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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **August 12, 2024**

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- Historically, when the Federal Reserve (Fed) has cut interest rates in response to falling inflation (as opposed to a rapidly weakening economy), equities have performed quite well.
- Our expectation is that the U.S. economy will avoid a recession and gradually strengthen through 2025. This, along with easier financial conditions, should support continued corporate earnings growth, equity-market strength, and our favorability toward high-quality companies within U.S. Large Cap Equities.

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- Rate cuts are only one factor in a mosaic of data that informs investment decisions. The beginning of cuts is not necessarily a green light to invest in speculative assets.
- Our preference is for high-quality investments that are not dependent on rate cuts — we are favorable on U.S. Intermediate Term Taxable Fixed Income, unfavorable on more speculative Leveraged Loans, and neutral on High Yield Taxable Fixed Income and High Yield Municipal Bonds.

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- Heightened geopolitical tensions in the Middle East have increased the risk of a global crude-oil supply disruption.
- However, oil prices are not reacting to additional actions in the Middle East but rather a softening global economy and overall financial-market derisking.

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- We believe retail real estate will likely continue to benefit from limited new supply and resurging demand in the near future.
- This market segment will need to successfully navigate new consumer trends and retail-industry transformations to shine over the long term.

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Equities Spotlight

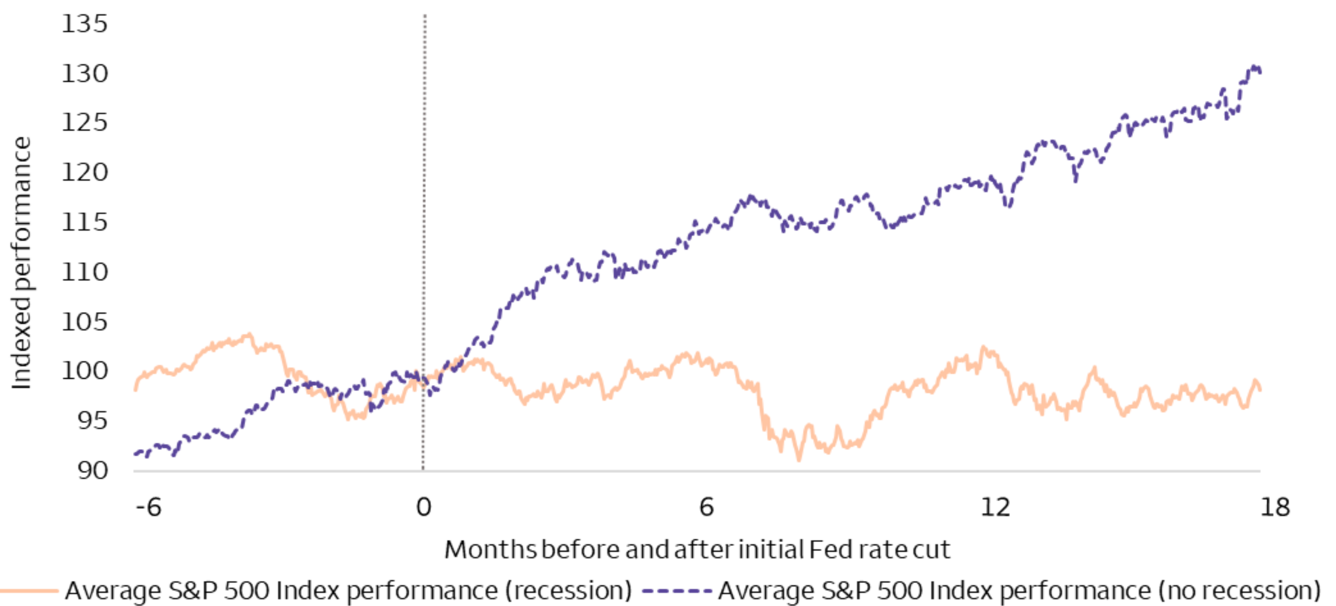
Chris Haverland, CFA
Global Equity Strategist

The "why" behind rate cuts key to equity performance

It has been over a year since the Fed last increased the federal funds rate. During this policy pause, equities have soared, reaching record highs. However, recent volatility (along with weakening economic data) has some wondering if the Fed will need to cut aggressively to avert a U.S. recession. Our view is that the Fed will reduce rates in September as it shifts from fighting inflation to stimulating the economy and hiring. While a recession is possible, our work suggests a greater likelihood of a near-term economic slowdown, followed by a recovery in 2025.

