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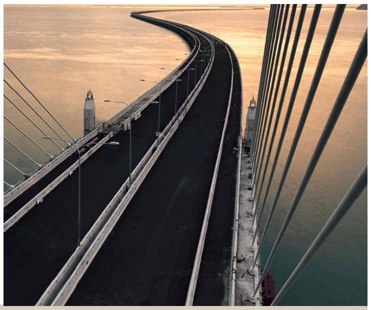


Investment Strategy

Weekly guidance from our Investment Strategy Committee September 16, 2024

Equities Spotlight: Selling season and election ahead, but keep an eye on ’25 2

- Volatility in the late summer and early fall have been typical in recent years as well as during election cycles. A tightly contested election and simmering economic concerns suggest this pattern may hold true in 2024 as well.
- Investors should be prepared to take advantage of market swings — we expect that these will present opportunities to align portfolios with our guidance, which has an eye to 2025.

Fixed Income: Rotating out of cash as the Federal Reserve (Fed) prepares to cut rates 4

- Our belief is that investors need to start repositioning excess cash or cash alternatives in the face of a new Fed rate-cutting cycle and falling interest rates.
- We favor moving excess cash alternatives to slightly longer maturities in U.S. Intermediate Term Taxable Fixed Income but are cautious of risks in U.S. Long Term Taxable Fixed Income.

Real Assets: OPEC+ extends production cuts 5

- In response to recent weakness in crude-oil prices, OPEC+ (the Organization of Petroleum Exporting Countries and their allies) extended its standing production cuts through the end of 2024.
- OPEC+ remains committed to maintaining relatively tight global supply conditions to support higher oil prices.

Alternatives: Distressed exchanges offset falling default rates 6

- Although traditional measures show default rates declining, the inclusion of distressed exchanges may highlight the hidden stress that continues to build under the surface.
- While the forecasted interest-rate cuts may benefit many small and mid-sized businesses, we expect the opportunity set for Distressed Credit strategies to remain robust as fundamentals continue to deteriorate in many overleveraged companies.

Current tactical guidance 7

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

Equities Spotlight

"Doing the best at this moment puts you in the best place for the next moment." — Oprah Winfrey

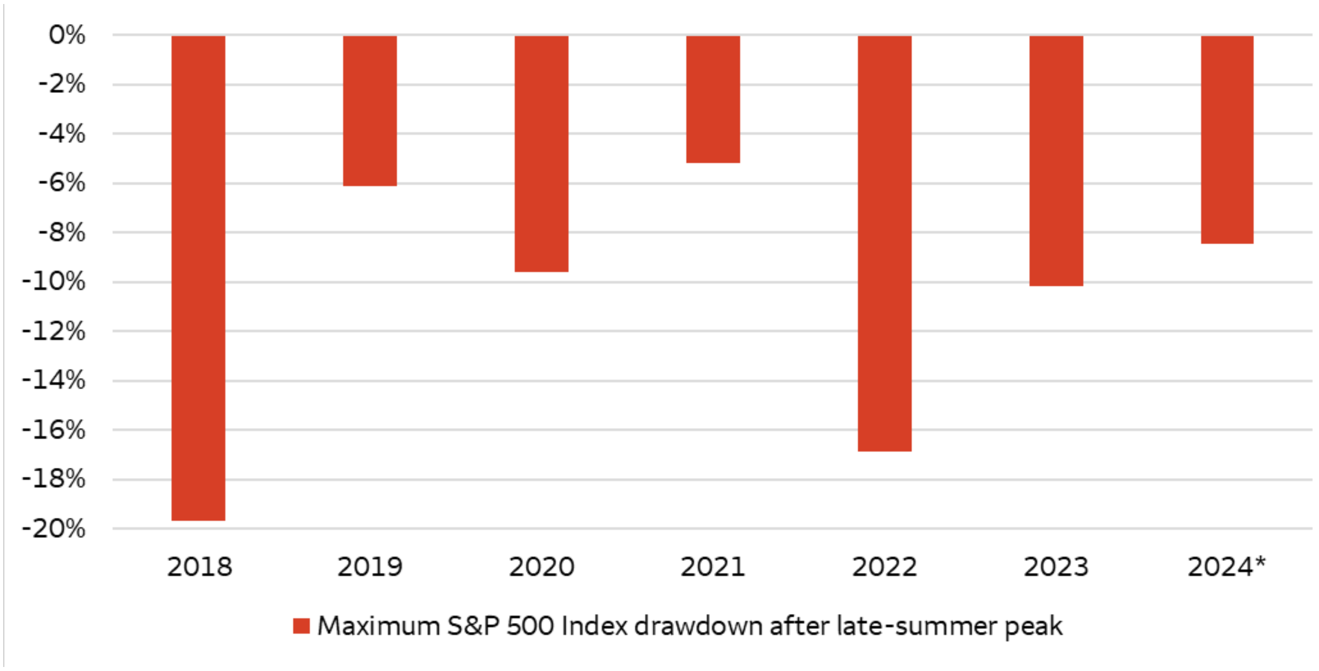
Austin Pickle, CFA
Investment Strategy Analyst

