WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee
November 21, 2022

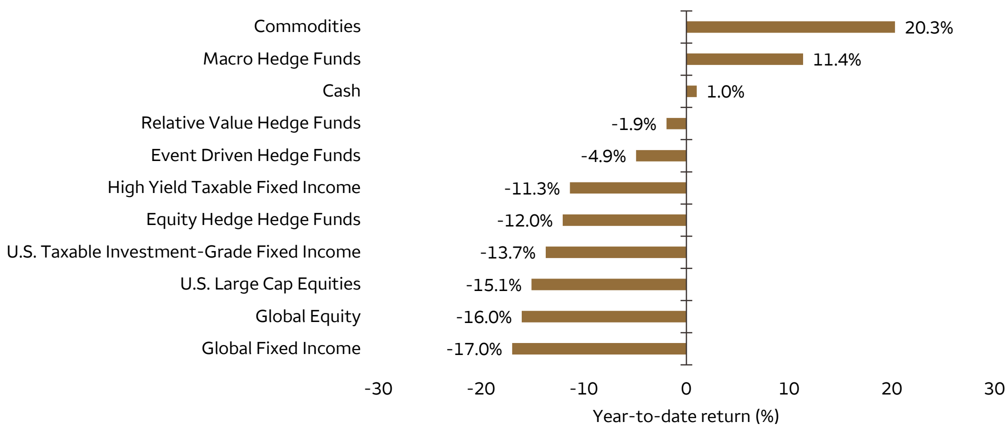
Asset Allocation spotlight

Veronica Willis
Investment Strategy
Analyst

An opportunity for tax-loss harvesting

2022 has been a challenging year for investors, with stocks and bonds both down sharply and only a select few asset classes having seen positive performance. While the downturn in the stock market has followed a somewhat average path for a bear market, with returns not yet reaching levels seen in the 2020 decline nor the 2007 – 2009 bear market, the steep decline in the bond market is much more severe than those we have experienced since the 1970s. Yet, there have been a few bright spots in the market with Commodities and Macro Hedge Fund strategies leading the way. Outside of those two asset classes, cash, and a few additional hedge fund strategies, many of the major asset classes are down double digits for the year.

There have only been a couple of winners year-to-date



Sources: Bloomberg and Wells Fargo Investment Institute, as of November 15, 2022. Hedge fund data is as of October 31, 2022. FI = fixed income. Global FI = Bloomberg Multiverse Index. Global equity = MSCI ACWI Index. U.S. large-cap equity = S&P 500 Index. U.S. investment-grade taxable FI = Bloomberg U.S. Aggregate Bond Index. Equity Hedge = HFRI Equity Hedge Index. High-yield taxable FI = Bloomberg U.S. Corporate High Yield Index. Event Driven = HFRI Event Driven Index. Relative Value = HFRI Relative Value Index. Cash = Bloomberg U.S. Treasury Bill (1-3 Month) Index. Macro = HFRI Macro Index. Commodities = Bloomberg Commodity Index. Index returns do not represent investment returns or the results of actual trading nor are they forecasts of expected gains or losses a fund might experience. Index returns do not represent investment performance. Index returns reflect general market results, assume the reinvestment of dividends and other distributions, and do not reflect deduction for fees, expenses or taxes applicable to an actual investment. Unlike most asset class indexes, HFR Index returns reflect deduction for fees. Because the HFR indexes are calculated based on information that is voluntarily provided actual returns may be lower than those reported. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results**. See end of report for index definitions.

What is tax-loss harvesting?

With markets hit so hard this year, taxable fixed income and equity investors may have an opportunity to harvest tax losses, and at the same time reallocate funds into the high-quality asset classes that we favor while prices are low. Tax-loss harvesting is a strategy of selling investments with a capital loss in taxable accounts to reduce taxable capital gains and potentially offset up to $3,000 in taxable income. When the loss exceeds capital gains, an investor would not owe any capital gains tax. Thus, individual investors have the potential to deduct up to $3,000 in excess losses from their ordinary income. Losses in excess of that $3,000 limit can be carried forward to future tax years.

