Global Economy Spotlight: A look back at a resilient 2023

- A surprisingly resilient economy in 2023 rode a tailwind of post-pandemic supports and ample liquidity to sustain growth.
- We prefer investors prioritize quality and caution in both equity and fixed-income positions and exercise patience until the next economic recovery comes into view.

Equities: 2023 year in review: Equities

- Inflation, the Federal Reserve (the Fed), interest rates, and artificial intelligence (AI) have been key drivers of a choppy 2023 for equity markets.
- Our preference for quality has been rewarded this year with our favorable rated U.S. Large Caps outperforming.

Fixed Income: A strong year for rates and credit markets

- The government-bond rally over the past two months has been spurred by market expectations for potential rate cuts by the Fed in 2024.
- U.S. credit markets outperformed rates markets (like long-term government bonds) in 2023 — as many investors sought the higher yields available in credit markets without much concern over credit risks.

Real Assets: Reviewing 2023 commodity performance

- Commodity performance turned negative in 2023 as tighter financial conditions and slowing economic growth softened demand.
- Precious Metals were the strongest performing sub-sector, with a year-to-date return of 7.9% (through December 15), after years of lagging performance.

Alternatives: 2023 — Opportunities amid uncertainties

- Through 2023, an uncertain macro environment and market volatility provided investors with unique opportunities in alternative investments.
- Our favorable views on relative value and distressed credit strategies, as well as our constructive outlook on small- and mid-buyouts, growth equity, and secondary markets added value.

Current tactical guidance

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Global Economy Spotlight

“The world is full of foolish gamblers, and they will not do as well as the patient investors.” — Charlie Munger

Jennifer Timmerman  |  Gary Schlossberg
Investment Strategy Analyst  |  Global Strategist

A look back at a resilient 2023

A resilient U.S. economy was on full display in 2023, powered by still-ample liquidity and lingering post-pandemic supports. For most of the year, the all-important consumer (accounting for two-thirds of economic activity) was unphased by the fastest pace of credit tightening in four decades. Investment spending was fueled by the buildout of U.S. infrastructure tied to 2022 government stimulus and private investment. Growth was on track to exceed its 2022 pace, despite a slowdown during the closing months of this year.

By comparison, international economic activity was slowed by rising U.S. and overseas interest rates that pressured growth directly, through higher borrowing costs, and indirectly, by adding to global deflation through its support to the dollar. Export-oriented Europe grappled with a slowdown in global trade, steady interest-rate hikes by the European Central Bank, and the absence of the kind of fiscal stimulus that supported U.S. growth. A gathering economic slowdown did accommodate a steep drop in inflation, cushioning household purchasing power and Europe’s downturn into 2024. In Asia, China’s struggling economy faced deflation tied to headwinds from consumer caution, a slumping property sector, and a lack of stimulus measures as a debt overhang hampered government action.

Lingering post-pandemic supports contributed to U.S. economic strength this past year, from the release of pent-up travel and entertainment demand; catch-up hiring that fueled job and income growth; and an unusually early break in inflation that preserved consumer purchasing power. Unexpectedly ample financial liquidity also provided support, from the Fed’s fresh wave of funds in the spring to limit fallout from the banking crisis and from a drawdown of Treasury cash balances during the standoff over the debt ceiling last spring. The increased availability of liquidity combined with lower interest rates and market expectations for a Fed pivot to rate cuts in 2024. Together, these factors eased financial conditions by the most on record in November, spurring a swift rally in both stocks and bonds.1

Are we there yet? In our view, the dual transition we wrote about a year ago is still developing. A year of disinflation pushed the Consumer Price Index (CPI) to 3.1% on a 12-month basis in November — on its way to our forecasted 2.5% target in December 2024. However, we expect the path to be choppy, especially if an economic slowdown proves more modest than we anticipate.

We believe an economic slowdown will continue to develop gradually, as key support from dominant consumer spending winds down in the first part of the new year. Excess pandemic cash balances are exhausted for most income quintiles,2 credit delinquencies are rising, households are relying more on credit to sustain purchases, and third-quarter corporate earnings transcripts confirm early weakness in consumer spending.

