CFA
Investment Strategy Analyst

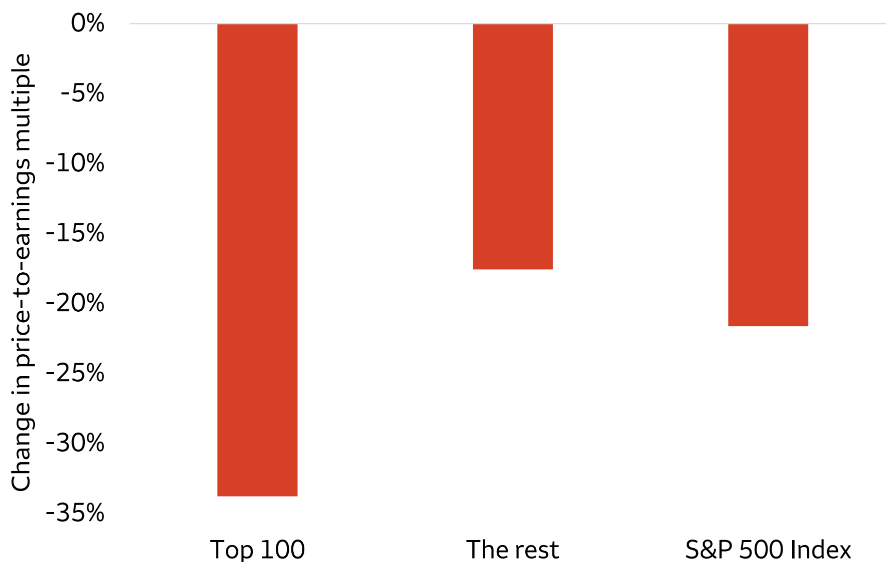
Equity valuation reset

After sharply rebounding from the pandemic low in March 2020, the S&P 500 Index has stalled and reversed course in 2022. Outsized gains in 2020 and 2021 have given way to losses in the early part of this year. Slowing economic growth, soaring inflation, aggressive monetary tightening, higher interest rates, and heightened geopolitical risks have been formidable headwinds that have weighed on sentiment this year, which is directly tied to price-to-earnings (P/E) multiples (what investors are willing to pay for corporate profits).

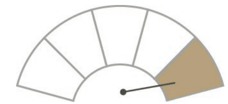
While 2022 has seen sizable declines in multiples, they actually began their descent in 2021 when corporate earnings surged as the economy reopened. As with most recessionary periods, stock prices tend to recover earlier than earnings, leading to elevated valuations. However, as earnings rebound post-recession, they often grow faster than prices, allowing P/E multiples to decline even with equity values rising. In 2020, the S&P 500 Index gained 16%, while earnings per share (EPS) contracted by 15%. In 2021, the S&P 500 Index rose 27%, while EPS grew by 52%.

The P/E retracement in 2022 has been driven by a considerable price decline, despite modest EPS growth. Multiple contraction has been more pronounced in lower quality, higher valuation segments of the market. For example, the 100 companies in the S&P 500 Index with the highest P/E's have seen multiples contract by 33% in 2022. This compares to 17% for the remaining 400 stocks in the index (see Chart 1).[1]

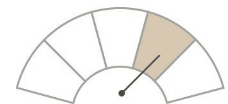
Chart 1. Top 100 multiples hit hardest in 2022



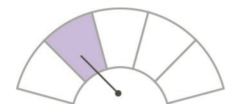
Sources: Bloomberg, Wells Fargo Investment Institute. Change in P/E measured from December 31, 2021 to May 17, 2022. Top 100 measures the 100 stocks within the index with the highest P/E multiples.