Investment implications

When investors sell assets as part of a tax-loss harvesting strategy, it can complement their rebalancing strategy, helping ensure that their portfolio remains aligned with their target asset allocation, taking into account their risk tolerance and investment objective, as well as the current market environment. Rebalancing during a downturn can be crucial to potentially leading to higher returns and a quicker recovery time. On the other hand, rebalancing during a recovery helps ensure that the allocation does not accumulate more equity and other risk assets than originally intended, placing the portfolio at risk of suffering greater losses due to a higher exposure to riskier assets.

We recently adjusted our tactical guidance, downgrading U.S. Intermediate Term Taxable Fixed Income to unfavorable and upgrading U.S. Long Term Taxable Fixed Income to a most favorable rating. With yields resetting at higher levels, we favor reallocating from the intermediate portion of the yield curve to long-term bonds. From a tactical asset allocation perspective, we also favor U.S. Short Term Taxable Fixed Income, thus suggesting a barbell strategy — investing first in longer-dated and shorter-dated bonds before investing in the intermediate-term bonds.

In equities, we continue to focus on quality. We favor U.S. equities over international equities as the U.S. economy continues to fare better than economies elsewhere. We believe that large-and mid-caps should prove more resilient entering an economic downturn than small caps. We are expecting continued volatility in equities and do not believe it is the time to move into the riskier, higher beta (market sensitivity) areas of the equity market.

Now could be a good time to assess investors' use of diversifiers, like commodities and hedge funds. They have performed well so far this year, and we continue to have favorable views for both over the next 6 to 18 months considering our expectation for elevated volatility over that timeframe. We expect inflation to ease in 2023, but it will likely remain above pre-pandemic levels and should still support higher commodity prices. Using diversifiers that do not necessarily move in the same direction as stocks or bonds historically has helped reduce downside risk in allocations that utilize them. This reduction in downside risk should help aid in recovery time and smooth returns over the long term, potentially providing more consistency in performance.

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Equities

Chao Ma, PhD, CFA, FRM
Global Portfolio and Investment Strategist

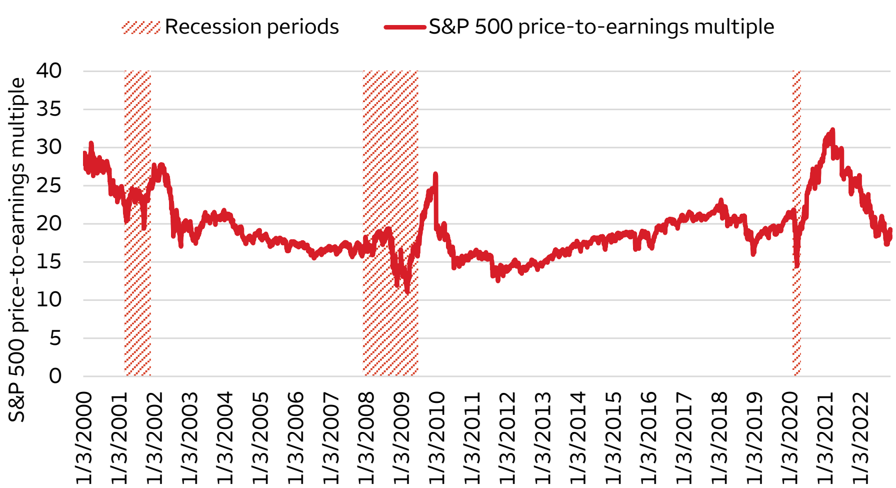
Equity valuation: Contraction and expansion

The equity markets are often considered "forward-looking", as they trade off expected future company earnings, rather than the past history. As a result, stock price movements have frequently led macroeconomic and company earnings development. This dynamic is illustrated in the chart below, where the price-to-earnings (P/E) multiple, albeit relatively stable in normal times, contracted and expanded significantly during market correction and rally periods in past recessions.

