WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **September 3, 2024**

Asset Allocation Spotlight: Diversifying can help smooth returns by reducing drawdowns 2

- During the early-August drawdown, a diversified portfolio of equities, fixed income, and commodities experienced significantly less volatility than equity markets.
- Historically, a diversified portfolio has experienced smaller drawdowns and recovered quicker than the S&P 500 Index.

Equities: Credit card charge-offs still rising but may peak soon 4

- The charge-off rate[1] for credit card loans has steadily increased since reaching its pandemic low in late 2021.
- The increase in the delinquency rate[2], a leading indicator of charge-offs, has been falling on a year-over-year basis, suggesting a peak in the charge-off rate may occur in the near future.

Fixed Income: Diversification remains important in fixed income 5

- Rate volatility varies across fixed-income sectors.
- Investors can take advantage of differences in yield changes across maturities in making investment decisions for their fixed-income portfolios.

Real Assets: U.S. crude inventories fall to six-month low 6

- Despite concerns over slowing crude-oil demand, U.S. inventories fell to a six-month low as of August 16, 2024.
- Consistent U.S. inventory declines could be a bullish sign for prices.

Alternatives: Middle-market buyout funds remain strong 7

- Middle-market buyout funds outperformed their larger counterparts for six consecutive quarters through the third quarter of 2023, the most recently available data.
- Smaller funds' outperformance may be related to their operation in a less efficient market, generally lower valuations, and fund managers' greater ability to add value.

Current tactical guidance 8

Investment and Insurance Products: ➤ NOT FDIC Insured ➤ NO Bank Guarantee ➤ MAY Lose Value

1. A credit card loan is charged off when an issuer does not believe an outstanding balance is recoverable and is written off as a loss. The charge-off rate is stated as an annualized percentage of loans outstanding.

2. A credit card loan is considered delinquent when it is past due thirty days or more. The delinquency rate is stated as the balance of delinquent loans as a percentage of loans outstanding.

© 2024 Wells Fargo Investment Institute. All rights reserved.