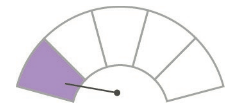
Most favorable
U.S. Large Cap Equities



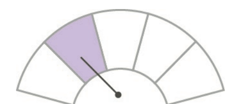
Favorable
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities



Unfavorable
Emerging Market Equities

1. As of May 17, 2022.

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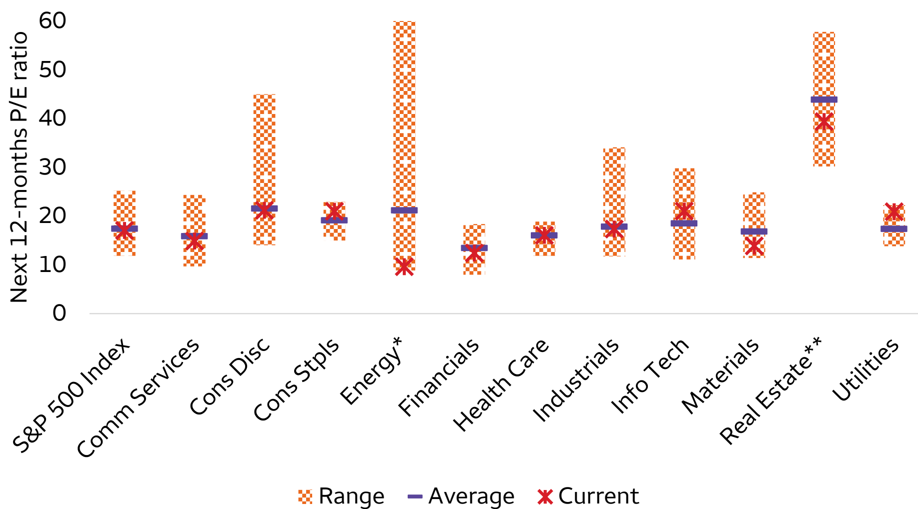
Valuations have retreated in all equity asset classes, market capitalizations, and regions. While U.S. large-cap stocks have not been immune, highly cyclical smaller-cap stocks and emerging market equities have seen valuations compress the most over the past year. As the cycle ages and growth slows, investors often sour on highly cyclical parts of the market. Investors have also seen international market multiples pressured lower largely due to their outsized exposure to headwinds related to the war in Ukraine and China's COVID-19 lockdowns.

The high valuation, growth-oriented sectors have been hit the hardest this year, as well as the so called COVID winners. Many of these stocks have returned to pre-COVID levels. These include many companies in the Communication Services, Consumer Discretionary, and Information Technology sectors, which have typically carried a higher valuation due to long-term growth prospects. However, as rates have risen, that potential earnings growth has been discounted, bringing down multiples. Alternatively, defensive sectors (whose attractiveness increases during late-cycle) have seen valuations surge. As recession risks rise, we believe investors are willing to pay a premium for consistent revenue and earnings growth that may be less impacted by an economic slowdown. Interestingly, the Information Technology and the Utilities and Consumer Staples sectors now trade at comparable forward multiples (see Chart 2).

Chart 2. S&P 500 Index and sector P/E range, average, and current readings



Sources: Bloomberg, Wells Fargo Investment Institute. Daily data: May 18, 2012 – May 18, 2022. Average and range readings are as of the past 10 years. Current reading is as of May 18, 2022. * Energy range extends beyond chart view and data excludes March 2020 - December 2020 readings. ** Due to data limitations, Real Estate readings are from 2016 which is the inception date of the index.

While valuations have fallen from lofty levels, they remain near long-term averages. If rates continue to rise and the prospects for growth dim, multiples could continue to deteriorate. In addition, as recession risks rise, earnings estimates are likely to come down, putting further pressure on prices and multiples. Equity valuation is one of many metrics we use in our guidance. While valuations can be useful in determining entry points for long-term investors, they tend to be poor predictors of near-term market performance, especially late in the cycle. We believe multiples may continue to decline in the near-term as investors price in the increasing likelihood of a recession. In this environment, we favor focusing on reasonably priced, high-quality U.S. companies with consistent revenue and earnings growth.