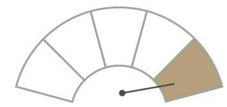
The year of 2022 is a great example of multiple contraction. The reported aggregate earnings for the S&P 500 Index have held up relatively well throughout the year. However, the index's valuation multiple has decreased from 25 times to below 20 times, driven by a sharp decline in index price in anticipation of rising interest rates and slower future earnings growth.

Similarly, the valuation multiple typically expands materially during market recovery. A case in point is the post-pandemic recovery, when the P/E ratio increased from 20 times to over 30 times, as the unprecedented fiscal and monetary stimulus significantly improved company earnings expectations. The same has been seen historically coming out of other recessions (see chart below): The valuation multiple spiked first and then eventually normalized to long-term levels as the higher expected earnings were realized. We believe that, going forward, valuations will eventually increase when the equity market turns, likely based on a more optimistic future earnings expectation driven by improvements in macroeconomic and market liquidity conditions.

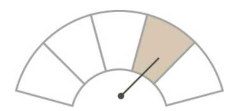
Price-to-earnings multiple for S&P 500 index



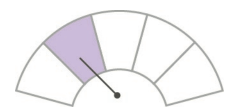
Sources: Wells Fargo Investment Institute and Bloomberg. Data as of November 15, 2022. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**



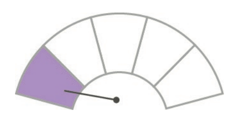
Most favorable
U.S. Large Cap Equities



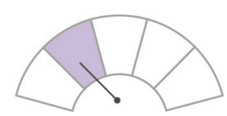
Favorable
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities



Unfavorable
Emerging Market Equities

Fixed Income

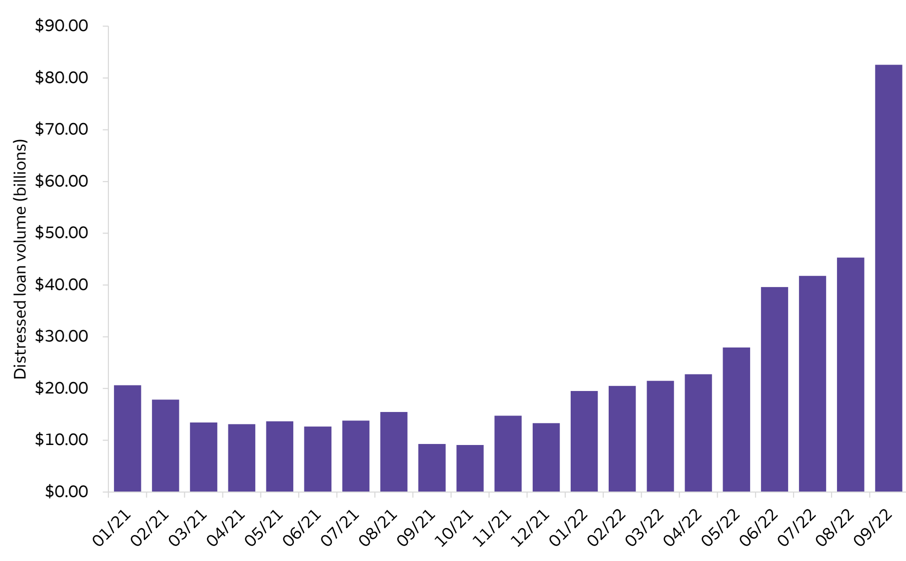
Leveraged loans: Potential headwinds ahead

Leveraged loans (LL) are senior secured bank loans made to companies that have a below-investment-grade rating, often outside the Financials sector. Investors tend to like the floating-interest-rate nature of this asset class, especially during periods of rising rates. Investor appetite for this asset class was evident throughout April 2022, as fund flows remained positive. However, the pace of flows has turned negative over the past six months as investors began to expect headwinds ahead.

