WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **September 26, 2022**

Alternatives spotlight: Adding alternatives to reduce portfolio drag..........2

- We believe alternative investments may be uniquely positioned to help portfolios regain lost returns, or altitude.
- We favor Global Macro and Relative Value strategies as a way to help potentially mitigate the drag of higher inflation and interest rates. As we get closer to recession, we will shift focus to certain Private Capital and Hedge Fund strategies that can potentially benefit from a recovery in the economy and asset prices.

Equities: Third-quarter earnings preview..........4

- After growing by 8% in the second quarter of 2022, S&P 500 Index earnings are expected to rise by less than 5% in the third quarter of 2022.
- The Energy sector is expected to lead growth for the quarter. However, excluding the Energy sector, overall S&P 500 Index earnings likely will be flat.

Fixed Income: Risks vary, rewards equally uncertain..........5

- Inflation and aggressive central-bank rate increases are the well-understood common drivers of yield increases in developed market (DM) bonds this year.
- But while U.S. yields tend to lead, each of the major DM bond markets faces idiosyncratic versions of the common inflation and growth problems.

Real Assets: Grain prices unlikely to drop from a recession alone..........6

- Historically, recessions haven't had a significant impact on major grain and oilseed prices.
- Reductions in food prices will likely have to come from improvements to supply.

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

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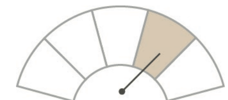
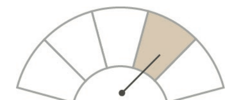
Alternatives spotlight

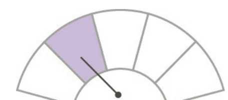
Justin Lenarcic
Lead Wealth Investment Solutions Analyst