Selling season and election ahead, but keep an eye on '25

With cooler temperatures around the corner, kids heading back to school, and multiple sports seasons heating up, the transition from late summer to fall is often looked upon with great anticipation. However, over recent years this season has also featured something particularly unpleasant for investors — sizable stock declines. With this in mind, we consider two questions: will the pattern continue in 2024, and what do we suggest investors do?

Chart 1 below illustrates how unsettling this season has been to equity investors. In each of the past seven years, the S&P 500 Index has experienced a late-summer peak and subsequent drawdown ranging from 5% to 20%. Simmering economic concerns, continued geopolitical risks, and increasing doubts about the near-term prospects for artificial intelligence suggest that stocks may continue to struggle this season as well.

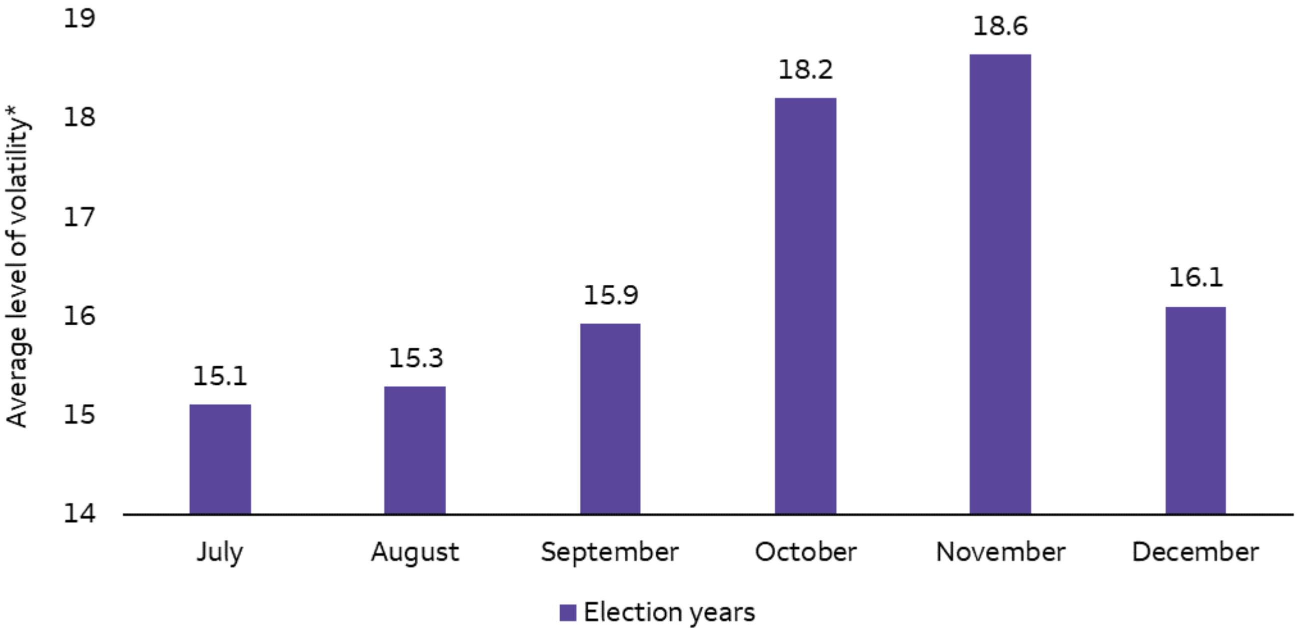
Chart 1. Late-summer stock selloffs



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of September 10, 2024. Maximum drawdown measured from the S&P 500 Index peak that occurred between July and September of each year to the following trough. Asterisk next to 2024 indicates that we are not through this season, and the final number could be different than what is currently represented in the chart. **Past performance is no guarantee of future results.**

The election is an additional headwind that we expect to weigh on markets in the near term. Chart 2 on the following page shows that volatility typically spikes as we approach an election. A tightly contested and open election where the incumbent is not seeking reelection, as we have currently, only serves to increase the uncertainty. Our view is that in the coming months, bouts of volatility are likely while stocks chop sideways and struggle to make meaningful new highs.