Despite the decline in prices and increase in yields, LL have performed better (-0.96%) than other major fixed-income asset classes (for example, high-yield -11.3%, investment-grade corporate bonds -16.2%) year-to-date.[1] But the tide may begin to turn, especially as headwinds surface. LL default rates have climbed over the past two quarters, marking the highest levels since June 2021, just as distress levels continue to rise. Tightening credit conditions and rapidly rising funding costs have placed renewed focus on leveraged credit risk.

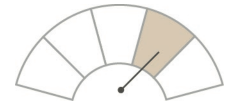
We currently have a neutral stance on leveraged loans relative to high-yield corporate bonds for those investors seeking additional sources of income, and we continue to advocate for selectivity and active management in this space. However, given the difficult outlook ahead, we believe investors can find better opportunities in other areas of fixed income, like long-term government bonds, especially ahead of an anticipated economic slowdown.

U.S. leveraged loan distressed volume

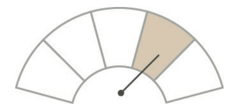


Sources: Leveraged Commentary and Data and Morningstar LSTA US Leveraged Loan Index, as of November 16, 2022. Monthly data from January 2021 to September 30, 2022. Distressed debts are those where the issuers cannot meet a large number of their financial obligations and usually have credit spreads that are 1000 basis points above the risk-free rate. (100 basis points equal one percent.)

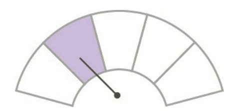
Luis Alvarado
Investment Strategy Analyst



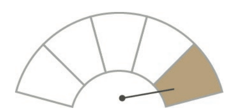
Favorable
U.S. Taxable Investment Grade Fixed Income



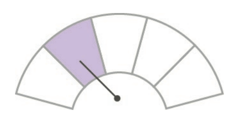
Favorable
U.S. Short Term Taxable Fixed Income



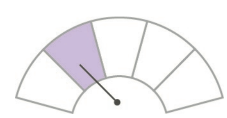
Unfavorable
U.S. Intermediate Term Taxable Fixed Income



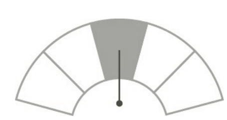
Most favorable
U.S. Long Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



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

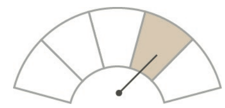


Neutral
Emerging Market Fixed Income

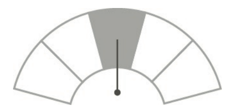
1. Based on the S&P LSTA Leveraged Loan TR Index, HY Corporate TR Index and the IG Corporate Bond TR Index as of November 16, 2022.

Real Assets

John LaForge
Head of Real Asset Strategy



Favorable
Commodities



Neutral
Private Real Estate

"Better a diamond with a flaw than a pebble without." — Confucius

Update on European natural gas storage

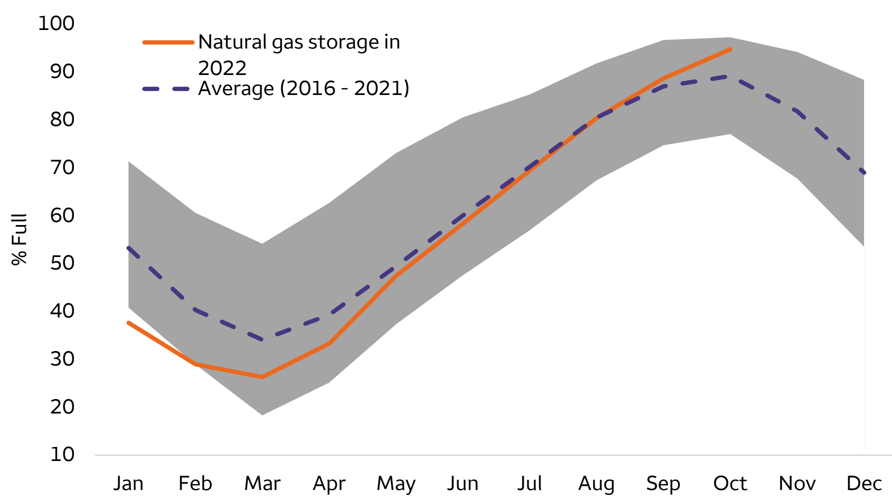
The European energy crisis was the center of attention this year, but Europe's outlook seems brighter as countries have exceeded their gas storage requirements. Temperature swings remain a risk, but we do not expect Europe to find itself in a scenario where it completely runs out of gas.