Historically, the reason the Fed begins to ease policy has been important to equity-market performance. Since 1974, the average drawdown has been roughly 20% over the 250 days following the first Fed rate cut. However, the average includes several bear markets associated with economic and earnings recessions — a scenario we view as unlikely in 2025. Digging a little deeper into the data reveals a much different picture in non-recessionary periods. When the Fed is cutting real rates in response to falling inflation (as opposed to a rapidly weakening economy), equities have performed quite well.

Chart 1. S&P 500 Index performance around first rate cut



Sources: Ned Davis Research, Bloomberg, and Wells Fargo Investment Institute. Data as of August 6, 2024. Indexed to 100 as of the initial rate cut to measure performance. Recession cases include the cutting cycles that began May 30, 1980; November 2, 1981; January 3, 2001; September 18, 2007; and July 31, 2019. No-recession cases include the cutting cycles that began November 21, 1984; June 6, 1989; July 6, 1995; and September 29, 1998. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

The chart above shows average S&P 500 Index performance from 6 months prior to the initial Fed rate cut to 18 months past the initial Fed rate cut. Historically, the index has continued its upward trajectory 18 months past the initial cut in periods when the Fed easing cycle did not correspond with a recession. Alternatively, when the Fed rate cut cycle did correspond with a recession, performance was choppy before ending essentially flat over the 18-month period.

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What clues can we take from 1995?

Many comparisons have been made between the mid to late 1990s and today's environment. Specifically, in 1995, the Fed began a rate-cutting cycle that coincided with disinflation and an economic soft landing. While the two instances are not perfectly aligned, there are enough similarities that the former could provide a potential roadmap for corporate earnings and equity prices in the coming quarters. For example, earnings have historically fallen during rate-cutting cycles associated with recessions. However, the 1995 scenario experienced uninterrupted economic growth, leading to a 12% increase in earnings for the S&P 500 Index in the year following the initial rate cut — not far off from our forecast.

Stock-market performance was strong during this period, with the S&P 500 Index gaining more than 40% in the 18 months following the first cut. Mid- and small-cap benchmarks also participated in the rally but failed to outperform large caps. Sectors were mixed, with Financials leading and Consumer Discretionary lagging. We see parallels between the Financials sector's outperformance in 1995 – 1996 and today, and we recently upgraded the sector to favorable. Also of note, the Information Technology sector significantly outperformed leading up to the first cut but consolidated for the next 6 – 12 months before reasserting itself as a leader. If the sector takes a similar path during the upcoming easing cycle, we will look for opportunities to upgrade given expectations for above-market growth.

Table 1. Absolute returns for S&P 500 Index and sectors around 1995 Fed rate cut

	-6 months	-3 months	-1 month	+1 month	+3 months	+6 months	+12 months	+18 months
Communication Services	12.3%	3.7%	3.9%	3.7%	15.9%	29.1%	22.4%	29.3%
Consumer Discretionary	14.1%	7.1%	3.1%	1.7%	0.4%	5.1%	13.9%	17.9%
Consumer Staples	20.1%	7.7%	2.6%	1.2%	9.4%	18.0%	31.0%	48.6%
Energy	14.1%	2.8%	-2.8%	2.2%	3.3%	16.8%	26.3%	44.8%
Financials	25.3%	11.0%	-1.2%	2.6%	16.4%	18.9%	30.3%	64.4%
Health Care	21.7%	7.8%	2.4%	4.3%	17.0%	27.5%	37.8%	59.7%
Industrials	20.9%	8.4%	3.3%	2.0%	3.0%	15.0%	27.2%	43.7%
Information Technology	42.7%	25.9%	7.9%	3.2%	1.9%	-3.8%	10.8%	46.0%
Materials	19.9%	9.2%	5.7%	1.7%	-1.3%	2.9%	7.0%	17.9%
Real Estate	5.7%	5.9%	1.6%	1.7%	4.7%	9.0%	16.5%	47.5%
Utilities	14.3%	6.1%	-2.5%	0.0%	7.0%	16.3%	14.6%	21.2%
S&P 500 Index	**20.5%**	**8.9%**	**2.4%**	**2.3%**	**7.2%**	**14.1%**	**23.0%**	**41.4%**

