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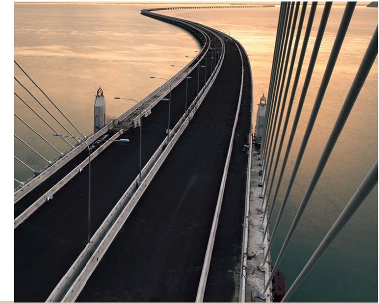
# Investment Strategy



**Weekly guidance from our Investment Strategy Committee** **October 7, 2024**

## Policy Spotlight: Takeaways from the start of a Fed rate-cutting cycle...........2

- Market expectations for interest rates appear mismatched with our expectations and those of the Federal Reserve (Fed) — we expect financial market volatility as those differentials dissipate.
- Short-term interest rates are likely to fall, and we continue to see risks in long-term yields. We favor U.S. Intermediate Term Taxable Fixed Income until more clarity on rates is provided.

## Equities: GLP-1s remain hot ticket, but cost-benefit balance key.....................4

- GLP-1 obesity drugs remain the hottest story in health care, though we have seen increased scrutiny on the high list prices for the drugs. As a result, we expect increasing focus on the cost-benefit equation for GLP-1s.
- Given a growing amount of favorable clinical data for an increasing number of significant indications, we believe broader insurance coverage and Medicare reimbursement for GLP-1s is likely going forward.

## Fixed Income: Healthcare exposure poses risks for some U.S. counties .........5

- While our outlook for the Local Government General Obligation sector remains stable, we believe the rating agencies may be somewhat underweighting the impact of county-owned and operated hospitals or nursing homes in some counties.
- We advise credit-conscious bondholders to focus on names that are rated double-A and better and that have geographically large, diverse economies with minimal exposure to hospitals or other healthcare-related facilities.

## Real Assets: REIT earnings have declined as internal growth moderates........6

- While real estate investment trusts (REITs) generated reasonable growth in same-store net operating income, funds from operations per share declined from the year-ago quarter.
- We recommend investors considering REITs focus on Data Center, Industrial, and Self-Storage REITs given positive long-term demand drivers.

## Alternatives: Secondaries remain attractive despite smaller discounts..........7

- Secondary valuations reached a recent low during the market drawdown in 2022 and have increased modestly through the first half of 2024.
- Discounts in the secondary private-equity market remain attractive as the likelihood of an economic soft landing increases.

## Current tactical guidance.........................................................................................8

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# Policy Spotlight

**Tony Miano, CFA**
Investment Strategy Analyst

## Takeaways from the start of a Fed rate-cutting cycle

The Fed kicked off a new interest-rate cutting cycle with a bang in September, delivering a 50 basis-point (bp, 100 basis points equals 1%) cut to policy rates. The announcement of a new rate-cutting cycle was not surprising, but the size of the rate cut, commentary from Chairman Jerome Powell, and, most importantly, the new Summary of Economic Projections helped provide further insight to investors.