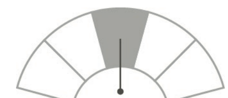
Favorable
Hedge Funds – Relative Value



Favorable
Hedge Funds – Macro

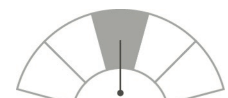


Unfavorable
Hedge Funds – Event Driven



Neutral
Hedge Funds – Equity Hedge

Neutral
Private Equity



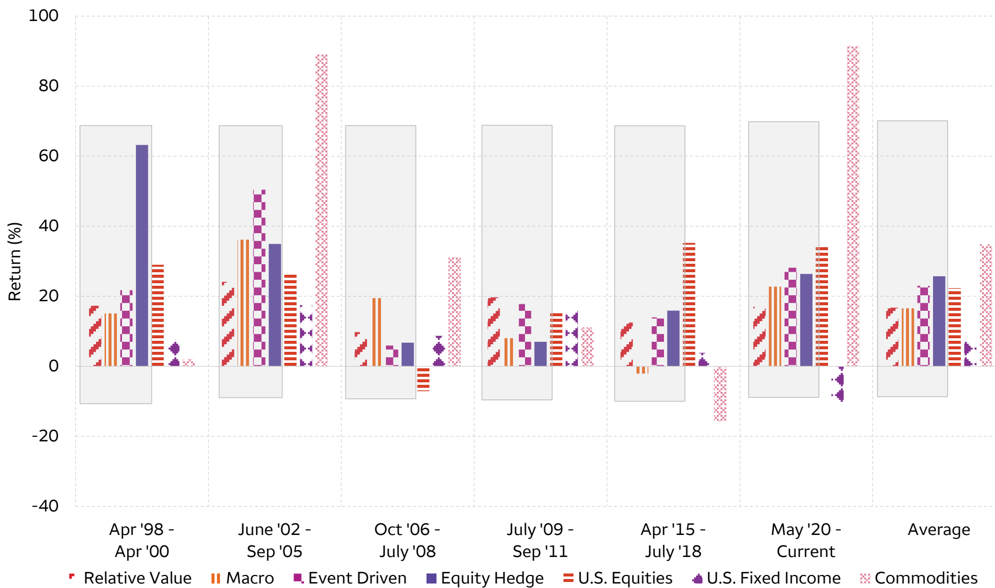
Neutral
Private Debt

Adding alternatives to reduce portfolio drag

Investment portfolios are losing altitude. Inflation is creating a "drag" on investment returns by reducing value over time. Central bankers, in their efforts to fight inflation, are removing liquidity and increasing interest rates, reducing the "thrust" that helped lift asset prices in recent years. The long-term negative correlation between equities and fixed income has broken down as a result, with investors experiencing losses in both. We believe that a selective approach across alternative investments may help portfolios regain altitude, especially during times of weakness in traditional equity and fixed-income markets.

Even considering the many geopolitical and socioeconomic risks that define our time, the single most important drag on investment expectations is still inflation. There are primary and secondary implications across nearly every asset, from equities to credit, currencies, interest rates, and commodities. It could be months, quarters, or years before inflation is sufficiently under control so that the Federal Reserve (Fed) can reduce interest rates and inject the thrust needed for portfolios to regain altitude. As seen below, over the past six inflationary periods, hedge funds on average significantly outperformed fixed income and performed in line with equities.

Hedge funds have done well in past inflationary cycles



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of August 31, 2022**.** An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Reducing drag with hedge funds

Heading into 2022, we wanted strategies that historically have performed well in periods of higher volatility, higher inflation, and higher interest rate risk. For hedge funds, we believe that boils down to two of our core strategies: Global Macro and Relative Value. Fortunately, in 2022, we have seen some of the best returns for Global Macro strategies in decades, and Relative Value has materially outperformed traditional fixed

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

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income. While in the current environment, we prefer hedge fund strategies that offer diversification, we also recognize that stress is building in the public credit markets. This stress, along with our expectation for a decline in private market valuations, may provide opportunities for more directional, risk-on strategies. Here is where we envision certain alternative investments may potentially provide near-term thrust in an effort to help recover performance. We are also paying careful attention to credit spreads, distress ratios, and default rates, all of which can indicate the depth and breadth of a potential credit cycle. Default-rate projections remain muted for now, but we suspect they may move higher as we get closer to recession. Should this occur, we would look to Distressed Debt and Special Situations strategies to help investors in their effort to augment returns as the economy recovers.

Private Capital and 2023 vintage year acceleration can help

We believe that major inflection points may provide opportunities for investors to capitalize on dislocations or cheaper valuations. Vintage[1] year acceleration offers a potential way for investors to add thrust by over-allocating to Private Capital funds that are fortunate to be investing during or immediately after recessions or periods of dislocation. While opportunities are presenting themselves in 2022, we are growing increasingly optimistic that 2023 may present the opportunity for vintage year acceleration.

Of the three private capital strategies, we believe that Private Debt offers the greatest opportunity, but also the greatest risks. We anticipate significant demand for loans to keep portfolio companies afloat through the recession, or simply to weather higher inflation and lower economic growth. We want to see how covenant packages and spreads react to the more challenging environment, and importantly, how portfolio managers deploy the large amount of capital raised over the past few years. Distressed debt potentially could augment returns once the credit cycle bottoms.

With the significant repricing of growth- and technology-related companies, we think Private Equity is in the early phases of recalibrating its investment approach to a new macro regime. We are more constructive on small- and mid-cap buyout strategies, as well as those focused on Growth Equity and Venture Capital. With respect to Growth Equity, as public market valuations for companies recalibrate to reflect current challenges, we favor gaining exposure to these earlier stage businesses via sector-focused Growth Equity strategies.

Dial up alternatives to potentially reduce drag and increase thrust

This is a challenging time for many investors and, understandably, fear is rising. The portfolio turbulence feels discomforting for those of us who became accustomed to recent history of broadly successive annual gains in equity and many fixed-income markets. We believe that alternative investments — including hedge funds and private capital — can potentially reduce the drag of higher inflation on portfolio returns, and may be uniquely positioned to help investment portfolio performance.