Sources: Bloomberg and Wells Fargo Investment Institute. Data as of August 5, 2024. Baseline date is July 5, 1995. Table color coded relative to S&P 500 Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

While the 1995 analogy may be fitting, every cycle has its own unique characteristics. For example, inflation peaked at a much higher rate during the current cycle, and the Fed has held rates at peak levels for much longer. Even so, we think the U.S. economy will avoid a recession and gradually strengthen through 2025. This, along with easier financial conditions, should support continued corporate earnings growth, equity-market strength, and our favorability toward high-quality companies within U.S. Large Cap Equities.

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Fixed Income

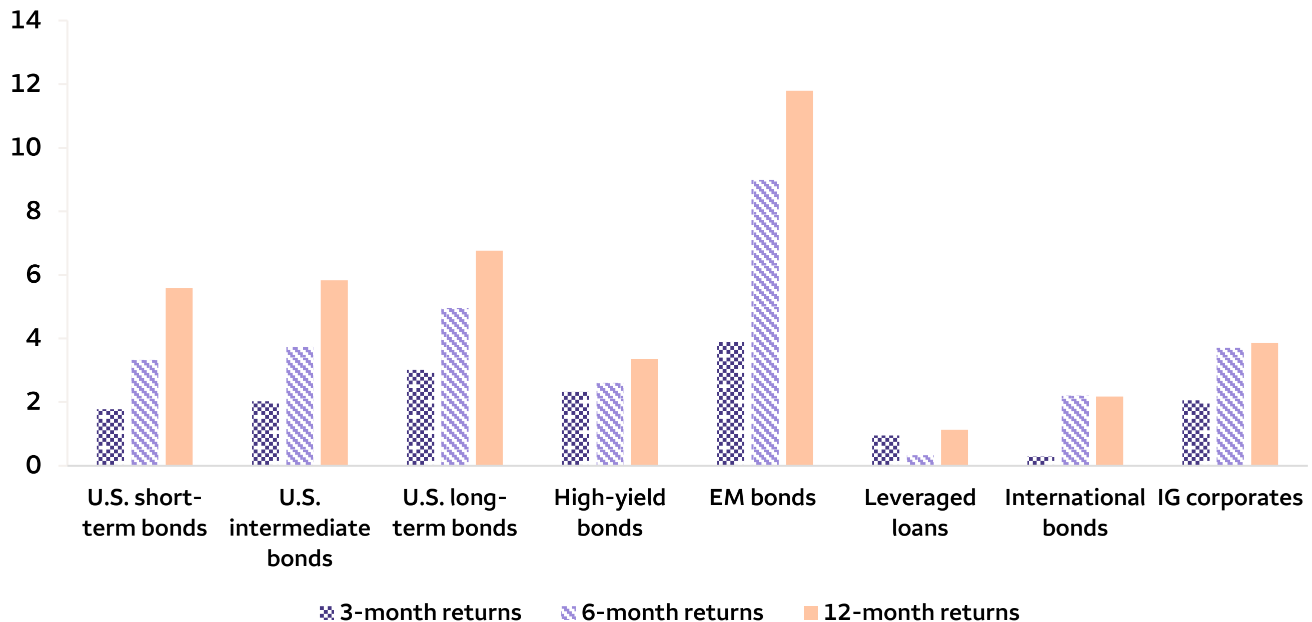
Tony Miano, CFA
Investment Strategy Analyst

Rate cuts have favored higher quality

Fixed-income investors have reacted jubilantly to the potential for U.S. rate cuts, with the market pricing in eight or more before the end of 2025. This potential has buoyed some bond market optimism. Theoretically, most major asset classes should benefit in some way from lower rates. However, the circumstances that allow significant cuts may have a different effect.

