WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee

December 5, 2022

Asset allocation spotlight:
Prepare for 2023: Diversify and rebalance allocations 2

- Diversification and rebalancing continue to be key long-term strategies in a volatile market and may help to prepare allocations for 2023.
- With a changing interest rate environment, we believe it is time to review risk-return profiles, revisit income generation approaches, and rebalance according to our long-term strategic allocation guidance.

Equity sector analysis:
Investing conditions looking up for select P&C insurers 4

- Industry conditions remain generally favorable for select players in commercial property and casualty (P&C) insurance.
- Managers of the investment portfolios of these companies are finally seeing the benefits of higher interest rates and improving portfolio yields.

Fixed Income sector analysis:
Federal aid cliff, low ridership challenge transit 5

- Slow ridership recovery, an impending federal aid cliff, inflation-induced wage pressures, and uncertain tax revenue conditions in 2023 continue to challenge transit systems.
- However, we expect transit systems will continue to receive broad political and financial support from parent governments to find solutions for operating and budgetary challenges.

Real Estate sector analysis:
REITs report solid earnings in third quarter 2022 6

- Despite another challenging comparison quarter, real estate investment trusts (REITs) were able to generate attractive growth in funds from operations per share and same-property net operating income.
- While many REITs maintained or modestly revised their 2022 earnings guidance, most REITs have not yet provided 2023 earnings guidance.

Alternatives: Caution ahead — preparing for recession 7

- As we believe the economy likely heads toward a recession, we expect the environment for Merger Arbitrage strategies to deteriorate as deal activity slows, spreads widen, and timeframes to close existing deals lengthen.
- In another sign that hedge funds are becoming more defensive, the Equity Hedge segment has experienced declining sensitivity to broad market movements.

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Asset allocation spotlight

Michelle Wan, CFA
Investment Strategy
Analyst

Prepare for 2023: Diversify and rebalance allocations

2022 has been challenging for investors in many ways — decades-high inflation, the war in Ukraine, and supply-chain disruptions, to name a few. The decline in price in both fixed income and equity asset classes, as both markets descended into bear territory, resulted in double-digit negative returns for many diversified allocations year-to-date.[1] Meanwhile, as inflation has persisted above 7%, the opportunity cost of holding cash cannot be neglected either. Even though inflation has receded from June's 9% peak level, it is still significantly above the Federal Reserve's 2% target. In comparison, the U.S. 10-year Treasury is currently yielding 3.7% and the S&P 500 dividend yield is at 1.7%.[2]

Tactical guidance is important to navigate through these short-term challenges, but we remind investors not to lose sight of allocation drift and favor a year-end review with a long-term perspective.

Maintaining a diversified allocation remains a key strategy during bear markets. As the table below shows, in the six previous bear markets, a broadly diversified allocation represented by the Moderate Growth and Income (MGI) allocation experienced less drawdown and fewer days to recover than a concentrated allocation to U.S. large-cap stocks represented by the S&P 500 Index.

The length of the current bear market remains unknown at this time, but so far, the drawdown seems to be following historical patterns where the MGI allocation has experienced a less severe maximum drawdown. Market activity this year underscores the power of diversification because this is the only bear market since 1980 (see table on next page) where stocks and bonds declined for three consecutive quarters. For example, diversifying into Commodities, which have advanced 15.8%[3] year-to-date, may have cushioned the downside. For clients who can further diversify into alternative assets, our research shows that hedge funds may be another attractive diversifier. Historically, they have experienced up and down capture ratios[4] of 51% and 21%, respectively, indicating less historical downside compared to global equities.[5] This is a particularly valuable characteristic in a year when stocks and bonds have concurrently experienced losses.

1. Bear markets are declines of 20% or more and allocation returns are published in the Capital Market Summary report dated October 31, 2022.
2. Bloomberg data as of December 2, 2022.
3. Capital Market Summary, October 31, 2022.
4. This ratio measures upside and downside participation relative to benchmark performance.
5. Quarterly Market Charts, September 30, 2022.