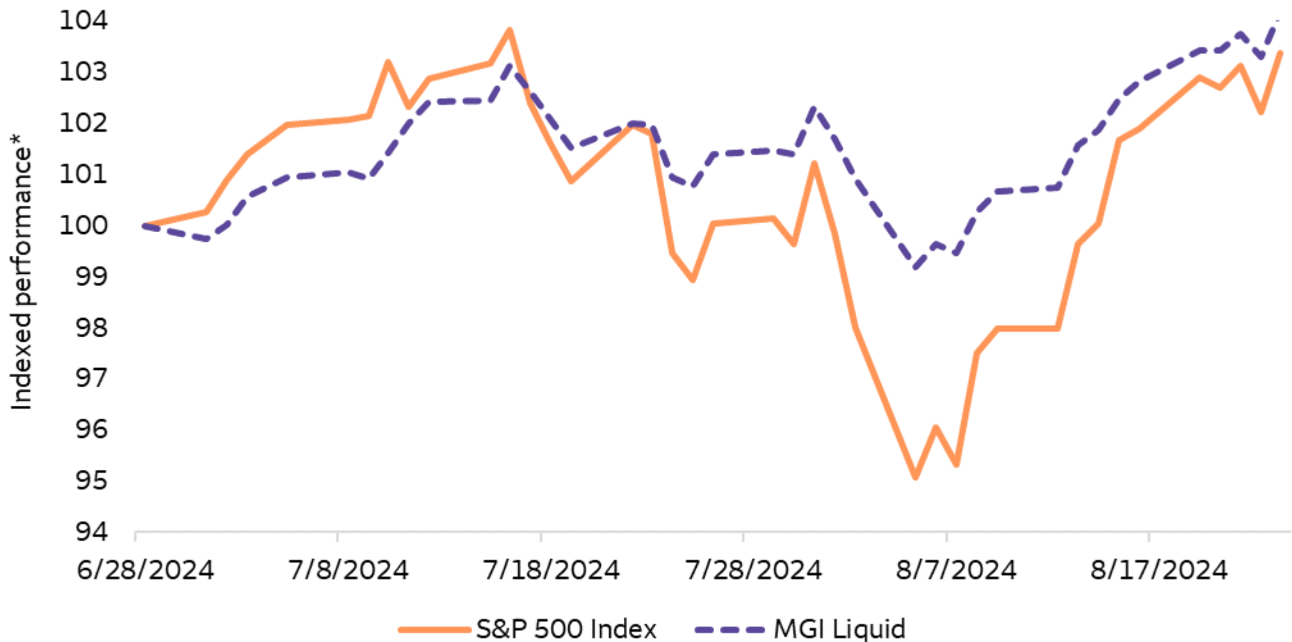
Asset Allocation Spotlight

Jeremy Folsom
Investment Strategy Analyst

Diversifying can help smooth returns by reducing drawdowns

In early August, U.S. equity markets dipped due to recessionary fears and the unwinding of global carry trades, sparked by a weak July employment report and the Bank of Japan's hawkish rate increase, respectively. The chart below shows that the S&P 500 Index's drawdown was significantly greater than that of our Moderate Growth and Income (MGI) Liquid allocation.[3] While the diversified MGI allocation experienced losses from its equity holdings, fixed-income gains helped to offset some of the losses.

MGI Liquid allocation experienced a modest drawdown during early-August selloff



Sources: Morningstar Direct, All Rights Reserved[4] and Wells Fargo Investment Institute. Data as of August 23, 2024. *Indexes are set to 100 as of closing prices on June 28, 2024. Index return information is provided for illustrative purposes only. Performance results for MGI Liquid are calculated using blended index returns. Results do not represent actual trading and the results achieved do not represent the experience of any individual investor. In addition, results do not reflect the impact of any fees, expenses or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. **Past performance does not guarantee future results.**

This event shows a key benefit of diversification: smoothing returns by holding assets that have low or even negative correlations with each other, meaning they tend to move in the same direction with varying magnitudes or even move in opposite directions. While stocks and bonds had been moving more in line with each other recently, causing the 20-year rolling average of stock-bond correlation to become slightly positive, we expect a return to the conditions of the prior two decades — that is, with a modest negative correlation between the two

3. The MGI Liquid composition and the definitions of the indexes and descriptions of the risks associated with investment in these asset classes are provided starting on page 9. The allocation is comprised of equities, fixed income, and commodities.
4. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.

© 2024 Wells Fargo Investment Institute. All rights reserved.

asset groups amplifying the benefits of diversification. Fixed-income holdings may prove especially beneficial during periods of economic uncertainty as expectations for a slowing economy can drive equities lower but also lead to price returns for bonds, as occurred in early August. These bond price appreciations often are driven by yields falling off prospects of the central bank cutting rates to support the economy, which was the case in August.

How the MGI Liquid allocation performs during drawdowns

While the market rebounded from the declines in early August quickly, historically this often has not been the case. A decline of a certain percentage requires a greater percentage increase to recoup the loss — for example, to recover from a 20% loss, a 25% gain is needed. For this reason, avoiding or minimizing drawdowns is helpful from not only a psychological standpoint (as investors do not see large declines in portfolio value) but also on a return basis. Looking to past bear markets[5], the table below shows that although the diversified MGI Liquid portfolio did experience significant peak-to-trough declines, they were on average significantly less than those of the S&P 500 Index. The diversified MGI allocation also recovered from those drawdowns significantly faster than the S&P 500 Index.

MGI Liquid portfolio has historically had lesser drawdowns and recovered faster

Bear-market recovery	Average peak-to-trough return	Average duration of drawdown (months)	Months to recover
3-month Treasury bill	3.61%	N/A	N/A
S&P 500 Index	-38.66%	10.9	37.5
MGI Liquid (rebalanced quarterly)	-20.16%	9.9	17.9

Sources: Morningstar Direct, All Rights Reserved[6] and Wells Fargo Investment Institute. Data as of August 23, 2024. Dates of drawdowns align with S&P 500 Index bear markets: August 26, 1987 – December 4, 1987; July 17, 1990 – October 11, 1990; March 27, 2000 – October 9, 2002; October 10, 2007 – March 9, 2009; and February 20, 2020 – March 23, 2020. Index return information is provided for illustrative purposes only. Performance results for MGI Liquid are calculated using blended index returns. Results do not represent actual trading and the results achieved do not represent the experience of any individual investor. In addition, results do not reflect the impact of any fees, expenses or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. **Past performance does not guarantee future results.** The MGI Liquid composition and the definitions of the indexes and descriptions of the risks associated with investment in these asset classes are provided starting on page 9.