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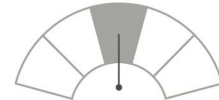
Fixed Income

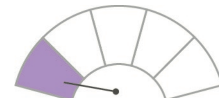
Luis Alvarado
Investment Strategy Analyst



Neutral
U.S. Taxable Investment Grade Fixed Income

Neutral
U.S. Short Term Taxable Fixed Income

Most favorable
U.S. Intermediate Term Taxable Fixed Income



Most unfavorable
U.S. Long Term Taxable Fixed Income

Neutral
High Yield Taxable Fixed Income

Neutral
Developed Market Ex.-U.S. Fixed Income

Neutral
Emerging Market Fixed Income

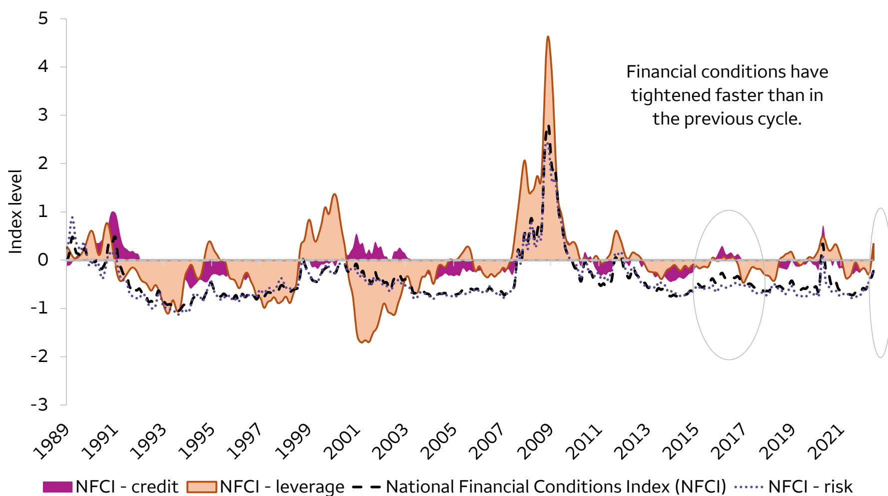
Financial conditions tighten quickly as Fed hikes rates

The Federal Reserve (Fed) is currently navigating in an economic and financial environment that is more complicated than any other in recent history. Its main risk, in out view, is shifting unintentionally from "hero" to "villain" of the U.S. economy by implementing monetary policies that are too restrictive as it attempts to tackle inflation. So far in May, U.S. financial conditions have already tightened at a faster pace than what investors experienced in the last Fed tightening cycle. Most of the recent change in the Chicago Fed's National Financial Conditions Index (NFCI) can be attributed to a broad-based widening of credit spreads, declining valuations, and an increase in equity and bond market volatility.

We believe that further tightening of the NFCI, at the current pace, could begin to exacerbate a sharper economic downturn — and sooner than Fed officials are probably expecting. Financial conditions have been historically indicative of future inflation trends, so their rapid tightening could eventually ease some of the stickiness and broadness of inflation pressures. However, although effective in terms of controlling inflation, aggressive tightening poses a risk. It may cause economic activity to weaken and unemployment to rise, precisely at the time when the stubbornly high inflation could begin to yield some ground.

These risks will most likely linger in the background over the next year as the Fed continues to normalize policy. We still believe that yields will continue to move higher across the curve and advise investors to consider positioning portfolios defensively in fixed-income, favoring shorter and intermediate bonds, and in higher quality.

Financial conditions are tightening quickly in this cycle



Sources: Federal Reserve Bank of Chicago. Weekly data not seasonally adjusted from Janaury 2, 1989 to May 13, 2022. Note: The Chicago Fed's National Financial Conditions Index (NFCI) provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets and the traditional and "shadow" banking systems. The NFCI is constructed to have an average value of zero and a standard deviation of one over a sample period extending back to 1971. Positive values of the NFCI have been historically associated with tighter-than-average financial conditions, while negative values have been historically associated with looser-than-average financial conditions. This figure plots the NFCI, along with contributions to the index from

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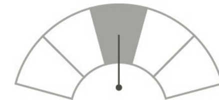
the three categories of financial indicators (risk, credit, and leverage). Currently, the NFCI index, along with the 3 subindexes, are signaling that financial conditions are tightening at a fast pace.