### What did we learn about the Fed's expectations for the future?

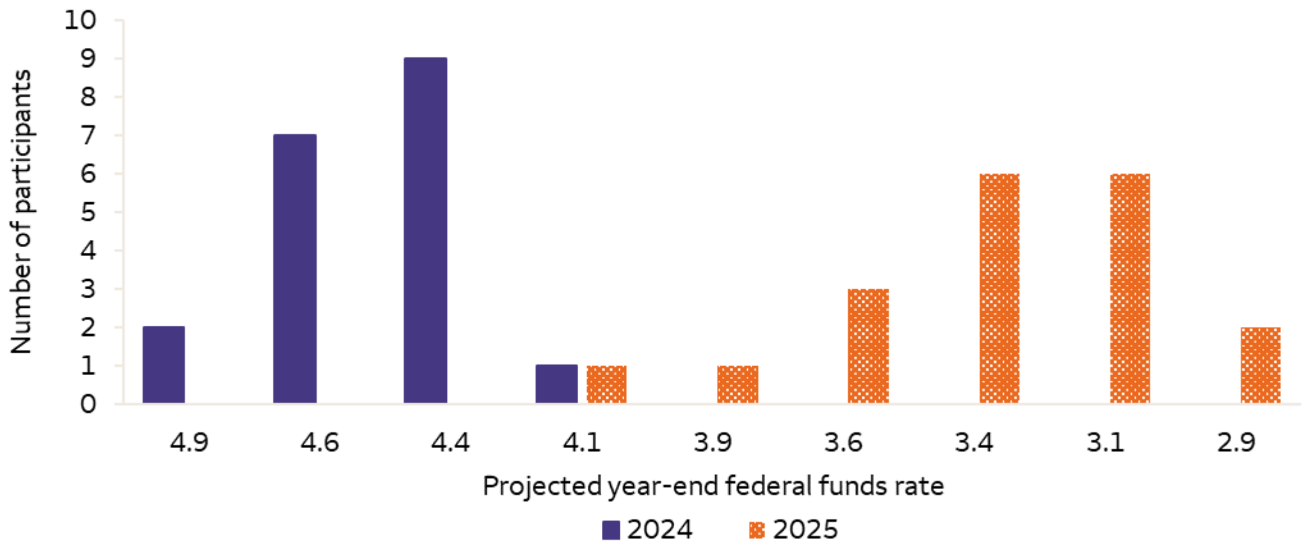
The first key takeaway from the Federal Open Market Committee (FOMC) meeting was simply the size of the cut they delivered. While there was dissension from one participant, the Committee voted overwhelmingly to deliver a 50 bp cut rather than a smaller cut of 25 bps. Given the Fed's dual mandate of balancing the labor market and inflation, this may indicate some concern over the state or direction of the job market and less concern regarding inflation. Powell indicated during his press conference that the labor market was in a strong place, and the Fed's rate decision was intended to keep it there.[1]

Looking at the median economic projections of individual FOMC members paints a similar picture. The median expectation for the unemployment rate sits at 4.4% for 2024 and 2025 while the expected change in real gross domestic product is at 2.0% for both. That paints the picture of a labor market that is cooling, but not considerably. Notably, the FOMC members also see inflation continuing to decline. We believe this base scenario sets the stage for rate cuts but leaves their magnitude in question, especially for the implied rate cuts in 2025.

The Fed changed its interest-rate forecast significantly from its Summary of Economic Projections report in June. On September 18, the median projection sat at 100 bps of cuts in 2024 (50 bps of which have already been delivered) and another 100 bps in 2025. The graph on the following page shows interest-rate expectations by FOMC participants and demonstrates that all but one participant see a maximum of 100 bps of cuts for this year. Meanwhile, expectations for 2025 are more spread out. We are not surprised by this wider dispersion of rate cuts in 2025 — the interest-rate outlook appears murky, and it will depend upon the strength (or lack thereof) of the economy over the next year.

1 ."Fed Chair Powell: The labor market is in a strong place," CNBC, September 19, 2024.

**Chart 1. Expected year-end interest rates by number of FOMC participants**




Sources: Federal Open Market Committee — Summary of Economic Projections. Current as of September 18, 2024.

## How does the Fed's expectation differ from the markets and ours?

Market expectations for rate cuts seem relatively unchanged by the Fed's new expectations. Market pricing continues to suggest a total of 125 bps of cuts in 2024 and an additional 125 bps in 2025.[2] With all but one FOMC participant seeing 100 bps or less of cuts in 2024, the market may be in for some disappointment. Market pricing would require at least one additional 50 bps cut in 2024 instead of two 25 bps cuts, which we do not believe is supported by the current state of the labor market. Also, judging by commentary from Powell, we do not believe the Fed sees that outcome either.