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1. Vintage refers to the first year of an investment project or company.

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Equities

Chris Haverland, CFA
Global Equity Strategist

Third-quarter earnings preview

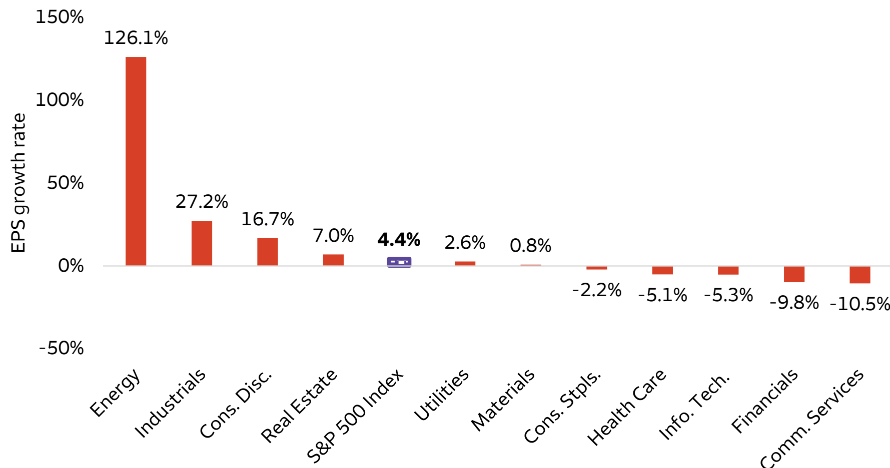
After growing by 8% in the second quarter of 2022, S&P 500 Index earnings are expected to rise by less than 5% in the third quarter of 2022. Actual earnings typically exceed estimated earnings, so the third-quarter growth rate could end up similar to the final second-quarter growth rate. Although earnings growth rates have declined from 2022 highs, they have settled in close to the median historical rate of 6.5%.

We believe the Energy and Industrials sectors should lead the way, with Energy earnings expected to more than double from the third quarter of 2021. While Energy sector earnings continue to impress, it is masking underlying weakness in other sectors. Excluding the Energy sector, overall S&P 500 Index earnings are expected to be flat in the quarter. Two-thirds of the S&P 500 Index is forecasted to show declining earnings, led by weakness in Communication Services and Financials (see chart below).

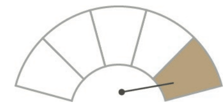
Forward guidance will be key as many companies continue to deal with high input prices, a tight labor market, and a slowing global economy. There have been several negative preannouncements in September leading to a modest decline in third-quarter earnings estimates. 2023 estimates also have been falling over the past few months, but remain well above our forecast of $220.

Looking forward, we expect earnings growth to peak in 2022 with a recession likely beginning near year-end. In this environment, we suggest focusing on high-quality companies with consistent earnings growth, low debt levels, and high return on equity.

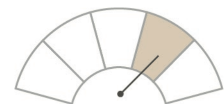
S&P 500 Index third-quarter earnings-per-share growth estimates



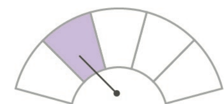
Sources: Wells Fargo Investment Institute and Bloomberg. Data as of September 21, 2022. EPS = earnings per share. See definitions on indexes at the end of the report. An index is unmanaged and not available for direct investment. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change. **Past performance is no guarantee of future results.**



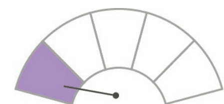
Most favorable
U.S. Large Cap Equities



Favorable
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities

Unfavorable
Emerging Market Equities

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Fixed Income

Risks vary, rewards equally uncertain

Common factors of inflation and aggressive central-bank responses have pushed DM yields higher across the board, but particular vulnerabilities exacerbate the situation facing individual economies. The chart below illustrates this. While U.S. yield rises lead all markets higher, European yields are converging with, or exceeding, U.S. Treasury rates.

