WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **September 19, 2022**

Fixed Income spotlight

Fixed-income playbook for the final stretch of the year

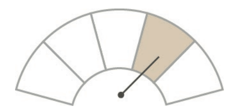
With a little over 100 days until the end of the year, investors are bracing for a bumpy ride. The U.S. economy is still facing threats from elevated inflation (as evidenced by last week's Consumer Price Index report for August) coupled with a slowdown in economic activity. On the other hand, the Federal Reserve (Fed) remains committed to bringing inflation under control. This is why we expect a 0.75% (75-basis-point) increase in the federal funds rate later this week, additional rate increases (albeit at a slower pace) at the following three to four meetings, and for the Fed's balance sheet runoff to continue at the stated level of $95 billion per month.

In our opinion, the two main drivers for fixed-income returns over the near term will still revolve around 1) the threat to bond prices from higher interest rates and 2) the widening of credit spreads as liquidity and financial conditions continue to tighten. So far, it looks like 2022 will be a year for the records. Fixed-income performance continues to struggle year-to-date, declining by 12.3%[1] using the Bloomberg U.S. Aggregate Bond Index as a proxy. However, we expect better returns ahead once yields peak in this cycle.

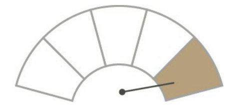
With this uncertain context in mind, we thought it would be timely to remind investors of our current fixed-income guidance. Our recent focus has been to favor assets that tend to perform well as we enter an anticipated U.S. economic recession, such as short-term fixed income, given the shorter duration[2] exposure during a rising interest rate period. We also advocate exposure to municipal bonds, given their relative low levels of defaults, positive technical trends due to the supply-demand imbalance, and improved fiscal positions after the pandemic.

On the other hand, we believe that investors should limit exposure to high-yield taxable fixed income (HY) in the near term. The main threat for HY, in our view, likely will come from further monetary tightening and the deterioration in credit conditions as economic growth slows. Instead, we believe fixed-income investors would be better served by holding higher-quality investment-grade (IG) corporate bonds. Although this asset class has a longer duration, once yields peak and we have confidence that the economy has turned the corner on inflation, we may shift to favor longer maturities.

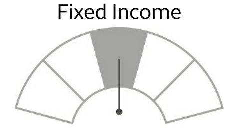
Luis Alvarado
Investment Strategy Analyst



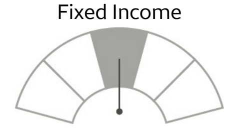
Favorable
U.S. Taxable Investment Grade Fixed Income



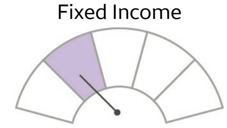
Most favorable
U.S. Short Term Taxable Fixed Income



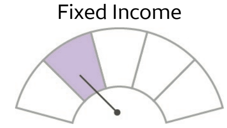
Neutral
U.S. Intermediate Term Taxable Fixed Income



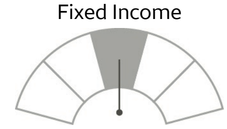
Neutral
U.S. Long Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



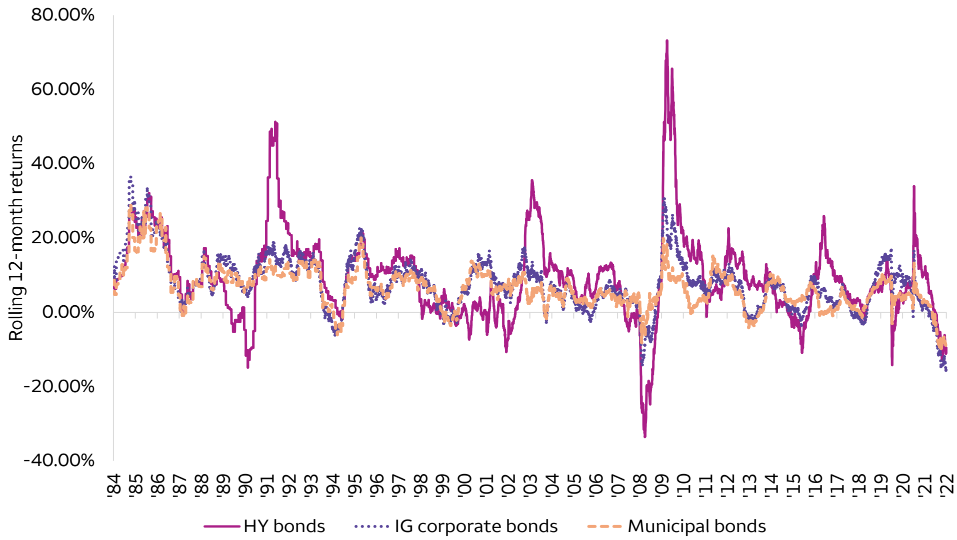
Unfavorable
Developed Market Ex.-U.S. Fixed Income