We continue to believe the market is too optimistic on the Fed's cutting cycle. An additional 200 bps of rate cuts between now and the end of 2025 would likely require an economic environment much more dire than our expectations or those of the Fed. If the economy continues to move toward a gradual slowdown followed by a recovery in the second half of 2025, as we expect, we believe the cut in September will probably be the only 50 bp rate cut we see in this cycle. Further, we see the potential for inflation to firm sometime in mid-2025, which may prevent the Fed from delivering the full complement of rate cuts it expects. We believe an additional 50 bps of cuts in 2024 and 75 bps in 2025 is more likely.

## How to position portfolios?

Differing expectations on the path of interest rates create the potential for financial-market volatility as the gap in expectations dissipates, which may provide opportunity in more speculative asset classes in the future. For now, we continue to prefer high-quality assets in both equities and fixed income — we favor U.S. Large Cap Equities and U.S. Intermediate Term Taxable Fixed Income as the interest-rate environment evolves. We also favor repositioning excess cash alternatives toward longer maturities as the Fed embarks in this cutting cycle. However, significant risks to long-term rates remain dependent on the evolution of the economy, inflation, and Fed rate cuts.

2. Bloomberg, September 23, 2024. Based on market pricing for Fed Funds futures.

# Equities

**Greg Simpson, CFA**
Equity Sector Analyst

## GLP-1s remain hot ticket, but cost-benefit balance key

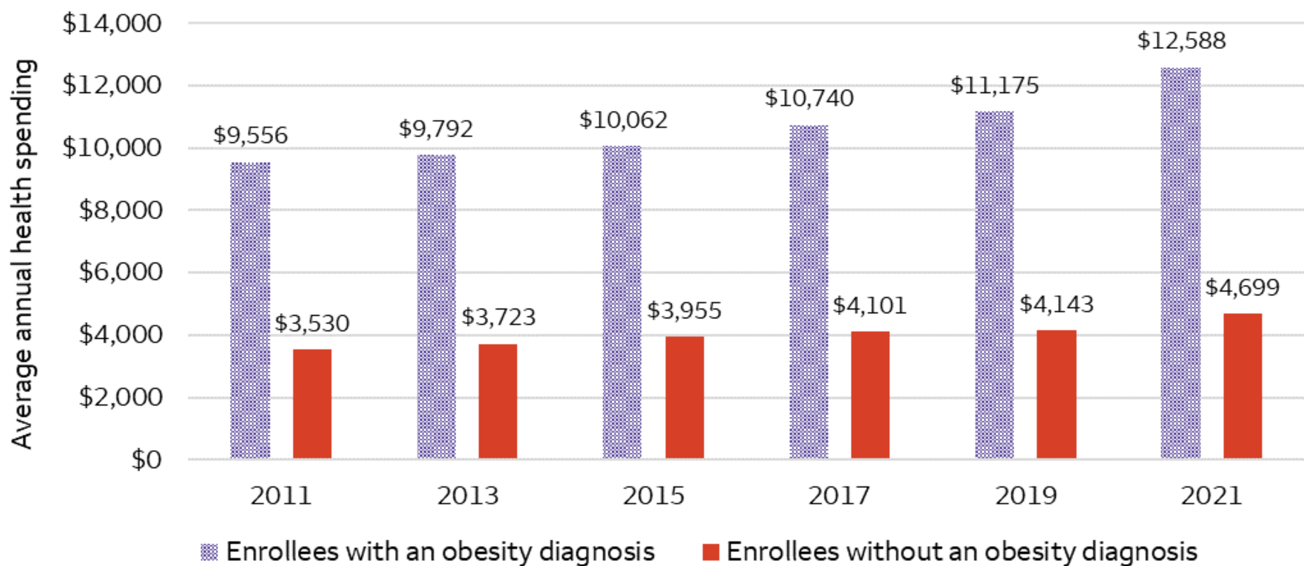
GLP-1 drugs for obesity remain the most compelling story within the Health Care sector, and with good reason. According to the Centers for Disease Control, approximately 74% of adults are considered to have either overweight or obesity in the U.S., of which approximately 42% have obesity. Looking forward, the market for weight-loss drugs should continue expanding rapidly, but we believe cost-benefit economics will be increasingly important.

