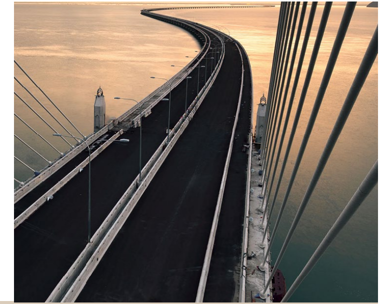

Investment Strategy

Weekly guidance from our Investment Strategy Committee **August 26, 2024**

Real Assets Spotlight: Remaining cautious on Real Estate 2

- Real estate investment trust (REIT) performance has picked up recently as markets have started anticipating interest-rate cuts by the Federal Reserve (Fed).
- But lower interest rates by themselves are insufficient for outperformance. So we remain cautious on Real Estate relative to the other equity sectors and continue to rank it as unfavorable.

Equities: An active August: Recapping guidance and target changes 4

- On August 6, we upgraded U.S. Small Cap Equities from most unfavorable to neutral and upgraded the Communication Services sector from neutral to favorable. Meanwhile, we downgraded the Health Care sector from favorable to neutral.
- On August 14, we increased our 2024 and 2025 S&P 500 Index price and earnings-per-share (EPS) targets. We also tweaked our Russell Midcap and Russell 2000 Index EPS targets due to index reconstitutions.