Significant Fed rate cuts would likely require a notable economic slowdown. Although recession is not our base case, a mild economic slowdown could still add volatility to the bond markets. Rate cuts could potentially take months to filter through the economy, and investors in some fixed-income asset classes and sectors could be negatively impacted by a still-slowing economy. The chart below shows returns for major fixed-income asset classes following the start of the past eight Fed easing cycles. U.S. investment-grade bonds have tended to hold up well in the months following cuts, but more speculative asset classes such as leveraged loans have tended to struggle or see more variable returns.

Average fixed-income asset performance following the beginning of a rate-cutting cycle



Sources: Bloomberg. Data as of July 30, 2024. Average of returns following the beginning of five different cutting cycles since 1995. (Cutting cycles began July 6, 1995; September 29, 1998; January 3, 2001; September 18, 2007; and July 31, 2019.) Data for leveraged loans only includes four cutting cycles since 1998. EM = emerging market. IG = investment grade. Please see end of report for asset class index definitions. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Rate cuts help financial conditions but are only one part of the story, and they should not be viewed as a clear signal to overweight more speculative fixed income asset classes and sectors. We generally favor high-quality investments in U.S. Intermediate Term Taxable Fixed Income but do not favor more speculative Leveraged Loans and neutral on High Yield Taxable Fixed Income and High Yield Municipal Bonds. In our view, this approach should best position fixed-income portfolios for the mild economic slowdown that we expect.

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Real Assets

Mason Mendez
Investment Strategy Analyst

John LaForge
Head of Real Asset Strategy

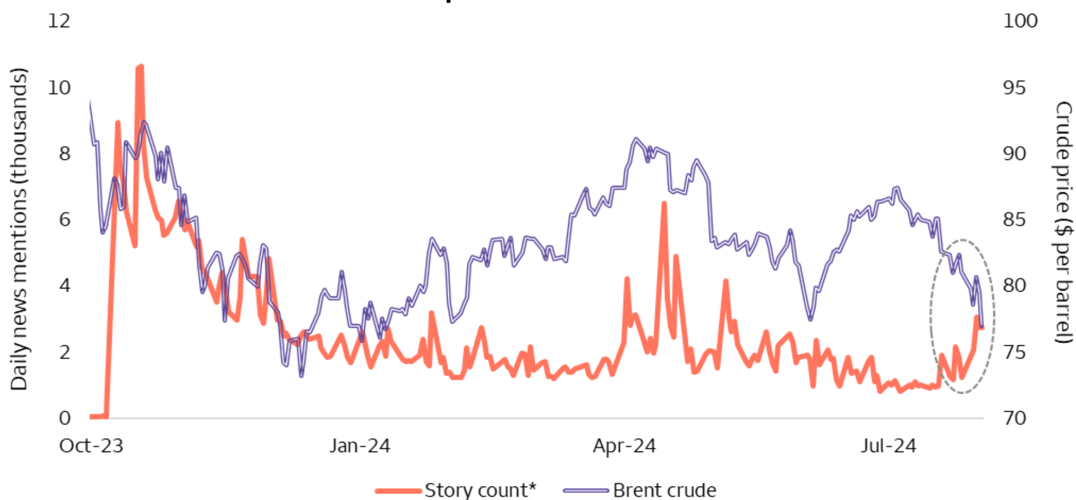
Oil's muted response to rising geopolitical tensions