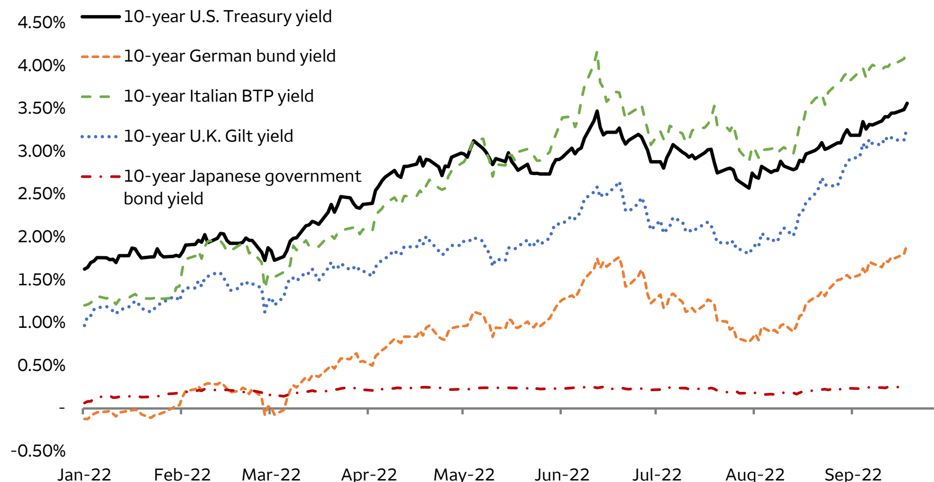
German bund yields have, in the past, been held down by a powerful export-driven economy, negative policy rates, and strong fiscal situation, but this situation is changing fast. The European energy crisis[2] is boosting inflation, spurring the European Central Bank (ECB) to normalize rates rapidly, and undermining Germany's export engine and its historically solid fiscal base.

For Italy, similar problems, but from a weaker macroeconomic starting point, and compounded by ongoing political instability. The fact that 10-year Italian yields have risen above 4% to their highest levels since 2013 is testament to this, and to their previous dependence on ECB bond buying for their apparent stability.

U.K. gilts have underperformed recently, as monetary and fiscal authorities struggle to reconcile conflicting needs: to offset massive increases in energy bills, to clamp down on inflation, and to avoid recession — all in the context of an economy now more obviously laboring under Brexit headwinds.

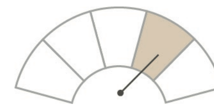
Japanese government bonds are the outlier. But this is of little comfort to the international investor, as yield stability is offset by the related facts that income is virtually zero, and currency losses are large, and we believe likely to be ongoing, given the widening gap with U.S. yields. For all these common and diverse factors, we remain unfavorable on DM ex-U.S. bonds.

What do yields tell us about international bond risk factors?

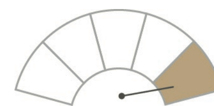


Sources: Bloomberg and Wells Fargo Investment Institute. Latest data as of September 20, 2022. **Past performance is no guarantee of future results.**

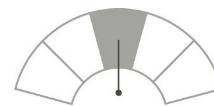
Peter Wilson
Global Fixed Income Strategist



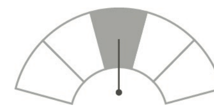
Favorable
U.S. Taxable Investment Grade Fixed Income



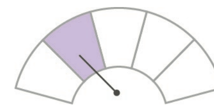
Most favorable
U.S. Short Term Taxable Fixed Income



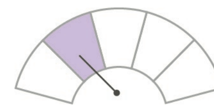
Neutral
U.S. Intermediate Term Taxable Fixed Income



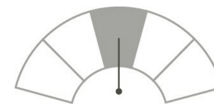
Neutral
U.S. Long Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