Fixed Income: Credit spreads react to recent market volatility...................5

- We upgraded our guidance on High Yield (HY) Taxable Fixed Income to neutral from unfavorable as credit spreads widened, creating a more attractive entry opportunity.
- Furthermore, fundamentals still appear to be supportive of HY. Several credit metrics in this asset class, like interest coverage, have improved while the default rate has started to decline after peaking in April for this cycle.

Alternatives: Lower rates may spur greater merger volumes 6

- Merger and acquisition (M&A) activity remains below long-term trends yet has improved modestly from the lows in early 2023.
- The outlook for interest-rate cuts in late 2024 into early 2025 and a gradually recovering economy may spawn greater levels of M&A activity in the coming quarters.

Current tactical guidance 7

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Real Assets Spotlight

John LaForge
Head of Real Asset Strategy

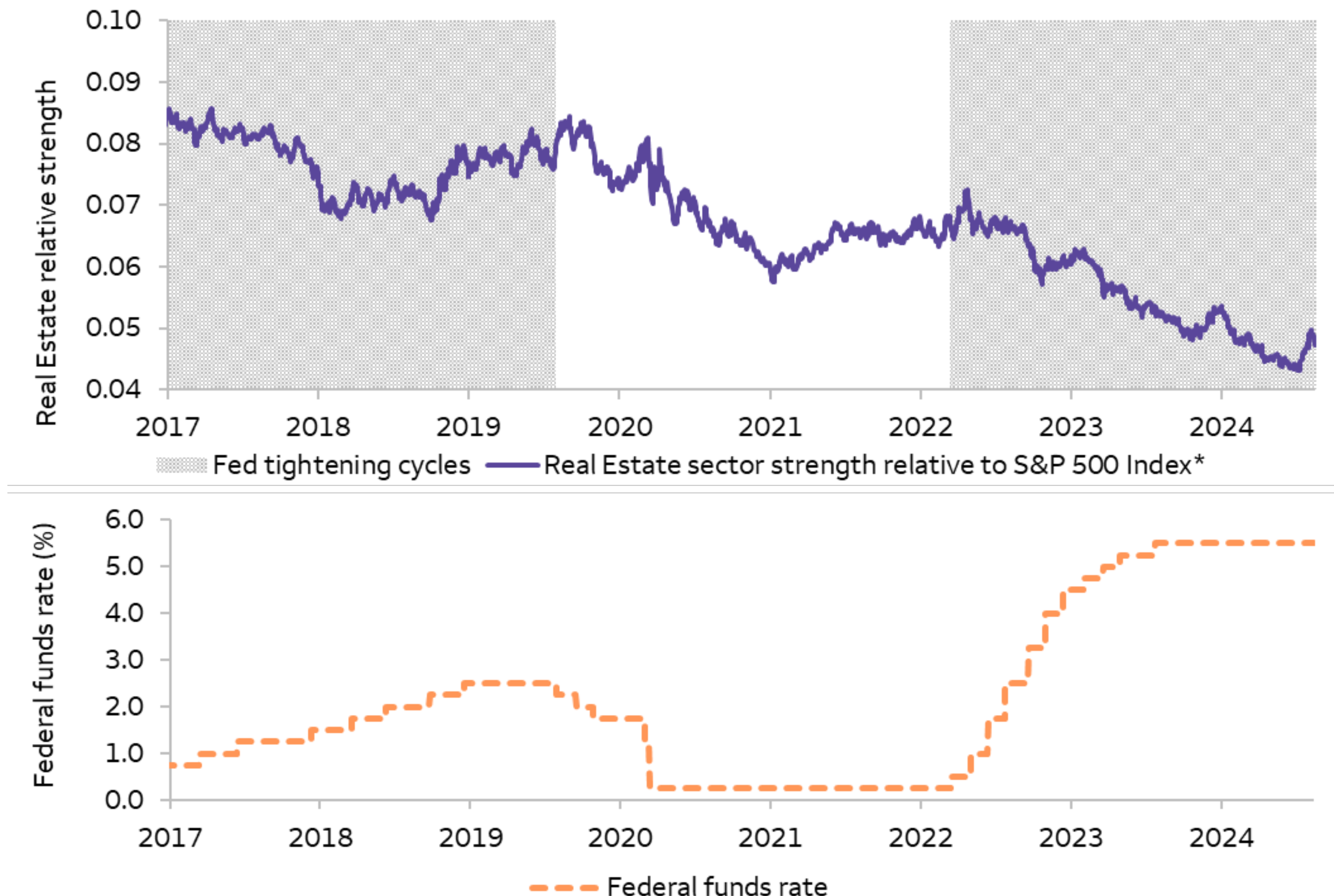
Mason Mendez
Investment Strategy Analyst