Importantly, the potential cost savings of lower rates of obesity could be quite significant. The chart below shows the cost differential for Medicare enrollees with or without an obesity diagnosis. We believe this offers strong support in the cost-benefit equation for these drugs and will be a critical factor supporting the expanded usage of GLP-1s going forward.

However, the issue goes beyond obesity as there has been a flood of positive clinical data showing the favorable effect of GLP-1s on several other indications. These include cardiovascular risk, sleep apnea, and dementia. This data could further expand the ultimate market opportunity for GLP-1s, but maybe more importantly, it offers strong pricing and reimbursement support for the drugs as high list prices come under increasing scrutiny.

While we remain neutral on the overall Health Care sector, we are favorable on the Health Care Equipment & Supplies, Life Sciences Tools & Services, and Managed Health Care sub-sectors. For a more detailed discussion on the topic please see our full report, "What investors should know about GLP-1 drugs."

**Average annual health spending of enrollees with or without an obesity diagnosis**




Source: Peterson-KFF Health System Tracker. Data as of July 29, 2024. Includes enrollees with insurance plans from large employers who have a diagnosis of overweight or obesity.

# Fixed Income

**Jon North**
Taxable Analyst

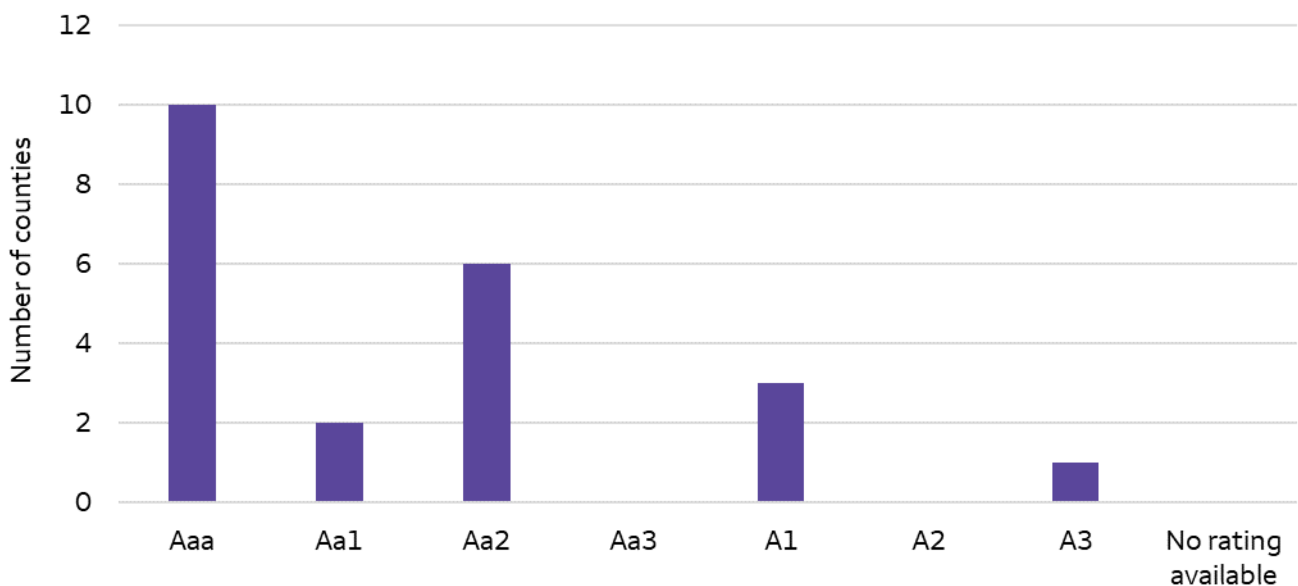
## Healthcare exposure poses risks for some U.S. counties

The Global Securities Research municipal research team's outlook on the Local Government General Obligation sector (which includes counties) is currently stable. This outlook is underpinned by the fact that the majority of local governments rely on stable property taxes as a primary revenue source. Well-rated counties tend to have low debt-service burdens, broad and diverse economic bases, and significant reserve balances, and they also generally have the flexibility to balance budgets by raising taxes, adjusting fees, and cutting expenditures.