Following Russia's conflict with Ukraine and suspicions that Russia would cut its supply of gas to Europe, natural gas prices skyrocketed, up 70% year-to-date. In response, the European Union (EU) mandated that storage reserves be at least 80% full by November 1, 2022. Recently, the EU reached this goal and reserves are 95% full, even higher than the 5-year average.

So far, it has been a warm winter, which has eased prices and allowed countries to hold off on withdrawals and continue filling reserves. The consensus is that Europe will experience moderate temperatures for the remainder of 2022, but there is a chance for a cold start to 2023, which could boost demand and drawdown stockpiles. We believe though that Europe will likely have enough gas, as shown by the current 103 days of supply, meaning that if production completely stopped (which rarely, if ever, occurs), supply could meet average consumption for 103 days.

Given that storage reserves are considerably above average and warm temperatures have pushed back withdrawals, Europe will likely have enough gas for the winter. If temperatures drop below normal for an extended period, we could see stockpiles drawn down and prices increase, but Europe completely running out of gas is an unlikely scenario.

The historical range of European gas storage



Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data is from January 2016 – October 2022.

Alternatives

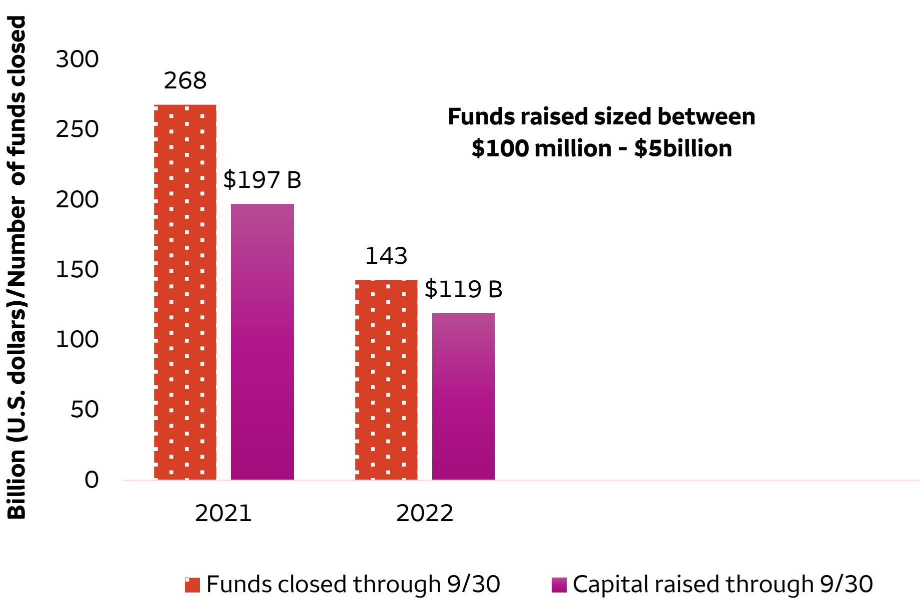
Private Equity fundraising slowing down

Karin Geldfeld
Lead Analyst, Private Equity
Global Manager Research

Given the market turbulence over the past several months and ensuing denominator effect on limited partners (increased exposure to alternatives due to decrease in public equity valuations), fundraising has become challenging for private equity fund managers. Consequently, some limited partners must reduce their exposure to private equity via secondary sales and/or reduced commitments to new funds. Global Manager Research (GMR) anticipates this trend to persist well into 2023. As a result of drawn-out fundraising periods, investors should be able to review initial investments in funds that have begun investing their partially fundraised funds, reducing "blind pool risk" (the risk that arises from committing to a blind pool of capital where investments are not yet known). Investors may also become pickier, and capital is likely to flow to managers who are already experienced and tenured, and away from newer managers and strategies without a proven track record.

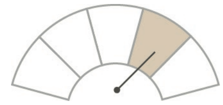
According to Pitchbook, private equity managers closed 143 vehicles with fund sizes between $100 million and $5 billion in the first three quarters of the year, raising $119 billion, compared to $197.4 billion across 268 such vehicles during the same period last year — nearly a 50% drop.

Fundraising slows down from 2021 to 2022

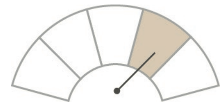


Sources: Pitchbook. Data as of September 30, 2022.

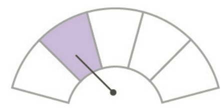
Given these dynamics, GMR is evaluating experienced private equity managers and additional secondary managers to add to the platform.



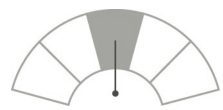
Favorable
Hedge Funds – Relative Value



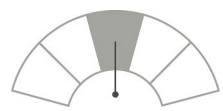
Favorable
Hedge Funds – Macro



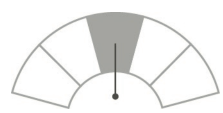
Unfavorable
Hedge Funds – Event Driven