Remaining cautious on Real Estate

We have been cautious on public real estate investment trusts (REITs) overall for a few years now, and when comparing Real Estate to other equity sectors, we have been downright negative. Since March 2022, we have had the S&P 500 Real Estate sector ranked unfavorable in relation to the other S&P 500 sectors. This relative performance call can be seen as the solid line in the top panel of the chart below.

While the unfavorable call has been one of our strongest for much of the past two years, it has not helped over the past few months. From July 1 through August 16, REITs (as measured by the S&P 500 Real Estate Index) were higher by 9.9% while the S&P 500 Index gained 1.4%. This recent outperformance by REITs is due to markets anticipating a shift in interest-rate policy by the Federal Reserve (Fed). REITs have historically been sensitive to interest-rates changes as they typically need access to external capital to fund acquisition and development activities. It was this historical connection, in fact, that swayed us to downgrade Real Estate to unfavorable back in March 2022.

Chart 1. REIT relative performance in high interest-rate environments



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data is from January 1, 2017 – August 16, 2024. *Relative strength is calculated as the S&P 500 Real Estate Index divided by the S&P 500 Index. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.**

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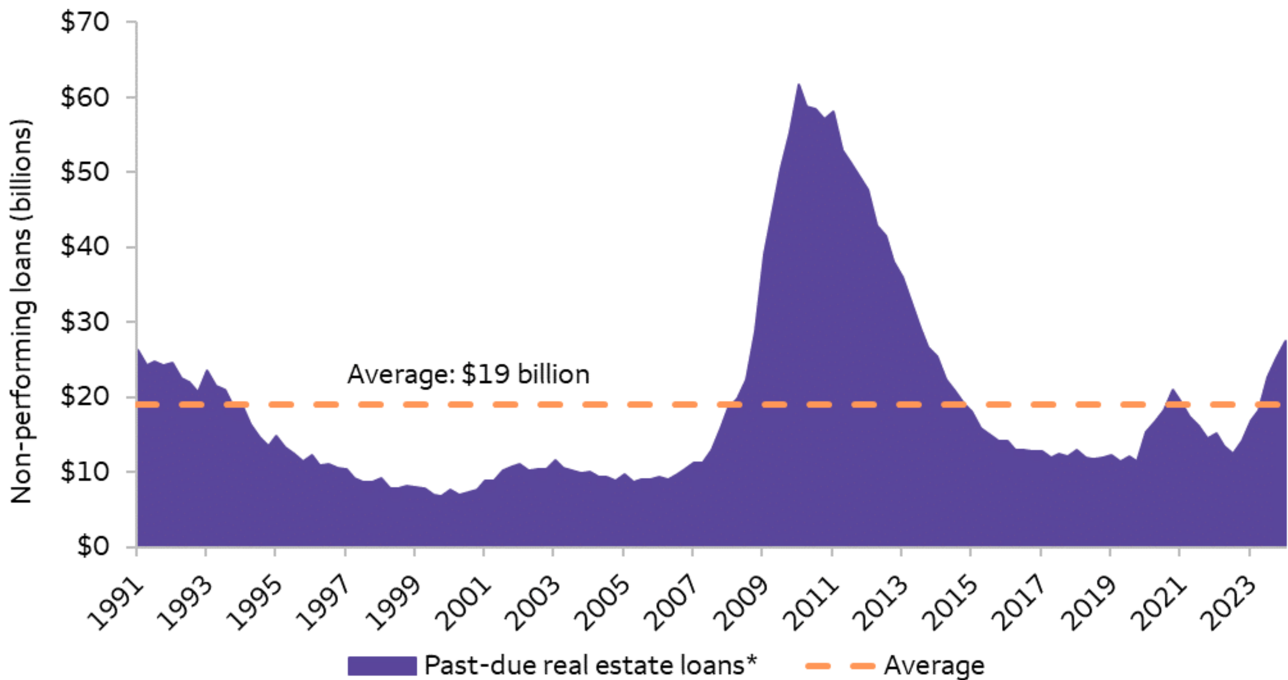
With Fed interest-rate policy likely shifting soon, we have considered lifting Real Estate out of the unfavorable cellar. We have decided not to at this time, though. Our reasoning for keeping Real Estate at unfavorable is threefold. First, low or declining interest rates is not a slam-dunk recipe for REIT outperformance — notice in the chart above that the relative performance of REITs stayed negative through much of the 2020 – 2022 period, when interest rates were falling and neared zero. Second, REITs have shown poor relative strength for years, and we are not convinced that this long-term trend has changed. Lastly, we are forecasting that the U.S. economy should continue to decelerate into early 2025. If this does occur, we suspect that the more economically sensitive areas like real estate could suffer. Further, the chart below shows that in recent years, past-due real estate loans have risen to levels last seen in 2013.

Chart 2. Past-due real estate loans



Sources: Bloomberg and Wells Fargo Investment Institute. Quarterly data from March 31, 1991 – March 31, 2024. *Reflects the combined count for real estate loans secured by non-farm, non-residential properties that were overdue by 30 – 89 days or 90-plus days as well as those in non-accrual status.

The bottom line is that despite the potential for the Fed to begin cutting interest rates later this year, we remain unfavorable on the Real Estate sector relative to other equities. REITs have outperformed in recent months because of the Fed's potential shift, but we are not yet convinced that the positive performance will last. History shows that it is not a guarantee that lower interest rates will lead to REIT outperformance. In addition, our expectation for a decelerating U.S. economy raises concerns given REITs' sensitivity to economic conditions. Within the Real Estate sector, we favor sub-sectors that are relatively less cyclically sensitive and those that are experiencing high demand from thematic trends, such as the adoption of generative artificial intelligence. These sectors include Data Center REITs, Industrial REITs, Self-Storage REITs, and Telecommunications REITs.

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Equities

"Great things are done by a series of small things brought together." — Vincent van Gogh