Approximately half of the 25 largest counties have exposure to a county-run hospital or other healthcare-related facility that is a contingent liability. Most counties provide similar services, such as social services and the maintenance of county roads. However, counties have discretion over whether they own and operate their own hospitals or nursing homes. While these can provide critical services in areas that lack private providers, these hospitals share the same financial challenges that other privately owned systems face. Counties often must subsidize these operations or promise to cover any contingent liabilities related to the county hospital debt, which poses a credit challenge that other counties do not face. We believe the rating agencies are somewhat underweighting the credit challenge of county-owned hospitals. Of the largest 25 counties, only one of the counties in the single-A rating category has exposure to a hospital, suggesting that factors other than hospital-related contingent liabilities are dragging down the credit.

We continue to advise credit-conscious investors to move up the credit scale, focusing on borrowers that are rated double-A and better and that have geographically large, diverse economies with minimal exposure to hospitals or other healthcare-related contingent liabilities.

**The majority of the 25 largest counties have high ratings from Moody's**




Sources: Moody's Ratings (Moody's) and Municipal Financial Ratio Analysis. Data as of September 25, 2024. County size based on population.

# Real Assets

**John Sheehan, CFA**
Equity Sector Analyst, Real Estate

## REIT earnings have declined as internal growth moderates

In the second quarter of 2024, the REIT industry reported a 1.6% decline in funds from operations (FFO)-per-share relative to the second quarter of 2023 — these results followed the first-quarter 2024 FFO-per-share decline of 1.3%.[3] Additionally, REITs reported 3.0% growth in net operating income (NOI) from their same-store portfolios relative to the second quarter of 2023. Most REIT investors view same-store performance as a good indicator of internal growth.

We view the same-store NOI growth generated during the second quarter of 2024 as relatively attractive despite moderation from recent quarters. It is worth noting that we believe REITs faced a somewhat challenging internal growth comparison with second-quarter 2023, when they generated a 5.0% increase in same-store NOI. Although we do not believe REITs faced an overly challenging comparison period for FFO-per-share growth (which increased 4.1% in second-quarter 2023), it is worth noting that following the pandemic, REITs began reporting strong FFO-per-share growth from second-quarter 2021 through year-end 2022 (quarterly FFO-per-share growth averaged over 20% during that time period). We believe higher interest costs versus a year ago and moderating rent growth contributed to the FFO-per-share decline reported this quarter.

In conjunction with their second-quarter 2024 earnings, the majority of REITs we closely monitor updated their 2024 earnings guidance — while most REITs affirmed their previous 2024 outlooks, a few lowered guidance and several boosted their 2024 expectations. We recommend investors considering REITs focus on Data Center, Industrial, and Self-Storage REITs given positive long-term demand drivers.