Chart 2. Elections have historically spurred volatility spikes



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data is from July 2, 1928, to December 31, 2020. *Volatility is calculated using a monthly average of the S&P 500 Index's daily price volatility during election years from 1928 to 1988 and a monthly average of the daily Chicago Board Options Exchange Volatility Index (VIX) from 1992 to 2020. **Past performance is no guarantee of future results.**

That is not to say that investors should close their eyes to the market and just wait until year end — far from that. Volatility presents opportunity, and we favor being prepared. We suggest having a shopping list ready if markets approach recent lows. We are favorable U.S. Large Cap Equities as well as the S&P 500 Index Communication Services, Energy, Financials, Industrials, and Materials sectors. We think U.S. Small Cap Equities (which we recently upgraded to neutral) could also be an attractive option for adding exposure near market lows if the portfolio is underallocated to the asset class. Alternatively, if markets approach recent highs, we favor trimming areas where the portfolio is overallocated, especially in the unfavorable Emerging Market Equities asset class as well as the S&P 500 Index Consumer Discretionary, Consumer Staples, Real Estate, and Utilities sectors.

Post-election, our outlook is for the economy to pivot from a slowdown to sustained growth in 2025 as the earnings recovery accelerates and equity prices resume their rally. Investors should view the anticipated stages of our outlook as guideposts to focus investment decisions as opportunities arise in the coming months. Put simply as a campaign slogan, “Keep an eye on ’25.”

Fixed Income

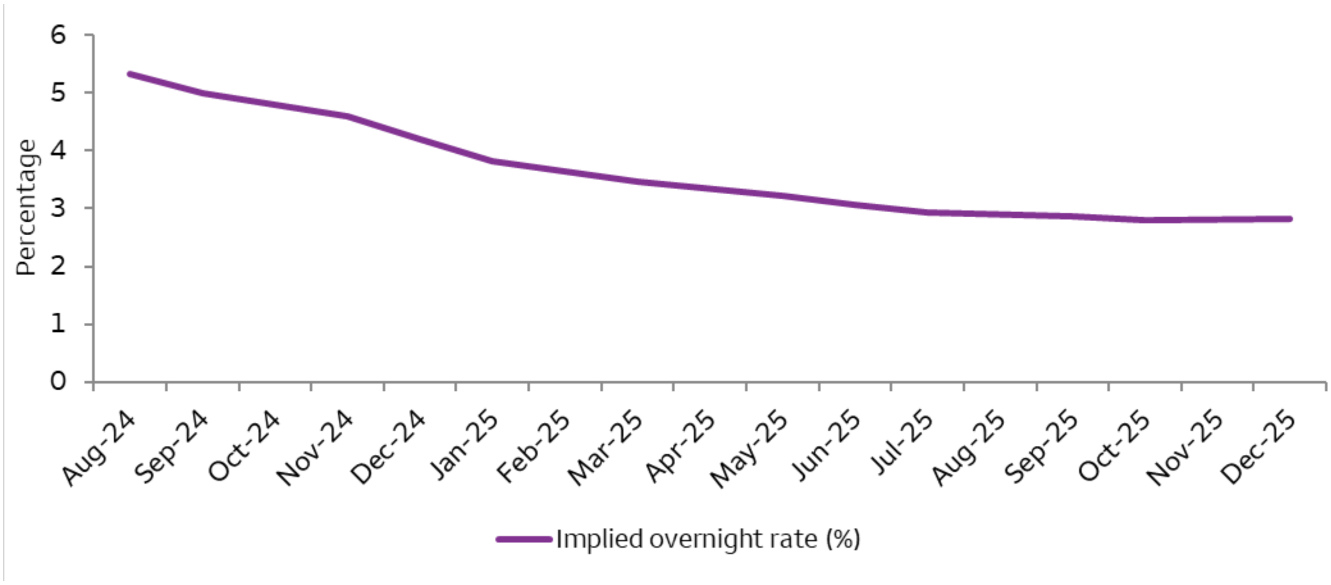
Tony Miano, CFA
Investment Strategy Analyst