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Moderate Growth & Income liquid allocation versus the S&P 500 Index

Bear markets	S&P 500 Index recovery date	S&P 500 Index drawdown (%)	Days to recover for S&P 500 Index	Moderate Growth & Income (MGI) recovery date	MGI drawdown (%)	Days to recover for MGI
Nov. 28, 1980 – Aug. 12, 1982	Nov. 3, 1982	-27.1	702	Aug. 31, 1982	-10.0	638
Aug. 25, 1987 – Dec. 4, 1987	Jul. 26, 1989	-33.5	700	Jun. 30, 1988	-10.4	309
Jul. 16, 1990 – Oct. 11, 1990	Feb. 13, 1991	-19.9	211	Feb. 13, 1991	-13.0	211
Mar. 24, 2000 – Oct. 9, 2002	May 30, 2007	-49.1	2620	Jun. 17, 2003	-19.1	1177
Oct. 9, 2007 – Mar. 9, 2009	Mar. 28, 2013	-56.8	1996	Oct. 1, 2010	-36.4	1087
Feb. 19, 2020 – Mar. 23, 2020	Aug. 18, 2020	-33.9	180	Aug. 3, 2020	-22.1	165
Jan. 3, 2022 – current	TBD	-25.4	TBD	TBD	-19.4	TBD
Average		**-36.7**	**1068**		**-18.5**	**598**

Sources: © 2022 – Morningstar Direct, All Rights Reserved,[1] and Wells Fargo Investment Institute, as of October 31, 2022. TBD = to be determined. January 3, 2022, to current decline is as of October 31, 2022, and is the peak to trough decline, with trough of October 12, 2022. Current bear market is not included in averages. Index return information is provided for illustrative purposes only. Performance results are calculated using blended index returns. Results do not represent actual trading and the results achieved do not represent the experience of any individual investor. In addition, results do not reflect the impact of any fees, expenses or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. **Past performance does not guarantee future results.** The blended index compositions and the definitions of the indexes and descriptions of the risks associated with investment in these asset classes are provided at the end of the report. Note: Bear markets are declines of 20% or more. Diversification strategies do not guarantee investment returns or eliminate the risk of loss.

The Wells Fargo Investment Institute macro outlook expects a recession in the first half of 2023, which likely will result in continued market volatility. We believe now is a good time to revisit investment allocations and to prepare for possible market dislocations by adding to asset classes according to our strategic and tactical guidance. In particular, we believe investors should consider adding favored asset classes in which they are not currently invested to broaden their diversification.

We also believe that investors should review the level of risk they are taking in their investment portfolios, revisit income generating strategies, and rebalance portfolios. Given the low interest rate environment prior to 2022, income-seeking investors may have relied on real estate investments, stock dividends, and other higher-volatility income-generating assets in addition to bonds. Given that interest rates have risen significantly this year, we believe now is a good time to review risk tolerance and ensure asset allocation aligns with long-term goals. Given the wild swings of both stocks and

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bonds this year, allocations may have drifted away from optimal targets. For that reason, rebalancing back to long-term target allocations may be appropriate for some investors.

Equities sector analysis

Sector analysis prepared by Wells Fargo Advisors Global Securities Research

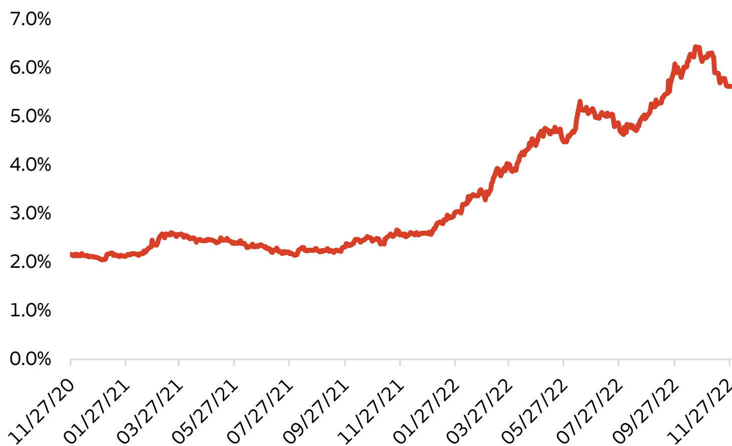
Mike Ruesy, CFA
Equity Sector Analyst
Wells Fargo Advisors

Investing conditions looking up for select P&C insurers

The underwriting environment this year has been positive for select commercial property and casualty (P&C) insurance companies, extending a multi-quarter stretch of such circumstances. These companies have seen premium growth, and markets are "hard," with rate still favorable across most product lines, even with some gradual moderation. Competition generally seems rational, although admittedly with some observed outliers. For first-class commercial insurance companies, including specialty carriers known for strong underwriting and risk management, and deep expertise in several industries and coverages, rate is exceeding observed and prospective loss cost. With the underwriting conditions still encouraging, the investment portfolio (the other half of an insurance operation) is finally starting to benefit after years of suppressed market yields.