Neutral
Emerging Market Fixed Income

1. As of September 15, 2022.
2. Duration is a measure of bond price sensitivity to interest rate changes. It is related to the maturity of the bond.

Higher-quality fixed-income sectors have proven resilient as the economy slows



Sources: Wells Fargo Investment Institute and Bloomberg. Data as of September 13, 2022. Daily 12-month rolling returns from January 2, 1984 to September 13, 2022. HY bonds = Bloomberg U.S. Corporate High Yield Index. IG corporate bonds = Bloomberg U.S. Corporate Bond Index. Municipal Bonds = Bloomberg Municipal Index. An index is not managed and not available for direct investment. **Past performance is no guarantee of future results.**

Implications for investors

We still believe that the yield curve has been and will continue to be the most important indicator to watch during Fed tightening cycles, rising-rate environments, and U.S. recessions. Our latest forecasts of U.S. Treasury yields already carry the expectation that the Fed will raise rates to around 4.25% for this cycle, but the bias on all our forecasts remains to the upside should inflation levels remain elevated.

In the past five Fed tightening cycles since 1990, U.S. Treasury yields have peaked before the end of the tightening cycle but did not begin a clear declining trend until the tightening cycle was over. The yield curve has been significantly inverted since July and it appears that it could remain inverted for a longer time than in prior cycles, even as we expect a recession during the first half of 2023.

As investors prepare to enter the final stretch of the year, we want to leave you with three additional fixed-income portfolio ideas that investors may want to consider in such volatile and unprecedented times.

- We favor a barbell fixed-income strategy.[3] This strategy involves investing in bonds with short- and long-term maturities, given our expectations that short-term rates will still move higher while longer-term yields will peak soon.
- Maintain a neutral allocation in preferred stock and emerging market bonds for those investors seeking yield. Floating-rate bonds (leveraged loans, for example) also tend to provide better relative performance than other fixed-income asset classes during a rising-rate environment, but a rapid change in credit sentiment could affect this asset class during a recession.
- Review portfolio holdings and consider liquidity and risk tolerance needs, especially ahead of an expected slowdown in economic activity.

3. A barbell strategy is formed when a trader invests in long- and short-duration bonds, but does not invest in intermediate-duration bonds. This strategy is useful when interest rates are rising; as the short term maturities are rolled over they receive a higher interest rate, raising the value.

Equities

Austin Pickle, CFA
Investment Strategy Analyst

"The question is not what you look at, but what you see." — Henry David Thoreau

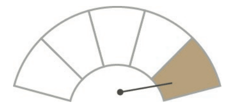
Concentration risk of select sectors

Equity sector investing has risen in popularity along with a myriad of sector-focused investment vehicles, managed products, and strategies. For the investor utilizing sector products now or in the future, we say this — know what you own.

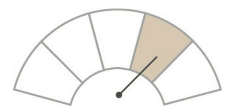
This generic bit of investing advice has numerous applications, but today we are referencing a specific risk often overlooked by sector product investors — concentration risks. While a sector product is undoubtedly more diversified than an individual stock, some suffer from significant concentration risk. For example, the top two stocks in each of the Tech +[4] and Energy sectors make up near or greater than 50% weighting (chart below). Said another way, the fortunes of just two companies heavily dictate the performance of each of these sectors. We suspect this concentration risk may be underappreciated by the average investor.