Both the recent event in early August and historical performance underscore the value of diversification, especially during downturns or periods of market volatility. We recommend that investors remain disciplined, sticking to their chosen allocations and investment objectives while not overweighting a single asset or making portfolio adjustments based off fear of missing out or concerns over further declines.

5. Bear markets are declines of 20% or more.
6. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.

© 2024 Wells Fargo Investment Institute. All rights reserved.

Equities

Robert Hammel
Equity Sector Analyst, Financials

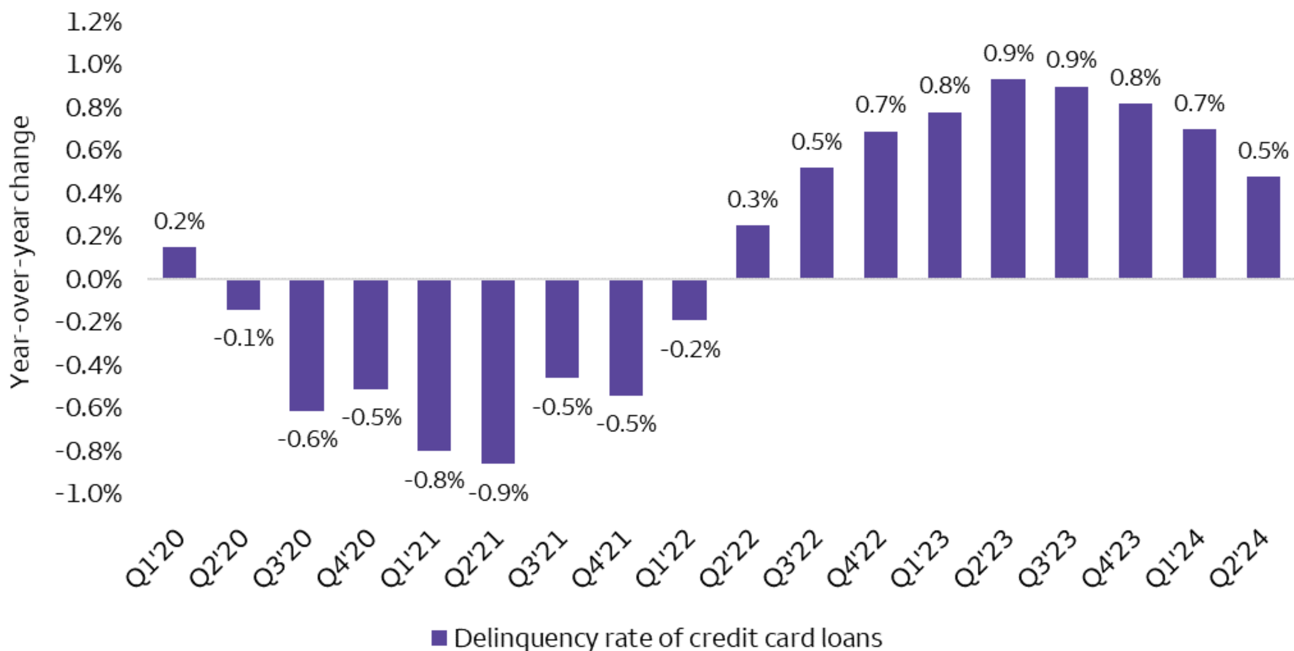
Credit card charge-offs still rising but may peak soon

Since reaching a pandemic low of 1.57% during the fourth quarter of 2021, the charge-off rate for credit card loans has steadily increased — it reached 4.73% during the second quarter of 2024, slightly above the long-term average of 4.26%.[7] While some observers believe the recent increase reflects deteriorating credit quality, others believe it suggests a normalization process following unusually low charge-offs during the pandemic.