Austin Pickle, CFA
Investment Strategy Analyst

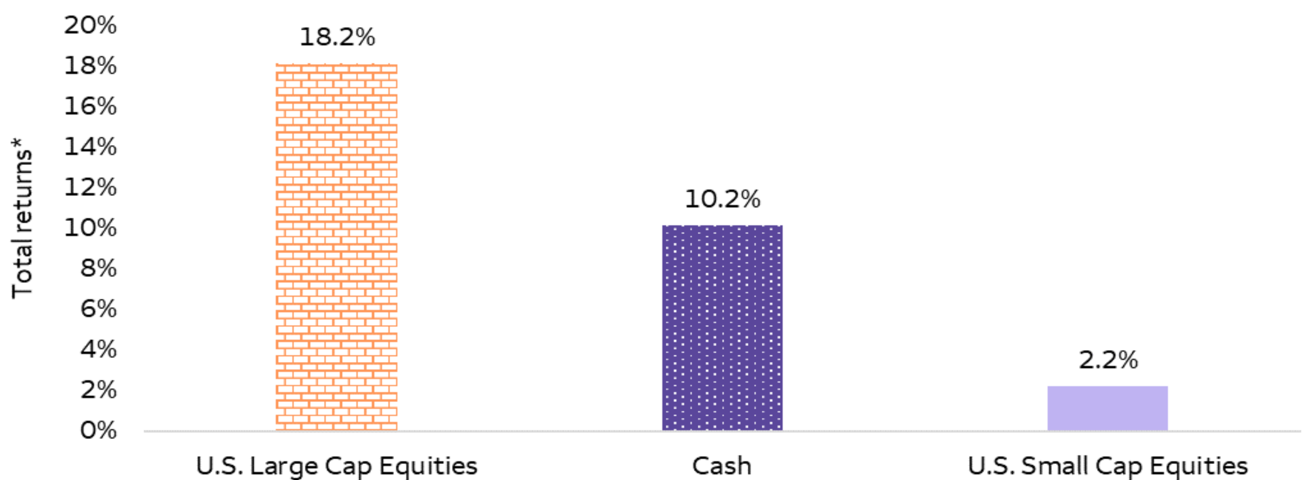
An active August: Recapping guidance and target changes

On August 6, we upgraded U.S. Small Cap Equities from most unfavorable to neutral and upgraded the Communication Services sector from neutral to favorable. Meanwhile, we downgraded the Health Care sector from favorable to neutral. Then on August 14, we published new S&P 500 Index earnings-per-share (EPS) and price targets and tweaked Russell Midcap and Russell 2000 Index EPS targets.[1] We recap the rationale below.

U.S. Small Cap Equities considerably underperformed the S&P 500 Index (and even cash) between our initial unfavorable rating on March 30, 2022, and our upgrade to neutral on August 6 (see chart). The fact that many small companies are unprofitable and lack the balance sheet quality of their large peers keeps our preference for large caps (favorable) over small caps intact. Still we believe the most extreme operating difficulties are in the past and the period of significant small cap underperformance appears to be closing. Additionally, the recent Communication Services selloff provided an opportunity to upgrade a sector with multiple secular earnings drivers — including search, social media, and the development of artificial intelligence (AI) — at attractive valuations. Alternatively, Health Care outperformance provided an opportunity to downgrade the more defensive sector as we approach our forecasted economic pivot to faster growth.

S&P 500 Index companies have demonstrated an intense focus on efficiencies that has allowed profit margins to improve more than we had initially anticipated. As a result, on August 14, we adjusted higher our 2024 and 2025 price and EPS targets for the S&P 500 Index, which now stand at 5300 – 5500 and $245 for 2024 and 5900 – 6100 and $270 for 2025. We also made modest tweaks to our Russell Midcap and Russell 2000 Index EPS targets to account for index reconstitutions.

Small caps underperformed while we were unfavorable



Sources: Bloomberg and Wells Fargo Investment Institute. *Total returns from March 30, 2022 – August 6, 2024. U.S. Small Cap Equities represented by the Russell 2000 Index. U.S. Large Cap Equities represented by the S&P 500 Total Return Index. Cash represented by the Bloomberg U.S. Treasury Bills Total Return Index. Total returns include reinvested dividends and interest income as well as price movement. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.** Please see end of report for index definitions.

1. Please see the August 6 and 14 Institute Alerts, "Rebalancing portfolio allocations" and "Adjusting targets as economy's pivot approaches", for more details.