Real Assets

John LaForge
Head of Real Asset Strategy



Neutral
Commodities

Neutral
Private Real Estate

Pain-at-the-pump stories

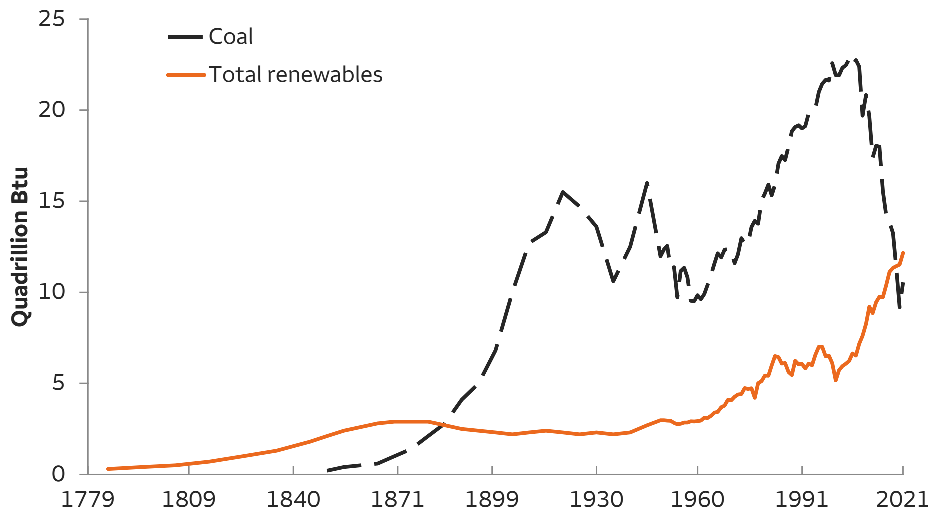
Energy prices have become so ridiculously high that even those that do not drive have a pain-at-the-pump story. This author's 81-year-old father called last week to say: "Three times! Three times is what I just paid for heating oil over last year's price! Is there really a shortage like they say?"

Unfortunately, "they" are right. Most forms of oil are in short supply. In fact, the U.S. has never seen petroleum inventories this low, when compared to the five-year average. We believe that price relief, if it comes, will likely come in the form of slowing demand, which means an economic slowdown.

Consumers' ire is often aimed at oil companies in such times, but we hope cooler heads will prevail. Oil prices are set globally, and companies have almost no control over base fuel prices. While fossil fuel companies may benefit in the short-term, we believe high prices eventually curtail demand and accelerate renewables use.

Renewables use is one of the bright spots in energy land, as the chart shows. Renewables (dashed orange line) surpassed coal (solid black line) as the U.S.'s third-largest energy source, and it is slowly gaining on oil and natural gas. While not a quick fix for high fossil fuel prices today, growing renewables use is hope for the future.

U.S. energy consumption by fuel: coal versus renewables



Sources: U.S. Energy Information Administration (EIA), Wells Fargo Investment Institute. Yearly data 1780-2021. Total renewables includes hydro, geothermal, wind, solar, and biomass primary energy consumption.