While the medium-term path of charge-offs will likely be influenced by the labor market, whose strength remains in question following a string of softer data points, year-over-year (YOY) increases in the delinquency rate (a leading indicator of charge-offs) have been falling. During the second quarter of 2024, the YOY increase in the delinquency rate fell to 0.48%, down from 0.70% in the first quarter and the high-water mark of 0.93% during the second quarter of 2023. This suggests a near-term leveling off in charge-off rates, supporting an assertion made by some of the largest credit card issuers that charge-off rates will peak during the next couple quarters.

Putting that debate aside, we can more confidently state that credit performance to date shows relative strength for affluent consumers and weaker relative performance among lower- and middle-income consumers. This is evidenced by higher relative charge-off and delinquency rates at private-label credit card issuers and smaller financial institutions.

Year-over-year increase in credit card delinquency rates have been gradually falling since 2023 peak



Source: Board of Governors of the Federal Reserve System. Delinquency rate on credit card loans, all commercial banks. Data from January 1, 2020, through June 30, 2024.

---

7. Board of Governors of the Federal Reserve System. Delinquency rate on credit card loans, all commercial banks. Data from January 1, 1985, through June 30, 2024.

© 2024 Wells Fargo Investment Institute. All rights reserved.

Fixed Income

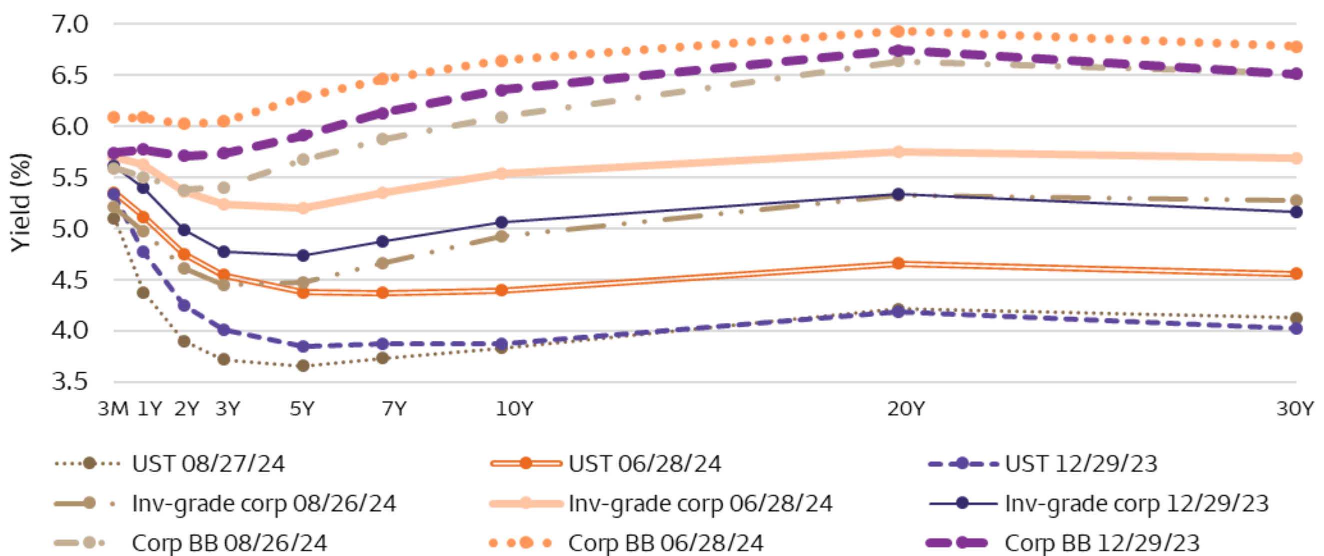
David Brandmire, CFA
Taxable Analyst

Diversification remains important in fixed income

Fixed-income investors have recently been treated to some of the highest yields over the past decade. The much neglected 20-year Treasury bond touched 4.93% in April. It is now priced at 4.20%, just slightly above where it started the year, at 4.19%.