Rotating out of cash as the Fed prepares to cut rates

Over the past two years, money market funds and short-term Treasury bills (T-bills) have been a popular place for investors to park cash as higher interest rates have provided attractive returns with relatively low risks. However, our belief is that investors need to start repositioning excess cash or cash alternatives in the face of a new Fed rate-cutting cycle and falling interest rates.

The chart below demonstrates market expectations for the federal funds rate through year-end 2025. Once the Fed begins cutting rates, market participants expect interest rates to fall at a relatively quick pace. We expect fewer rate cuts than the market, with our targets implying a 1% decrease in rates for 2024 and 0.75% in 2025. However, that still would represent a significant decline from current levels. In our view, investors who have grown accustomed to returns above 5% on cash alternatives are unlikely to keep those returns for long and we favor exploring other options to lock in relatively higher yields.

Market expectations for the federal funds rate



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of September 10, 2024. Based on federal funds rate futures market pricing.

We prefer to decrease excess cash and cash-alternative holdings and reallocate toward fixed income with longer maturities, especially ahead of a new Fed interest-rate cutting cycle. We favor the intermediate-term portion of the curve, which provides attractive yield opportunities while not being overly exposed to negative price movements should yields move above our target levels. High Yield Taxable Fixed Income (which we recently upgraded to neutral) may also be a target for excess cash deployment, especially for investors with a need for income.