Note that these companies have relatively short durations in their fixed-income portfolios and look forward to higher interest rates and better new money yields. More specifically, for some of them, reinvestment rates may be 200 basis points (a basis point is 1/100th of a percentage point) higher than the current portfolio yield. We believe this yield pickup is meaningful and realized without having to extend duration or dip down in credit quality and can be a strong contributor to future earnings power. Insurance company book values may have been reduced recently because of after-tax net unrealized losses in the investment portfolio due to the mark-to-market impact of higher interest rates on fixed-income securities. As buy-and-hold investors of high-quality, liquid securities, P&C companies should see these marks accrete back to book value over time.

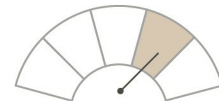
Bloomberg U.S. Aggregate Baa Index yield-to-worst



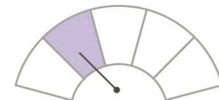
Sources: FactSet and Wells Fargo Investment Institute. Data as of November 28, 2022. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** See the definition of the index on page 8.

Wells Fargo Investment Institute guidance:

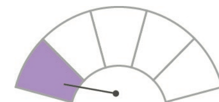
Most favorable
U.S. Large Cap Equities



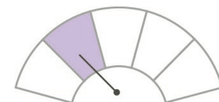
Favorable
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities



Unfavorable
Emerging Market Equities

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Fixed Income sector analysis

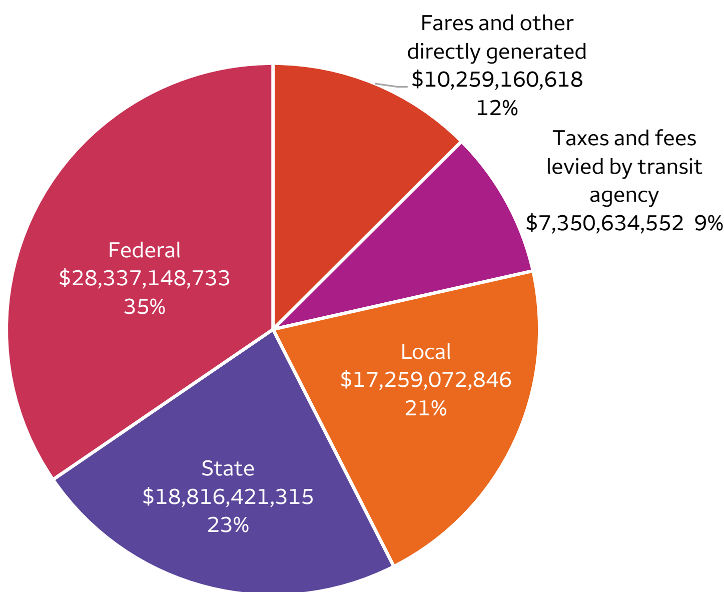
Sector analysis prepared by Wells Fargo Advisors Global Securities Research

Federal aid cliff, low ridership challenge transit

On November 15, Moody's Investors Service (Moody's) revised its outlook for the U.S. mass transit sector to negative from stable due to slow ridership recovery, an impending federal aid cliff, inflation-induced wage pressures, and uncertain tax revenue conditions in 2023. According to Moody's projections, ridership will continue to slowly improve as workers increasingly return to the office but will reach only 65% – 75% of pre-coronavirus levels by the end of 2023. The slow recovery will force systems to adjust service or find new revenues to meet changing consumer behavior and balance budgets. Some transit systems will likely struggle to replace massive federal pandemic aid used to offset operating losses caused by low ridership, leaving fare-dependent transit systems to confront large budget gaps.