Fixed-income investors have seen higher levels of rate volatility in 2024 as the Federal Reserve (Fed) has continued to fight the battle with inflation and economists have warned of a weakening economy. The chart below highlights rate movements across the Treasury, corporate investment-grade, and corporate-BB yield curves for the beginning of the year, the end of June, and current rate levels. Since the end of June, yields for Treasury and corporate investment-grade bonds have declined the most (bond prices rise when yields decline). The largest yield reductions have been in the 2-year to 7-year segments of the curves, ranging from 63 to 85 basis points (bps, 100 bps is 1%). The corporate-BB yields still declined between 58 and 64 bps over the corresponding segments.

Yield-curve comparison by sector and date



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of August 27, 2024. UST = U.S. Treasury. Inv-grade corp = Investment-grade corporate. Corp BB = corporate BB. **Past performance is no guarantee of future results.**

Although BB yields have declined, they now reflect better relative value compared to the Treasury and corporate investment-grade bonds. BB spreads are now 112 – 214 bps above Treasury bonds for the 1-year to 10-year segment of the curve. That compares to 100 – 247 bps at the start of the year and 97 – 225 bps at the end of June. Investors can also take advantage of the positive yield differential for BB corporate bonds, with the 5-year BB yield near 5.68% compared to the 3-month BB yield of 5.59%. Meanwhile, 5-year investment-grade bonds yield 50 bps less than 3-month investment-grade bonds.

We have favorable guidance on U.S. Intermediate Term Taxable Fixed Income and recently moved High Yield Taxable Fixed Income from unfavorable to neutral for tactical positioning. The rate volatility provides investors across fixed-income sectors with relative value opportunities that can enhance a portfolio's returns.

© 2024 Wells Fargo Investment Institute. All rights reserved.

Real Assets

John LaForge
Head of Real Asset Strategy

Mason Mendez
Investment Strategy Analyst

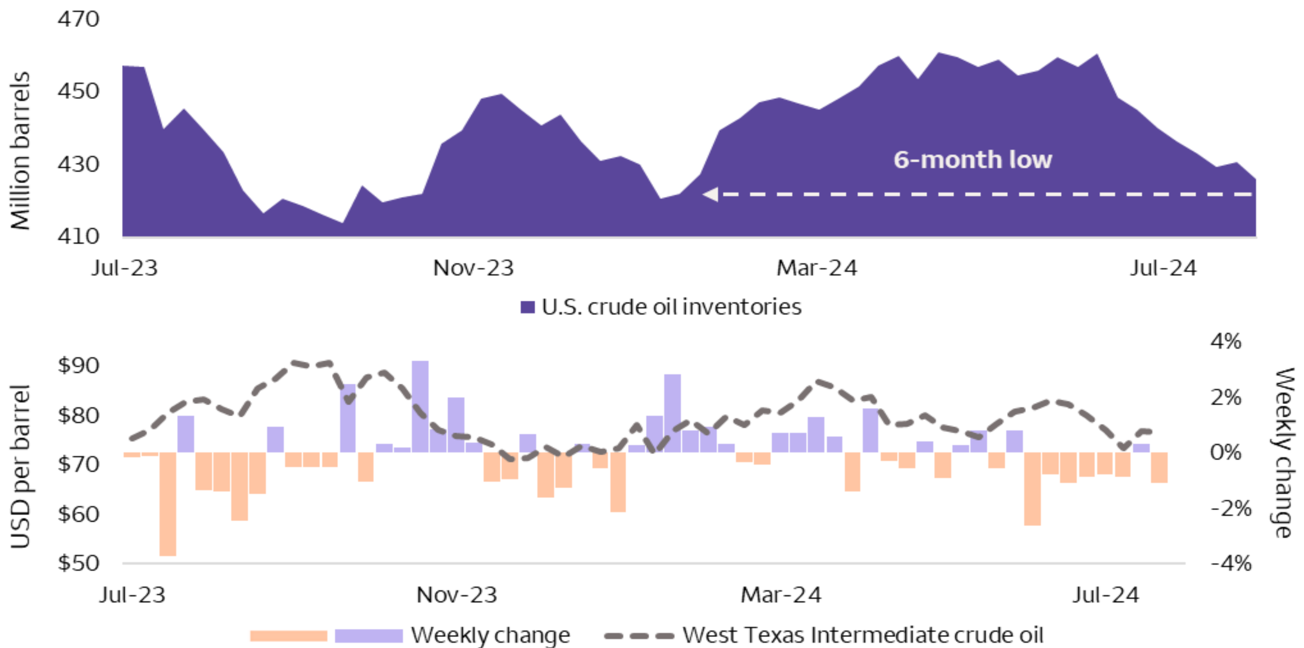
U.S. crude inventories fall to six-month low