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



Neutral
Emerging Market Fixed Income

2. For more detail, please see the Institute Alert: *European energy crisis Q&A – Potential ramifications*, September 16, 2022

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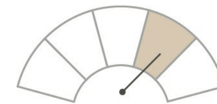
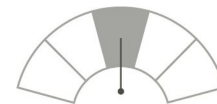
Real Assets

"Difficult roads often lead to beautiful destinations." — Zig Zigler

John LaForge
Head of Real Asset Strategy



Favorable
Commodities



Neutral
Private Real Estate

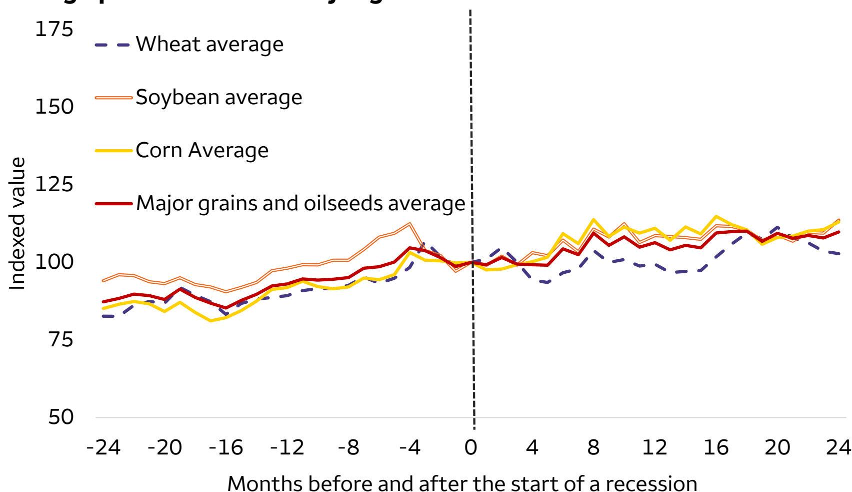
Grain prices unlikely to drop from a recession alone

Headlines about high food prices and recession fears have been abundant this year, and rightfully so. U.S. prices of major grains and oilseeds – soybeans, corn, and wheat – are up 10%, 15%, and 17% year to date, respectively.

On the plus side, global food prices have dropped recently. Some believe that this is due to the anticipation for a global recession later this year, and that it may drive food prices even lower. While we do see the potential for a recession later this year, we caution investors not to expect a recession to trigger further price drops.

Historically, commodities haven't experienced the same impact from recessions as stocks or bonds. Looking at the chart, we see that recessions have had little impact on the performance of major grains and oilseeds. Agricultural commodities have benefited from better economic conditions, such as rising gross domestic product (GDP), but they also have not been significantly impacted by downturns either. After all, food is fairly inelastic to price changes because consumers still demand food in recessions. They may switch between cheaper grains, but the overall demand remains. Another reason is that crop prices are partially impacted by factors completely independent of the economy, such as weather. The final reason is that we believe we are still in the early stages of a commodity bull super cycle[3], a long-term period marked by demand overwhelming supply – driving commodity prices up. Bottom line, a recession alone likely won't relieve prices. Improvements to supply will also be needed.

Average performance of major grains and oilseeds around recessions



Sources: Bloomberg, Bureau of Labor Statistics (BLS), National Bureau of Economic Research (NBER), Wells Fargo Investment Institute. Monthly data from 12/29/1967-8/31/2022 is indexed to 100 at the start of recessions. The overall average is the average performance of wheat, soybeans, and corn during the periods around every U.S. recession since 1969. **Past performance is no guarantee of future results.**

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3. Super cycles are extended periods of either "boom" or "bust". During these periods commodities generally move in the same direction. Historically, these cycles have lasted between 15-20 years, which is why we call them "super cycles".

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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. 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. 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.

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

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.

An index is unmanaged and not available for direct investment.

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