However, we expect transit systems will continue to receive broad political and financial support from parent governments to find solutions to operating and budgetary challenges. Generally, Congress is involved in surface transportation funding which can lead to legislative risk — this has encouraged several states to raise their own gas taxes or create toll roads to fund transportation improvements. Federal funding from the $1.2 trillion Infrastructure Investment and Jobs Act has replaced new debt issuance for capital projects for some municipal issuers, which has contributed to a 17% decline in transportation bond issuance year over year. In general, highly rated transit systems that provide a critical service and possess monopolistic control over large service areas should continue to be more resilient against negative economic pressures.

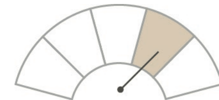
U.S. mass transit system funding sources



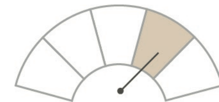
Sources: Federal Transit Administration's National Transit Database, Global Securities Research Municipal Research Group. Data as of November 28, 2022.

Dorian Jamison
Municipal Analyst
Wells Fargo Advisors

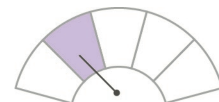
Wells Fargo Investment Institute guidance:



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

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Real Estate sector analysis

Sector analysis prepared by Wells Fargo Advisors Global Securities Research

John Sheehan, CFA
Equity Sector Analyst
Wells Fargo Advisors

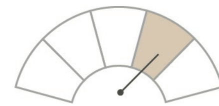
REITs report solid earnings in third quarter 2022

Data provided by the National Association of Real Estate Investment Trusts (Nareit) shows the real estate investment trust (REIT) industry generated growth in funds from operations (FFO, the primary earnings measure utilized by REITs) per share of 13.6% over third-quarter 2021 results. These results follow second-quarter 2022 FFO per share growth of 14.2%. Additionally, REITs reported 7.1% growth in net operating income (NOI) from their same-property portfolios relative to the third quarter of 2021. Most REIT investors view same-property performance as a good indicator of internal growth.

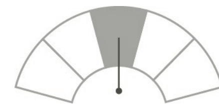
We view the FFO per share and same-store NOI growth generated by the REIT industry during the third quarter of 2022 favorably. It is worth noting we believe REITs faced challenging comparisons with the third quarter of 2021; data from Nareit indicated REITs generated nearly 35% growth in FFO per share (likely reflecting an economic recovery following the pandemic) and a 7.2% increase in same-store NOI in the third quarter of 2021.

While Nareit does not track changes in REIT earnings guidance, the majority of REITs we closely monitor either maintained or modestly revised their prior 2022 earning guidance. As is customary for this time of year, most REITs have not provided investors with earnings guidance for 2023. When most REITs issue 2023 earnings guidance, we expect guidance to reflect the impact of higher capital costs, elevated inflation, and expectations for rental rate growth across the different REIT sub-industries.

Wells Fargo Investment Institute guidance:



Favorable
Commodities



Neutral
Private Real Estate

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Alternatives

Caution ahead — preparing for recession

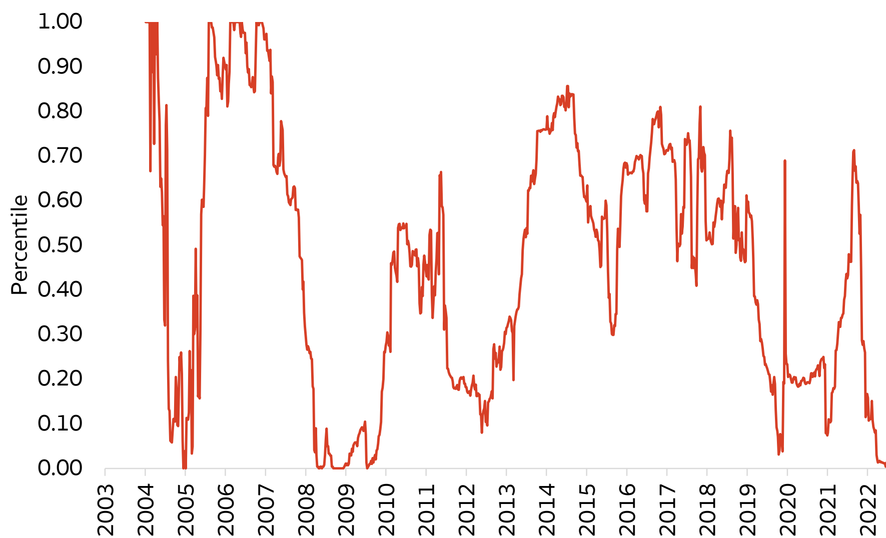
Mark Steffen, CFA, CAIA
Alternative Investment Strategist

As we believe the global economy likely heads toward a recession in 2023, mounting risks may become realities for many areas of the market over the next few quarters. As higher interest rate levels ripple throughout the economy, higher debt service levels and slower (or negative) gross domestic product growth should meaningfully impact many industries, particularly small- and mid-sized businesses. While the environment remains sanguine for many companies, cracks are beginning to appear as consumers begin to alter their purchase patterns in the face of persistent inflation.