As the U.S. entered its summer driving season this past May, many were concerned that demand would slow with the U.S. economy. While the U.S. economy did slow some, demand for U.S. crude oil did not. In fact, demand was strong enough to draw down U.S. crude-oil inventories to six-month lows (excluding the strategic petroleum reserve).

In the past, large U.S. crude-oil inventory drawdowns have often been associated with large drops in U.S. crude-oil production growth too. This has not been the case in 2024, however. The U.S., the world's largest crude-oil producer, has been producing near record high levels lately, averaging 13.17 million barrels per day since January 2024. Still, U.S. demand growth has been enough to outpace supply growth. It is this growth gap between demand and supply that has us positive on energy-related assets over a tactical timeframe. It is also the same growth gap that is driving the commodity bull super-cycle[8] that began in March 2020.

The bottom line is that within Commodities, we remain favorable on Energy — this includes crude oil as global demand growth continues to outstrip global supply growth. We do not see this balance changing anytime soon, which should lead to higher oil prices over the tactical horizon. For 2024, we expect prices to rise between $80 – $90 per barrel for West Texas Intermediate and $85 – $95 for Brent crude. For 2025, our target ranges are higher by $5 per barrel as we expect economic conditions to improve.

U.S. crude inventories fall to six-month low



Sources: Bloomberg, Energy Information Administration, and Wells Fargo Investment Institute. Weekly data from July 14, 2023 – August 16, 2024. USD = U.S. dollar. **Past performance is no guarantee of future results.**

8. Bull super cycles are an extended period of time, historically 15 – 20 years, where commodity prices move upward together.

© 2024 Wells Fargo Investment Institute. All rights reserved.

Alternatives

Sam Lombardo
Investment Strategy Analyst

Middle-market buyout funds remain strong

Middle-market buyout funds have outperformed their larger counterparts for the past six consecutive quarters as of the third quarter of 2023, the most recently available data.[9] Preliminary data for the fourth quarter suggests continued outperformance.[10] Several factors may account for this performance advantage, most notably:

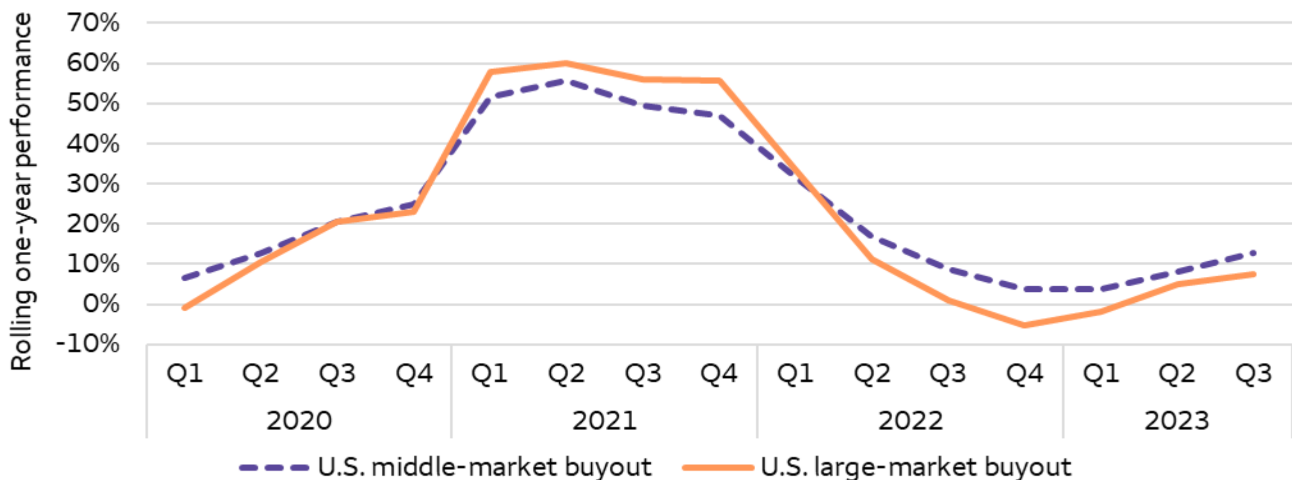
Less efficient market: While smaller companies (revenues less than $250 million) vastly outnumber their larger counterparts (by over 12x), small- and mid-cap buyout funds account for only about 15% of the capital raised.[11]