There are a number of methods to help mitigate this risk, including: 1) employing an active manager that follows a prudent diversified approach, 2) considering equal weighted rather than market cap weighted products, and 3) referencing our sector guidance and weighting recommendations. We utilize a number of macro, fundamental, and technical factors to develop a risk and reward profile that informs our S&P 500 Index sector guidance. Tilting a portfolio toward our favorable rated sectors and away from our unfavorable sectors allows investors to stay diversified while possibly increasing return potential per unit risk.

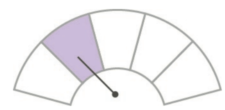
Ultimately, know what you own, be aware of the risks, and consider using our sector guidance and weighting recommendations as a guide to invest responsibly.



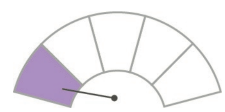
Most favorable
U.S. Large Cap Equities



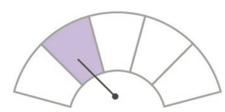
Favorable
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities

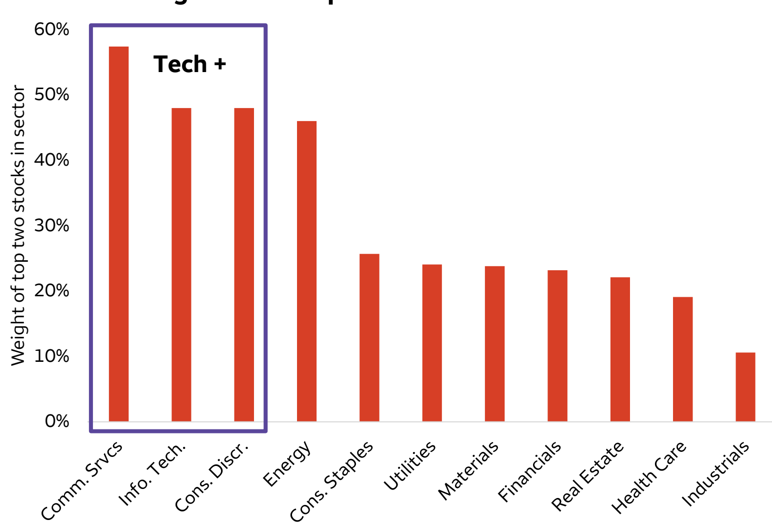


Most unfavorable
Developed Market
Ex-U.S. Equities



Unfavorable
Emerging Market Equities

Cumulative weight of the top two stocks in each S&P 500 Index sector



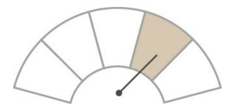
Sources: Bloomberg and Wells Fargo Investment Institute. Top two stocks refers to the two stocks with the largest weights in the S&P 500 sector. As of September 14, 2022. Comm. Srvcs = Communications Services. Info. Tech. = Information Technology. Cons. Discr. = Consumer Discretionary. Cons. Staples = Consumer Staples

4 .Tech + refers to the S&P 500 Index Communication Services, Information Technology, and Consumer Discretionary sectors.

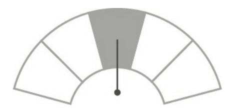
Real Assets

John LaForge
Head of Real Asset Strategy

"If life were predictable it would cease to be life, and be without flavor." — Eleanor Roosevelt