Geopolitical tensions in the Middle East have escalated further over the past few weeks, particularly after the violent deaths of some Hamas and Hezbollah leaders. Iran blames Israel for both deaths. The events were unique during the ongoing conflict as they played out in Tehran, the capital of Iran, and Beirut, the capital of Lebanon. This has not only raised the risk of more regional conflicts, but it has also increased the odds of a global oil supply shortage, if Iran's allies in Yemen join any Iranian-led attacks. The Strait of Hormuz, located between Oman and Iran, is one of the most active waterways exporting crude oil to the world. In fact, nearly 21% of global daily crude-oil demand is filled by supplies flowing through the Strait of Hormuz.[1]

Despite rising odds of a global supply shortage, it has surprised some that oil prices have not risen in recent weeks. Considering that some of the most notable oil price spikes in history have been connected to conflicts in the Middle East, the surprise is understandable. The difference with this conflict is that it has lasted longer than most. Early in conflicts, oil markets tend to be highly sensitive to potential disruptions to global trade, and often spike based on these fears. As conflicts rage on, however, oil markets become less jittery with time, as supply and trade risks become better understood. The current conflict is a good case in point, seen in the chart below. Early in the conflict, with trade and supply risks not well understood yet, oil prices (purple line) often moved with the number of news stories (orange line) reporting on it. Notice in recent months however, that oil prices have become less sensitive to the additional news stories.

The bottom line is that oil prices are no longer baking-in a geopolitical risk premium for the current Middle East conflict. Oil prices, which have fallen to the mid-$70s per barrel range, are likely reflecting the true global supply-demand balance. Investors should be aware, though, that supply and trade disruption risks appear to be rising. If they continue to rise, we would not be surprised to see oil markets quickly reattach a $5-$15 per barrel geopolitical risk premium.

Middle East tensions versus crude-oil prices



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data is from October 2, 2023 – August 2, 2024. *Represents stories related to the war between Israel and Hamas.

1. Source: U.S. Energy Information Administration's 2023 annual data

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Alternatives

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

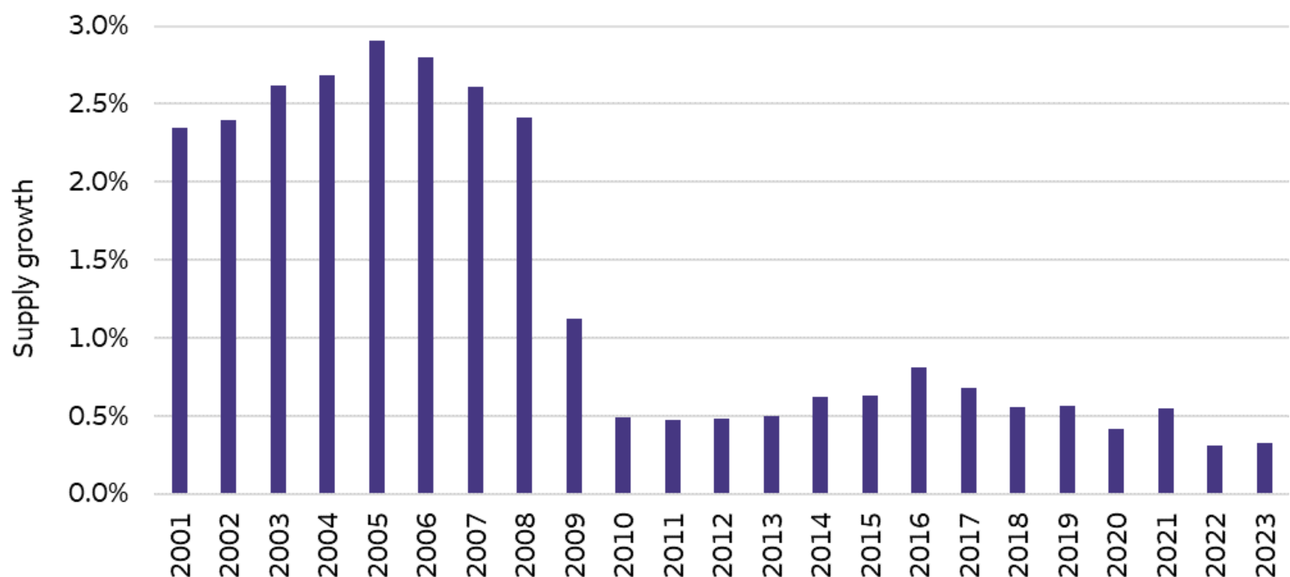
The beauty of limited new supply for retail real estate

Fundamentals for retail real estate ended on a high note in 2023. Occupancy stayed near record levels, aided by strong leasing activities and a high tenant-retention rate. Further, a dearth of new supply left negotiating leverage in favor of the landlords and allowed rents to grow.