Eyeing a pivotal 2024: Investors have anticipated a pivot to rate cuts by the Fed seven times since 2021, but stock rallies have been reversed in the last six instances.3 Hopeful developments during much of this year risk disappointing investors in 2024, as cascading weaknesses become more evident. Our view is that the surge in real (inflation-adjusted) interest rates witnessed in 2023 likely will stress the economy further as the calendar turns,

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given the lagged effect of Fed credit tightening. We see the U.S. central bank holding the federal funds rate steady in the 5.25 – 5.50% range until an economic slowdown pressures inflation further, rather than cutting rates too soon and risking higher inflation.

Still, we think that key pivot points are coming in both the economic cycle and Fed policy. In our view, disinflation should gather enough momentum through what we believe will be a moderate economic slowdown, setting the stage for rate cuts in the second half of 2024. Furthermore, the U.S. presidential election likely will exacerbate market volatility. Given our base case for the economy, we reiterate our more defensive portfolio guidance, focusing on quality in both equity and fixed-income positions and exercising patience until signs of a new economic cycle emerge.

Chart 1. Sharp increases on the road to interest rate normalization


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4. The lagged effect of credit tightening refers to the fact that the Federal Reserve can raise its benchmark interest rate in a day, but leases, wage contracts, and agreements to buy or sell assets at predetermined prices and future dates can take a year or longer to account for the central bank’s rate decision.
Equities

“Christmas is a season not only of rejoicing but of reflection.” — Winston Churchill

Austin Pickle, CFA
Investment Strategy Analyst

2023 year in review: Equities

2023 has been eventful with wide swings in sentiment and markets. Let’s look back at the main 2023 stock market drivers.

Investor concern over the most aggressive Fed rate hiking cycle in decades was front and center at the start of the year. “How high would the Fed raise rates to tackle inflation?” and “When would something break?” were the often-discussed questions at the time. An answer to the latter question came in the spring when three regional banks failed. Sentiment soured on the news and weighed on stock prices. Fortunately, regulators stepped in to backstop the banking industry to prevent contagion, which arrested the decline.

Over the next several months, inflation declined rapidly, the Fed slowed its pace of hiking, and AI buzz took the markets by storm. The resulting rally lasted through July — that is, until inflation paused its disinflationary trend and long-term interest rates broke out to 15+-year highs. Stocks reversed course over the next three months, with some markets testing their March mini banking crisis lows or even their 2022 lows.

A furious rally — built on market expectations that the Fed hiking cycle is over and a soft landing may be achieved — has unfolded since those October lows. In fact, we are poised to end the year with major stock indexes higher on the year, generally by double digits.

Our favorable rating on U.S. Large Caps outperformed this year, while our Large Caps over Mid Caps (we are neutral) over Small Caps (most unfavorable) as well as our Developed Markets ex-U.S. (neutral) over Emerging Markets (unfavorable) guidance matched the 2023 performance stack rank to date (see chart below).

2023 asset-class returns match our guidance stack rank

Sources: Bloomberg and Wells Fargo Investment Institute. December 31, 2022 – December 18, 2023. U.S. Large Caps is represented by the total return of the S&P 500 Index. U.S. Mid Caps is represented by the total return of the Russell Midcap Index. U.S. Small Caps is represented by the total return of the Russell 2000 Index. Developed Markets ex-U.S. is represented by the total return of the MSCI EAFE Index. Emerging Markets is represented by the total return of the MSCI Emerging Markets Index. An index is unmanaged and not available for direct investment. Past performance is no guarantee of future results.

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Fixed Income

Luis Alvarado
Global Fixed Income Strategist

A strong year for rates and credit markets

Most major fixed-income asset classes managed to recover and display positive returns in 2023, following two consecutive years (2021 and 2022) of negative performance as interest rates increased. It has been an unusual finish to the year in that both rates markets (like high-quality government bonds) and credit markets (such as high yield (HY) corporate bonds and emerging market debt) have displayed strong returns. Granted, the government-bond rally over the past 2 months has been spurred by market expectations for potential rate cuts by the Fed in 2024.