Favorable
Commodities



Neutral
Private Real Estate

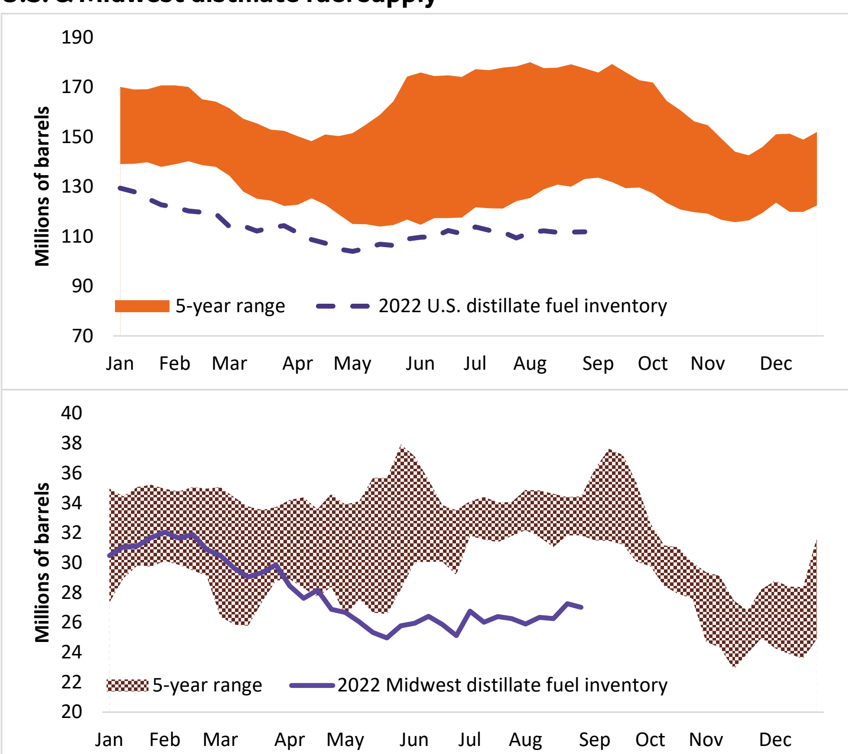
U.S. diesel supply below five-year lows

The Midwest is home to the "Corn Belt", a region that produces extensive amounts of corn. Harvest season is fast approaching, and it has the potential to clash with a brewing problem — fuel. Prices and supplies of U.S. distillate fuels, used to power farming machinery, are tight and likely to get tighter over the coming months as the Midwest heads into peak harvest season.

Throughout the U.S. in 2022, distillate fuels, such as diesel, have been in short supply. This can be seen in the top panel of the chart, where 2022 inventories have been consistently tracking below their historical five-year range. The same dynamic can be seen in the bottom panel, which tracks inventories in the Midwest specifically. Most importantly, notice that this is the time of year when inventories typically begin to draw down even more, due to farmers needing fuel for the peak harvest season.

The bottom line is that U.S. distillate fuel inventories remain abnormally low, which is keeping prices elevated right as farmers need to begin buying fuel for harvest season. If fuel prices stay elevated, we believe the impact will be felt broadly, from farm to table, and into 2023. Farmers, forced to buy expensive fuel to reap their harvests, will have less profit for next year's plantings. And consumers will likely feel the crunch too, as it is common for high energy costs to ultimately find their way into food prices.

U.S. & Midwest distillate fuel supply



Sources: Energy Information Administration and Wells Fargo Investment Institute. Weekly data from January 2, 2015 – September 2, 2022.