Going forward, several structural drivers will likely continue to shape retail real estate. First, we believe new supply will remain limited in the near future. Stagnant rent growth and elevated construction costs will likely slow any new development within retail real estate as profitability remains challenged. Second, retailers have increasingly adopted a hybrid business approach in recent years, driven by the growth of e-commerce and the global pandemic. However, instead of abandoning brick-and-mortar stores, retailers have begun to rediscover the value of having a physical presence that is near their customer base. Brick-and-mortar stores have played a vital role in lowering retailers' distribution and fulfillment costs as well as improving customer engagement and retention. According to Green Street, with more store openings than closures in recent years, many retailers plan to further expand their physical footprints.

That said, we continue to see economic uncertainties, elevated financing costs, rising credit-card delinquencies, and weakening spending by lower-income consumers as the main risks to retail real estate. Further, tenant turnover and bankruptcies as well as strong bargaining power by key retailers may keep rent growth and operating income in line with other property types. The sector also needs to successfully navigate new consumer trends and retail-industry transformations to shine over the long term.

Retail real estate sees limited new supply



Sources: Green Street and Wells Fargo Investment Institute. Data as of May 30, 2024.

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
	U.S. Long Term Taxable Fixed Income U.S. Short Term Taxable Fixed Income	Cash Alternatives Developed Market Ex-U.S. Fixed Income Emerging Market Fixed Income High Yield Taxable Fixed Income	U.S. Intermediate Term Taxable Fixed Income U.S. Taxable Investment Grade Fixed Income	

Equities

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
	Emerging Market Equities	Developed Market Ex-U.S. Equities U.S. Mid Cap Equities U.S. Small Cap 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, August 12, 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 are not guaranteed and 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. **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. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. 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

Short Term Taxable Fixed Income. **Bloomberg U.S. Aggregate 1-3 Year Bond Index** is the one to three year component of the Bloomberg U.S. Aggregate Bond Index, which represents fixed-income securities that are SEC-registered, taxable, dollar-denominated, and investment-grade.

Intermediate Term Taxable Fixed Income. **Bloomberg U.S. Aggregate 5-7 Year 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 with maturities of 5-7 years.

Long Term Taxable Fixed Income. **Bloomberg U.S. Aggregate 10+ Year 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 with maturities of 10 years or more.

High Yield Taxable Fixed Income. **Bloomberg U.S. Corporate High-Yield Index** covers the universe of fixed-rate, non-investment-grade debt.

Emerging Market Fixed Income (U.S. dollar). **J.P. Morgan Emerging Markets Bond Index (EMBI Global)** currently covers more than 60 emerging market countries. Included in the EMBI Global are U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

Leveraged Loans. **S&P/LSTA Leveraged Loan Index** is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads and interest payments.

Developed Market Ex-U.S. Fixed Income (Unhedged). **J.P. Morgan GBI Global ex-U.S. Index (Unhedged)** in USD is an unmanaged index market representative of the total return performance in U.S. dollars on an unhedged basis of major non-U.S. bond markets.

U.S. Investment Grade Corporate Fixed Income. **Bloomberg U.S. Corporate Bond Index** measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

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S&P 500 Index is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation and financial companies.

An index is unmanaged and not available for direct investment.

Investment Grade bonds - A rating that indicates that a municipal or corporate bond has a relatively low risk of default. Bond rating firms, such as Standard & Poor's, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ('BB', 'B', 'CCC', etc.) are considered low credit quality, and are commonly referred to as "junk bonds".

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