U.S. credit markets outperformed in 2023 — as many investors sought the higher yields available in credit markets without much concern over credit risks. Also, as U.S. equity markets climbed close to previous highs, HY (Bloomberg U.S. Corporate High-Yield Index) credit spreads tightened from close to 468 basis points (100 basis points equals 1%) over Treasury yields on December 30, 2022, to below 350, taking year-to-date (YTD) HY returns to 12.2%, while investment-grade corporates (Bloomberg U.S. Corporate Bond Index) gained 8.0%. Dollar-denominated emerging market sovereign-bond (J.P. Morgan Emerging Markets Bond Index) spreads similarly tightened, and YTD returns reached 9.7%.

In Europe, an aggressive interest rate hike campaign from the European Central Bank drove 10-year German bund yields to the highest level in more than a decade (2.97% on October 3, 2023). Developed market bonds (J.P. Morgan GBI Global ex-U.S. Index (Unhedged)) returned 2.6% YTD in local currency terms; however, investors who hedged against the U.S. dollar (J.P. Morgan Non-U.S. Global Government Bond Index (Hedged)) saw returns closer to 7%.

Fixed-income returns have benefited from lower rates and credit spreads

Sources: Bloomberg and Wells Fargo Investment Institute. Data as of December 15, 2023. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. High yield is represented by the Bloomberg U.S. Corporate High Yield Index. An option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return. An index is unmanaged and not available for direct investment. Past performance is no guarantee of future results.

5. All performance figures in this page are year-to-date as of December 15, 2023.

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Real Assets

John LaForge
Head of Global Real Asset Strategy

Mason Mendez
Investment Strategy Analyst

Reviewing 2023 commodity performance

2023 was year three of the commodity bull super-cycle. 7 2023 reminded investors, however, that performance is not always positive during a bull super-cycle. Commodities in 2023 were hampered by tighter financial conditions, a strong U.S. dollar, and slowing global economic growth.

As of December 15, the Bloomberg Commodity Index (BCOM) has declined 7.86% YTD. The underperformers were the more economically sensitive groups — industrial metals and energy. Through December 15, the Bloomberg Energy and the Bloomberg Industrial Metals sub-indexes declined 11.2% and 21.4%, respectively. Of these, we thought Energy had the best chance to rise, even with global economies weakening, as crude supply remains a long-term challenge. Energy prices did rally in the third quarter, but the gains did not hold. Ultimately, slowing demand and record U.S. crude production pushed prices down.

However, not all sub-sectors performed poorly, as the Bloomberg Agriculture (-2.3%) and Precious Metals sub-indexes (+7.9%) outperformed the BCOM. While agriculture’s outperformance was modest, Precious Metals downright shined. Precious Metals’ performance was especially impressive considering a strong U.S. dollar and positive real interest rates. Historically, these conditions have often been headwinds to gold prices. Not only did gold fight off these headwinds in 2023, it managed to hit an all-time high of $2,135 per troy ounce. The likely tailwind behind gold’s strength was persistent and record purchases by global central banks.

In summary, 2023 marked the first negative performance year since the bull super-cycle began in March 2020. However, negative performance years are common during bull super-cycles. They are also generally necessary to sustain the cycle, as they can incentivize production discipline, keeping supplies low. We believe the current bull super-cycle remains intact, with many strong years left, and favor dollar-cost averaging during the first half of 2024.

Commodity sub-sector performance in 2023

Sources: Bloomberg and Wells Fargo Investment Institute. Daily data is from December 31, 2022, to December 15, 2023. Performance is indexed to 100 as of December 31, 2022. An index is unmanaged and not available for direct investment. Past performance is no guarantee of future results.

7. Bull super-cycles are multi-year periods, often lasting a decade or longer, when commodity prices trend higher, and typically together, due to widespread supply shortages.
Alternatives

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

2023 — Opportunities amid uncertainties

Uncertainty regarding the trajectory of inflation and interest rates, as well as the health of the job market, impacted financial markets throughout 2023. Although these uncertainties led to significant market reversals, the uncertain market also provided long-term investors with the chance to capitalize on unique opportunities presented throughout the year.