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

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. **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. Investing in **distressed** companies is speculative and subject to greater levels of credit, issuer and liquidity risk. In addition, the repayment of default obligations contains significant uncertainties. **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.

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

Bloomberg U.S. Aggregate Bond Index is composed of the Bloomberg U.S. Government/Credit Index and the Bloomberg U.S. Mortgage-Backed Securities Index and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities.

Bloomberg U.S. Corporate High Yield Bond Index covers the U.S.-dollar-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB= or below. Included issues must have at least one year until final maturity.

Bloomberg U.S. Treasury Bill (1–3 Month) Index is representative of money markets.

Bloomberg Commodity Index is a broadly diversified index of commodity futures on 20 physical commodities, subdivided into energy, U.S. agriculture, livestock, precious metals, and industrial metals sectors. Commodity weights are derived in a manner that attempts to fairly represent the importance of a diversified group of commodities to the world economy.

Bloomberg Multiverse Index provides a broad-based measure of the global fixed-income bond market. The index represents the union of the Global Aggregate Index and the Global High-Yield Index and captures investment grade and high yield securities in all eligible currencies.

HFRI Equity Hedge Index consists of Investment Managers who maintain 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. EH managers would typically maintain at least 50%, and may in some cases be substantially entirely invested in equities, both long and short.

HFRI Event Driven Index maintains positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Event Driven exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

HFRI Macro Index: Investment Managers which trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed-income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom up theses, quantitative and fundamental approaches and long and short term holding periods. Although some strategies employ RV techniques, Macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments, rather than realization of a valuation discrepancy between securities. In a similar way, while both Macro and equity hedge managers may hold equity securities, the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposes to EH, in which the fundamental characteristics on the company are the most significant are integral to investment thesis.

HFRI Relative Value Index maintains positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed-income, derivative, or other security types.

The HFRI indexes 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 indexes may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways.

MSCI All Country World Index (ACWI) is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. It consists of 46 country indexes comprising 23 developed and 23 emerging market countries.

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S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value.

An index is unmanaged and not available for direct investment.

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