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Alternatives

Credit concerns building, depth of cycle uncertain

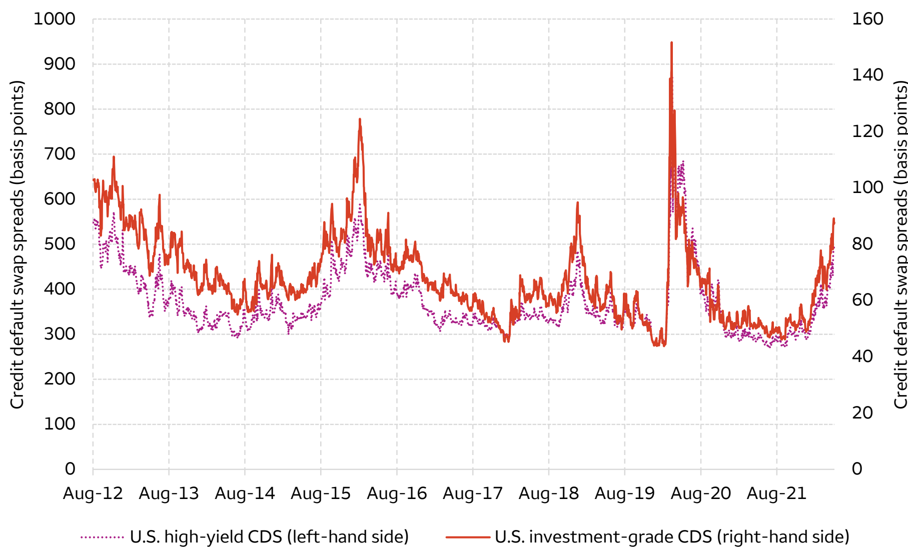
Justin Lenarcic
Senior Wealth Investment Solutions Analyst

One of the most difficult questions we are asking ourselves these days is what to make of the credit cycle. On one hand, both investment-grade and high-yield credit default swaps (CDS) are pointing to mounting stress. As seen below, CDS spreads are approaching levels seen during the mini cycle of 2018, and already more than half the levels seen during the throes of the pandemic. This is concerning given that the Fed has only just begun to raise rates. A potent combination of higher rates, above-trend inflation, and slower economic growth could certainly result in an interesting credit cycle later this year and into next year.

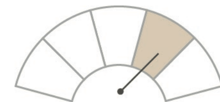
However, we also recognize that the flood of post-pandemic liquidity allowed many zombie companies to refinance debt and extend their maturity walls. Fundamental metrics such as leverage appear to be in good shape, though we are beginning to see deterioration in earnings for high-yield issuers. Further economic weakness and our expectation for a mild, but short-lived potential recession might not necessitate a large-scale default cycle. Again, we just do not know at this point.

Despite a lack of clarity, we do know that a combination of tactical, long-short credit exposure combined with opportunistic, distressed debt experts is an attractive approach for qualified investors. We favor starting now with Relative Value, and then building into Event Driven as the environment unfolds.

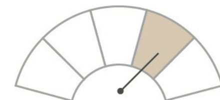
Credit default swaps signaling mounting concerns



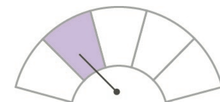
Sources: Bloomberg. Data as of May 11, 2022. 100 basis points equals 1%



Favorable
Hedge Funds – Relative Value



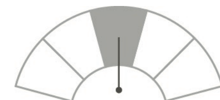
Favorable
Hedge Funds – Macro



Unfavorable
Hedge Funds – Event Driven

Neutral
Hedge Funds – Equity Hedge

Neutral
Private Equity



Neutral
Private Debt

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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Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

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. **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. Risks associated with the **Consumer Discretionary** sector include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players; reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. **Consumer Staples** industries can be significantly affected by competitive pricing particularly with respect to the growth of low-cost emerging market production, government regulation, the performance of the overall economy, interest rates, and consumer confidence. The **Energy** sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. Investing in the **Financial** services companies will subject an investment to adverse economic or regulatory occurrences affecting the sector. Some of the risks associated with investment in the **Health Care** sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio's performance. **Materials** industries can be significantly affected by the volatility of commodity prices, the exchange rate between foreign currency and the dollar, export/import concerns, worldwide competition, procurement and manufacturing and cost containment issues. **Real estate** investments have special risks, including possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions. 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. **Utilities** are sensitive to changes in interest rates, and the securities within the sector can be volatile and may underperform in a slow economy.

Credit default swap (CDS) is a financial swap agreement that the seller of the CDS will compensate the buyer in the event of a debt default (by the debtor) or other credit event.

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.

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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