3. All data provided by the National Association of Real Estate Investment Trusts (Nareit).

# Alternatives

**Mark Steffen, CFA, CAIA**
Global Alternative Investment Strategist

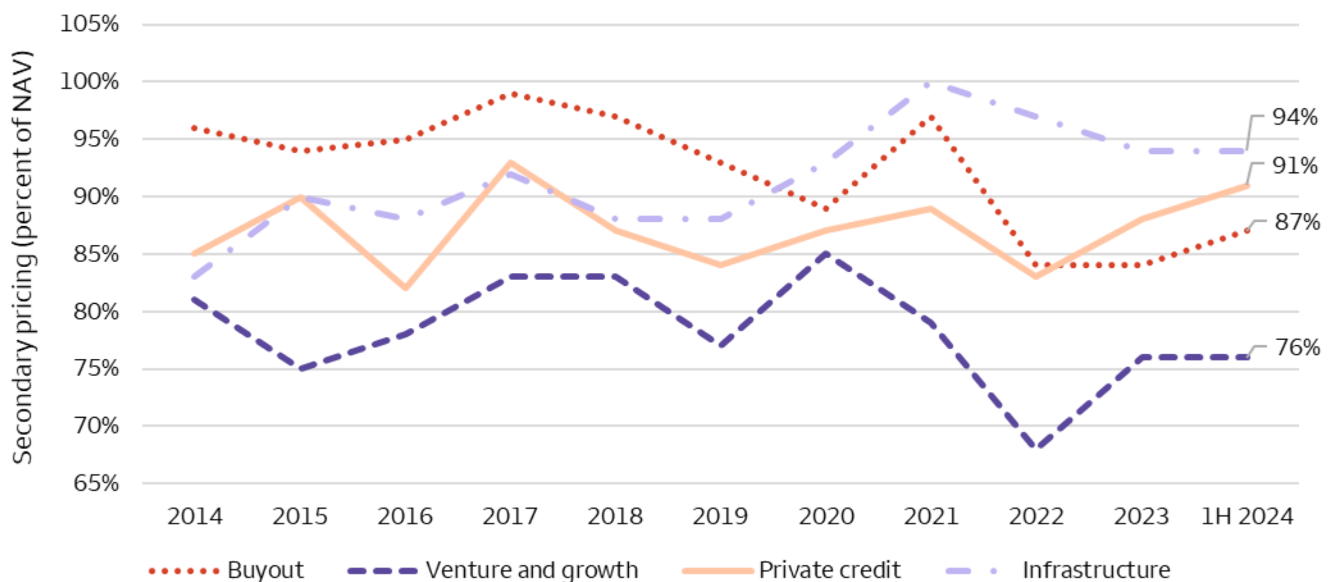
## Secondaries remain attractive despite smaller discounts

Investors in private-equity funds commit their capital for the duration of the fund's life, with a typical horizon of 6 to 12 years. While these investments have limited liquidity options, investors are able to sell their fund interests on the secondary market. The secondary market is typically only available for larger fund stakes and is a common solution for institutional investors looking to rebalance their portfolios.

Investors who purchase these secondary interests are often able to buy at a discount to the fund's current net asset value (NAV). In addition to purchasing at a significant discount, other advantages accrue to secondary investors — these include improved visibility in the underlying portfolio holdings, a shortened path to potentially positive returns, and a shortened fund life span. Given that secondary investors often purchase these interests after the fund's investment period, the portfolio is often fully (or close to fully) invested and beginning to distribute capital as investments are exited.

Secondary valuations reached a recent low during the market drawdown in 2022 and have increased modestly through the first half of 2024 (see chart). While discounts may be lower, the expectation for several interest-rate cuts is expected to spark a sustained economic expansion that may translate into rising valuations for private-equity investments in general (that is, increasing fund NAVs). We believe the current environment remains attractive for secondary investors as this combination of discounts and the increasing likelihood of a soft landing should lead to an improved environment for private-equity strategies in the near future.

**Historical pricing of secondary-market transactions across private-capital categories**




Sources: Greenhill Private Capital Advisory transactions and Wells Fargo Investment Institute. Data as of June 30, 2024. 1H = first half. **Past performance is not a 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<br><br>U.S. Short Term Taxable Fixed Income | Cash Alternatives<br><br>Developed Market Ex-U.S. Fixed Income<br><br>Emerging Market Fixed Income<br><br>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<br><br>U.S. Mid Cap Equities<br><br>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<br><br>Hedge Funds—Equity Hedge<br><br>Private Equity<br><br>Private Debt | Hedge Funds—Relative Value<br><br>Hedge Funds—Macro | |

Source: Wells Fargo Investment Institute, October 7, 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.

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.

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