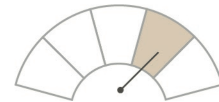
Merger and acquisition activity will likely decline significantly during a recession, and deals in process may be delayed several months as acquirers look to reprice existing terms. Downturns are often characterized by broken deals and vastly wider spreads. We expect that this looming recession will be similar, though shorter in duration than the average downturn. Accordingly, we downgraded the Event Driven – Merger Arbitrage strategy to unfavorable. Given our forecast for a recovery in late 2023 and into 2024, we expect the decline in deal activity to be relatively short-lived and for activity to resume in earnest as the economy reemerges from recession.

In another sign that some hedge funds may be turning more cautious, Equity Hedge Funds have reduced their portfolios' sensitivity to the broad equity market. We expect that the forecasted downturn may also lead to increasing dispersion between stocks, which should bode well for strategies that can generate positive returns from both their long and short portfolios.

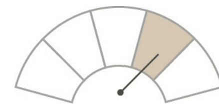
HFRX Equity Hedge Index 12-month rolling sensitivity to the S&P 500 (in percentile)



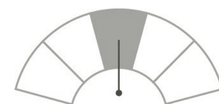
Sources: Bloomberg and Wells Fargo Investment Institute. Data as of November 28, 2022. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** See the definition of the index on page 8.



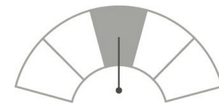
Favorable
Hedge Funds – Relative Value



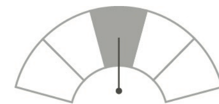
Favorable
Hedge Funds – Macro



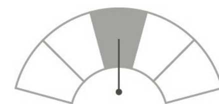
Neutral
Hedge Funds – Event Driven



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.

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Risk Considerations

Forecasts and targets are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.

All investing involves risks, including the possible loss of principal. There can be no assurance that any investment strategy will be successful and meet its investment objectives. Investments fluctuate with changes in market and economic conditions and in different environments due to numerous factors, some of which may be unpredictable. Asset allocation and diversification do not guarantee investment returns or eliminate risk of loss.

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.

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

Moderate Growth & Income Liquid = 2% Bloomberg U.S. Treasury Bills (1–3 Month) Index, 30% Bloomberg U.S. Aggregate Bond Index, 6% Bloomberg U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index, 24% S&P 500 Index, 10% Russell Midcap Index, 6% Russell 2000 Index, 8% MSCI EAFE Index, 5% MSCI Emerging Markets Index, 4% Bloomberg Commodity Index.

Bloomberg Aggregate Baa Index is a sub-index of the Bloomberg US Aggregate Index that measures the USD-denominated, fixed-rate corporate bond market containing securities that are classified by a credit rating from Moody's of Baa. Bonds rated Baa are subject to moderate credit risk, considered medium grade, and as such may possess certain speculative characteristics.

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 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 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 Bills (1-3 Month) Index is representative of money markets.

HFRX Equity Hedge Index tracks strategies that 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.

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JPM EMBI Global Index is a U.S. dollar-denominated, investible, market cap-weighted index representing a broad universe of emerging market sovereign and quasi-sovereign debt. While products in the asset class have become more diverse, focusing on both local currency and corporate issuance, there is currently no widely accepted aggregate index reflecting the broader opportunity set available, although the asset class is evolving. By using the same index provider as the one used in the developed-market bonds asset class, there is consistent categorization of countries among developed international bonds (ex. U.S.) and emerging market bonds.

MSCI EAFE Index is a free-float-adjusted market-capitalization-weighted index designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

MSCI Emerging Markets (EM) Index is a free-float-adjusted market-capitalization-weighted index designed to measure equity market performance of emerging markets.

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Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 25% of the total market capitalization of the Russell 1000® Index.

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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