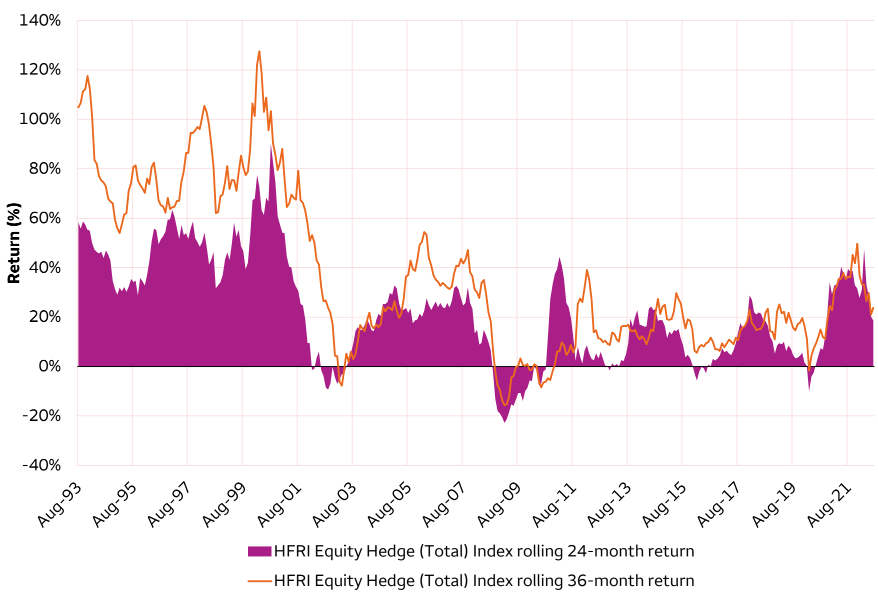
Alternatives

2023 could be a better year for Equity Hedge

There is no doubt that 2022 has been a frustrating year for equity hedge funds. As measured by the Hedge Fund Research, Inc. Equity Hedge (Total) Index, the average equity hedge fund lost 10.0% in the eight months through August this year. The average fund still outperformed global equity benchmarks, most notably the MSCI All Country Index (-17.8% on a net total return basis). However, investors may be forgiven for expecting a larger outperformance. After all, bear markets are supposed to be when equity hedge funds have historically outperformed, taking advantage of down markets to short stocks when long-only investors cannot.

Some of the negative factors holding back equity hedge manager performance are high and uncertain inflation, as well as rising interest rates, which tend to override the more idiosyncratic or individual fundamental characteristics that equity hedge managers use to decide which equities to buy and which to sell. The broad weakness in technology is noteworthy. While performance has moderated from its peak in late 2021 (see chart), we believe that the main headwind for Equity Hedge strategies will moderate. In particular, we project that inflation will ebb (if slowly) next year, which should lead to a better opportunity set in 2023.

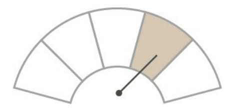
Equity Hedge strategies



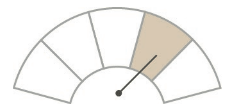
Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data, August 1993 – August 2022. An index is not managed and not available for direct investment. **Past performance is no guarantee of future results.**

Justin Lenarcic
Lead Wealth Investment Solutions Analyst

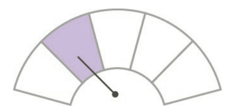
Paul Christopher, CFA
Head of Global Market Strategy



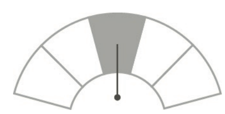
Favorable
Hedge Funds – Relative Value



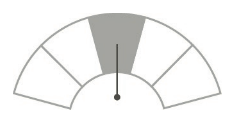
Favorable
Hedge Funds – Macro



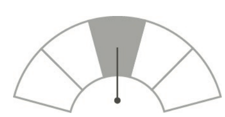
Unfavorable
Hedge Funds – Event Driven



Neutral
Hedge Funds – Equity Hedge



Neutral
Private Equity



Neutral
Private Debt

Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not appropriate for all investors and are only open to “accredited” or “qualified” investors within the meaning of U.S. securities laws.

Risk Considerations

Forecasts and targets are 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. **Preferreds** securities have special risks associated with investing. Preferred securities are subject to interest rate and credit risks. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. 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.

Leveraged loans are generally below investment grade quality ("high-yield" securities or "junk" bonds). Investing in such securities should be viewed as speculative and investors should review their ability to assume the risks associated with investments which utilize such securities.

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. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market. **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. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Bloomberg U.S. Corporate Bond Index includes publicly issued U.S. corporate and Yankee debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

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

Bloomberg Municipal Bond Index is an unmanaged index composed of long-term tax-exempt bonds with a minimum credit rating of Baa.

HFRI Equity Hedge (Total) Index maintains positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios.

Note: HFRI Indices have limitations (some of which are typical of other widely used indices). These limitations include survivorship bias (the returns of the indices may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information self-reported by hedge fund managers that decide on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.

MSCI All Country World Index (MSCI ACWI) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of 23 developed and 26 emerging markets.

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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 Information Technology Index comprises those companies included in the S&P 500 that are classified as members of the GICS® information technology sector.

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