Lower valuations: Smaller buyout deals often trade at lower valuations, allowing investors to buy at a lower price, grow the business, and potentially sell a much larger business at higher valuations.

Greater ability to add value: Small- and mid-cap buyout fund managers may have more opportunities to add value by recruiting talented management to streamline operations and drive productivity gains.

In addition, the appetite for large buyout deals has declined as higher interest rates have constrained lending, most impacting the larger deals financed through the broadly syndicated loan market. Conversely, the smaller buyouts were often financed by private direct lenders, which continued to provide significant capital for new loan originations despite the challenging environment. Despite the uncertain economic growth, we maintain our favorable guidance on the Small- and Mid-Cap Buyout strategy. However, as inflation falls and the job market remains weak, the Fed has signaled that it will begin its next easing cycle. A lower interest-rate environment may lead to a revival in the larger deal market as well. We will continue to watch for signs of improvement and may look to upgrade the Large Cap Buyout strategy as the risks continue to fade and a gradual economic recovery takes hold.

Middle-market funds have seen continued outperformance over their larger counterparts in recent quarters



Source: PitchBook. Data as of September 30, 2023. See page 10 for a definition of the funds.

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. **Past performance is no guarantee of future results.**

9. Middle-market buyout funds are those that raise between $100 million and $5 billion while large buyout funds are those that raise greater than $5 billion.
10. PitchBook, "US PE Middle Market Report," first-quarter 2024.
11. RCP Advisors, "The Case for Small Buyouts," July 17, 2024.

© 2024 Wells Fargo Investment Institute. All rights reserved.

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, September 3, 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.

© 2024 Wells Fargo Investment Institute. All rights reserved.

Risk considerations

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

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

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

Definitions

An index is unmanaged and not available for direct investment.

Bloomberg U.S. Treasury Bills (1-3M) 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.

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.

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

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 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000 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. 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.

MSCI EAFE Index (Europe, Australasia, Far East) Index is a free float-adjusted market capitalization index designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

© 2024 Wells Fargo Investment Institute. All rights reserved.

The MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets countries, including Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Kuwait, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

The 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.

US middle-market buyout funds, as defined by PitchBook, are funds between $100 million and $5 billion in fundraising activity. US large-market buyout funds, labeled by PitchBook as US megafunds, are funds with greater than $5 billion in fundraising activity.

Bond rating firms, such as Moody's, Standard & Poor's and Fitch, 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".

Allocation compositions

Moderate Growth and 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, 27% S&P 500 Index, 10% Russell Midcap Index, 3% Russell 2000 Index, 8% MSCI EAFE Index, 5% MSCI Emerging Markets Index, 4% Bloomberg Commodity Index.

General disclosures

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS' opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability or best interest analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon. The material contained herein has been prepared from sources and data we believe to be reliable but we make no guarantee to its accuracy or completeness.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company. PM-02282026-6968111.1.1

© 2024 Wells Fargo Investment Institute. All rights reserved.