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Fixed Income

Luis Alvarado
Global Fixed Income Strategist

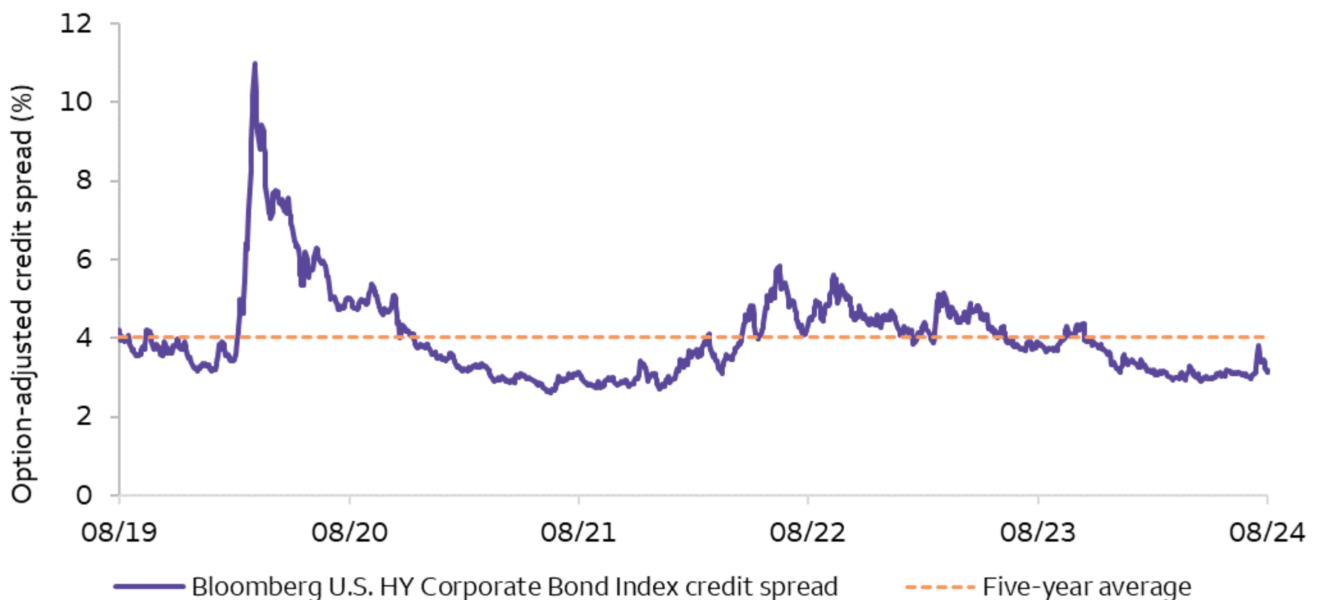
Credit spreads react to recent market volatility

Credit spread is the additional yield a fixed-income investor receives over the risk-free rate of return (often measured by a 10-year U.S. Treasury). Credit spreads tend to increase during periods of uncertainty as investors negatively price the capacity of debt issuers to make payments. In general, if credit spreads increase, bond prices fall. However, if credit spreads fall, investors may experience a positive contribution toward total return.

During the most recent market volatility in early August, we observed credit spreads in the Bloomberg U.S. High Yield (HY) Corporate Bond Index increase (see chart), creating an attractive entry opportunity into this asset class. At that time, we updated our guidance on High Yield Taxable Fixed Income to neutral from unfavorable. Furthermore, fundamentals still appear to HY. Several credit metrics in this asset class, like interest coverage, have improved while the default rate has already started to decline after peaking in April for this cycle.

The expectation for lower interest rates over the next 12 months as the Fed prepares to begin a new interest-rate cutting cycle coupled with continued economic growth prospects in 2025 may make HY more attractive for income-oriented investors. For now, we will continue to evaluate the merits of HY exposure, balancing the benefits of the additional yield pickup versus increasing risks in light of a potential economic slowdown in the second half of 2024. Differences remain evident among HY sectors and credit ratings, so selectivity remains important. We favor professional, active management as we believe investors will require more due diligence to uncover HY value and yield potential.

HY credit spread still trading below five-year average



Sources: Wells Fargo Investment Institute and Bloomberg. Data as of August 20, 2024. Daily data from August 20, 2019 – August 20, 2024. Option-adjusted spread (OAS) is the spread relative to a risk-free interest rate. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.** Please see end of report for index definitions.