Real Assets

Mason Mendez
Investment Strategy Analyst

John LaForge
Head of Real Asset Strategy

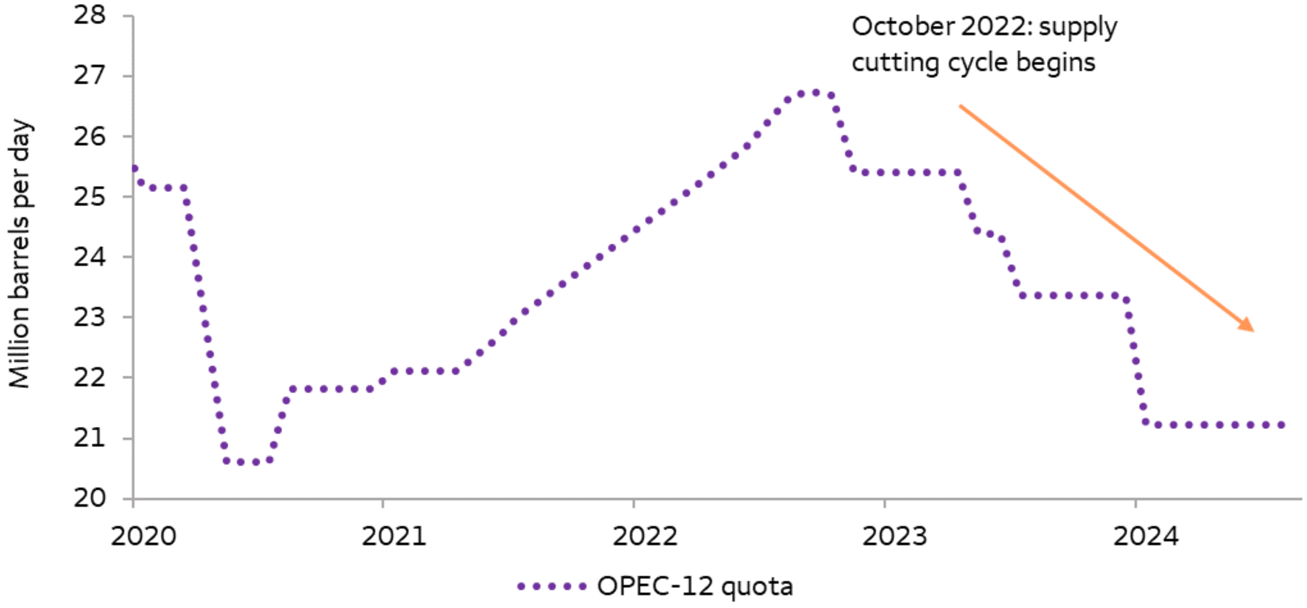
OPEC+ extends production cuts

In response to declining oil prices, OPEC+ postponed upcoming changes to its production policies. Prior to this, OPEC+ was planning to unwind a portion of its standing production cuts beginning in October 2024. We view this news as a positive sign for oil prices for the remainder of 2024.

Earlier this year, OPEC+ announced plans to begin unwinding 2.2 million barrels per day of production cuts, roughly 2% of global supply, from October 2024 through September 2025. Crude-oil prices have been weak recently, however, amid a slowing global economy. To avoid pressuring prices even lower, OPEC+ decided to postpone its October unwind at least until December 2024. We suspect that the extension of production cuts through year end should help offset recent global demand weakness.

We are watching the global supply situation for 2025 closely, however. OPEC+ has taken a cautious approach to unwinding production cuts for almost two years now. While OPEC+ has proven its commitment to supporting higher oil prices by maintaining production cuts, we do wonder how much longer it can maintain such support. To be clear — we are not expecting OPEC+ to deviate from its commitment to support higher crude-oil prices. It is something we are watching, though, as crude-oil prices approach key technical support levels. Our West Texas Intermediate and Brent crude price targets remain $80 – $90 per barrel and $85 – $95 per barrel respectively for 2024 with a $5 increase for year-end 2025, reflecting an improved macro environment.

Production quota for OPEC-12



Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data is from January 2020 – August 2024. OPEC-12 includes the 12 member countries of OPEC. **Past performance is no guarantee of future results.**

Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

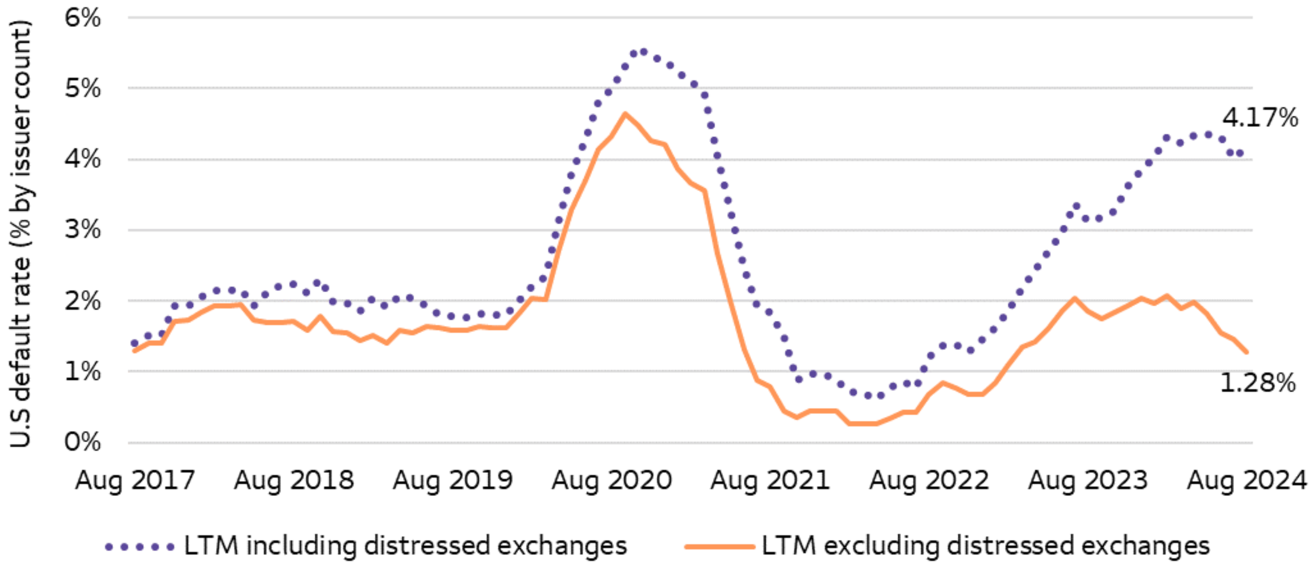
Distressed exchanges offset falling default rates

The conventional default rate has declined in recent periods, suggesting businesses may have weathered the storm of higher interest rates as the Fed begins to embark on its next easing cycle. However, it may not paint an accurate picture of the stress levels present in today's economy. Today, many struggling companies are instead opting to avoid the courts and preemptively restructure their debts. Termed distressed exchanges, the goal of these transactions is to improve the overall health of the company by reducing debt, extending maturities, or reducing regular debt-service payments. Distressed exchanges are often used by firms owned by private equity sponsors, and these transactions allow the owners to potentially preserve their equity stakes throughout the restructuring process.

When viewing default rates that include distressed exchanges, we see that the levels have trended sideways for several months (see chart). In other words, the decline in conventional default rates has been mostly offset by the growing number of distressed exchange transactions occurring in recent periods. As confirmation that the lowest-quality segment of companies may still not be in the clear, the percent of the small-company universe (Russell 2000 Index) with negative earnings on a 12-month trailing basis continues to register over 40%, up from under 30% a decade ago.

While the forecasted lower interest-rate environment will undoubtedly benefit many companies by reducing the cost of servicing their debt, it may be too little and too late for the weakest operators that have been unable to pass rising costs along to consumers. Given these ongoing dynamics, we remain favorable on Distressed Credit strategies as the opportunities remains robust for those seeking to create viable paths forward for many overleveraged businesses.

Decline in U.S. loan default rates by issuer count mostly offset by the increase in distressed exchanges



Sources: Pitchbook (Leveraged Commentary and Data) and Morningstar (Morningstar LSTA U.S. Leveraged Loan Index). Data as of August 31, 2024. LTM = last 12 months. **Past performance is no guarantee of future results.**

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.

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	

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 16, 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.

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. **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. **Utilities** are sensitive to changes in interest rates, and the securities within the sector can be volatile and may underperform in a slow economy.

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.

Chicago Board Options Exchange Volatility Index (VIX) reflects a market estimate of future volatility, based on the weighted average of the implied volatilities for a wide range of strikes.

Morningstar LSTA U.S. Leveraged Loan Index is a market value weighted index designed to measure the performance of the U.S. leveraged loan market. The legacy payment default rate includes Morningstar LSTA U.S. Leveraged Loan Index constituents where the company files for bankruptcy, the facility gets downgraded to D by S&P (excluding distressed exchanges and sub-par buybacks), or the interest payment is missed without a forbearance. Distressed exchanges include all liability management transactions considered a distressed exchange or default by S&P Global Ratings.

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 Communication Services Index comprises those companies included in the S&P 500 that are classified as members of the GICS® communication services sector.

S&P 500 Consumer Discretionary Index comprises those companies included in the S&P 500 that are classified as members of the GICS® consumer discretionary sector.

S&P 500 Consumer Staples Index comprises those companies included in the S&P 500 that are classified as members of the GICS® consumer staples sector.

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

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

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

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.

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

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