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Alternatives

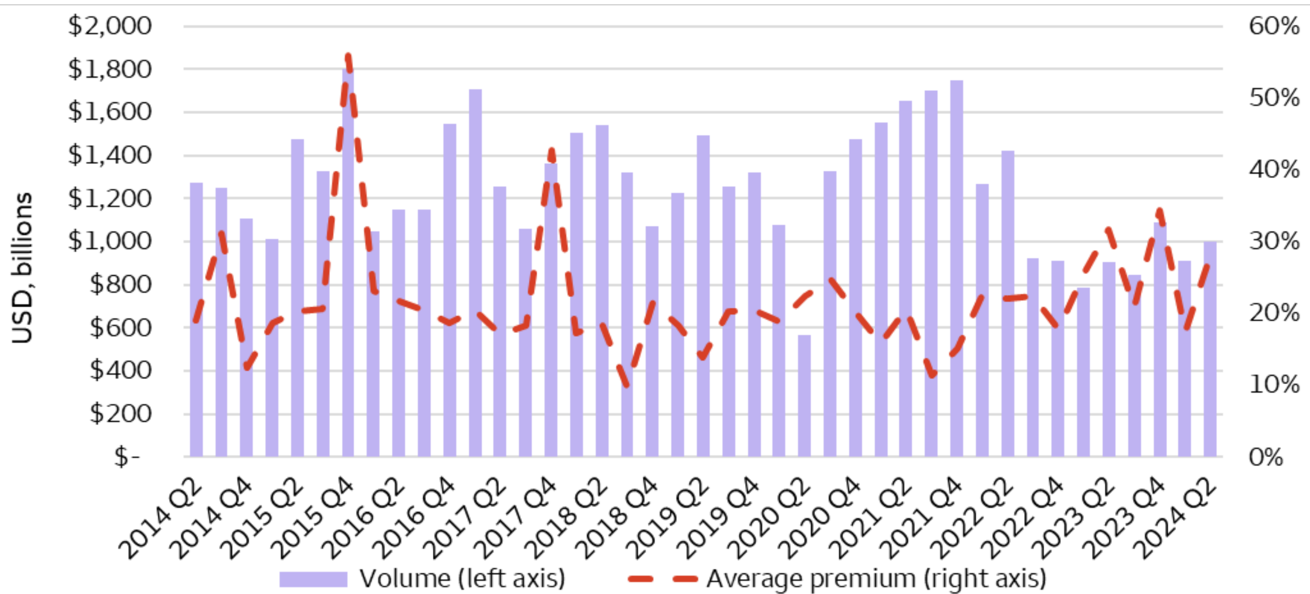
Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

Lower rates may spur greater merger volumes

Merger and acquisition (M&A) activity remains below long-term trends yet has improved modestly from the lows in early 2023. The recent improvement is due in part to the growing confidence that the Fed may be able to navigate a softer landing for the economy. In addition, the increased likelihood that interest-rate cuts may begin in late 2024 and continue into 2025 has many investors optimistic that deal activity will rise as financing conditions improve.

For most mergers, the acquirer generally offers to pay a premium to the target company's current stock price. While the majority of the spread (between offering price and current price) converges very quickly after the announcement, a portion of the premium often persists and is dependent on the successful completion of the merger. Most Merger Arbitrage strategies attempt to capture this post-announcement spread. The primary drivers of these strategies include the size of the residual premium, the time it takes to complete the merger, and the risk that a merger may not be finalized. Current premiums and the length of time required to close a deal have remained in-line with longer-term averages[2], yet deal activity has been slow to recover. The higher interest-rate environment, a lack of confidence by corporate leaders, and slow economic growth may be contributing factors to the lack of deal activity. We continue to look for green shoots, and a more accommodative financing environment may be enough to spawn greater levels of activity in the coming quarters.

M&A deal volumes remain relatively low while premiums remain rangebound



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of September 30, 2023. The average premium reflects all announced deals on a global basis and includes those in pending, proposed, terminated, completed, and withdrawn status. Volume reflects the aggregate value of all announced deals on a global basis and includes those in pending, proposed, completed, withdrawn, and terminated status. USD = U.S. dollar.

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.

2. Citi Event Driven M&A Executive Summary, July 2024.

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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 26, 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. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is appropriate only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

Bloomberg U.S. Corporate High Yield Index covers the universe of fixed-rate, noninvestment-grade debt.

Bloomberg U.S. Treasury Total Return Index is a market index that tracks the performance of U.S. Treasury bills.

Russell Midcap® Index measures the performance of the 800 smallest companies in 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. The Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

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.

S&P 500 Total Return Index is a total return index that reflects both changes in the prices of stocks in the S&P 500 Index as well as the reinvestment of the dividend income from its underlying stocks.

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

An index is unmanaged and not available for direct investment.

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