Given the impact of a maturing cycle, we continued to emphasize quality and preferred defensive strategies. Our favorable view on relative value – arbitrage and long/short credit strategies added value, achieving returns over 5.5% (see chart below) and outpacing some public fixed-income asset classes.

Similar dynamics affected private capital strategies, where a soft exit environment, a difficult financing market, and declining valuations created headwinds for managers and investors alike. Despite this, our preference for small- and mid-buyout and growth equity strategies performed well relative to other private equity categories, a likely result of shifting investor preference for higher-quality and smaller-sized deals.

As a diversifying strategy, the backdrop for global macro was still favorable in 2023. However, significant market reversals that occurred in both March and November weighed on performance, especially apparent in trend-following strategies that lagged the broader category.

For the year, the elevated interest rate environment and a slowing economy also created opportunities for managers to capitalize on rising credit stress and the resulting price dislocations. We continued to see additive returns and elevated capital activities in our favored distressed credit strategy and private capital secondary markets. We also believe the tailwinds for these strategies will continue as rising debt costs continue to stress over-leveraged companies. Many of these businesses will likely be forced to recapitalize and restructure, and many may re-emerge over time.

Performance of select hedge fund strategy performance in 2023

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<thead>
<tr>
<th>Strategy</th>
<th>Year-to-date Return (as of 11/30/2023)</th>
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<tbody>
<tr>
<td>Event driven - Activist</td>
<td>9.6%</td>
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<tr>
<td>Event driven - Distressed credit</td>
<td>6.9%</td>
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<tr>
<td>Relative value - Long/short credit</td>
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<td>Relative value - Arbitrage</td>
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<td>Macro - Discretionary</td>
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<td>Event driven - Merger arbitrage</td>
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<tr>
<td>Macro - Systematic</td>
<td>-2.2%</td>
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Sources: Wells Fargo Investment Institute, Hedge Fund Research. Data as of November 30, 2023. Wells Fargo Investment Institute favorable and unfavorable hedge fund strategies are shown in the chart, sorted by return from high to low. Wells Fargo Investment Institute was favorable on Relative Value — arbitrage and long/short credit. Event driven – Distressed credit, as well as Macro – Discretionary and Systematic. Wells Fargo Investment Institute was unfavorable on Event driven – Merger arbitrage and Activist. An index is unmanaged and not available for direct investment. Past performance is no guarantee of future results. Please see the end of the report for the index definitions and risk considerations. 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. © 2023 Wells Fargo Investment Institute. All rights reserved.
## Current tactical guidance

### Cash Alternatives and Fixed Income

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<thead>
<tr>
<th>Most Unfavorable</th>
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<td>U.S. Intermediate Term Taxable Fixed Income</td>
<td>Cash Alternatives</td>
<td>U.S. Taxable Investment Grade Fixed Income</td>
<td>U.S. Long Term Taxable Fixed Income</td>
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<td>High Yield Taxable Fixed Income</td>
<td>Developed Market Ex-U.S. Fixed Income</td>
<td>Emerging Market Fixed Income</td>
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<td>U.S. Mid Cap Equities</td>
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<td>Emerging Market Equities</td>
<td>Developed Market Ex-U.S. Equities</td>
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### Real Assets

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### Alternative Investments*

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<td>Hedge Funds—Equity Hedge</td>
<td>Hedge Funds—Relative Value</td>
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<td>Private Equity</td>
<td>Private Debt</td>
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*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.
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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. **U.S. government securities** are backed by the full faith and credit of the federal government as to payment of principal and interest. Unlike U.S. government securities, agency securities carry the implicit guarantee of the U.S. government but are not direct obligations. Payment of principal and interest is solely the obligation of the issuer. If sold prior to maturity, both types of debt securities are subject to market risk. The **commodities** market is 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.

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Definitions

**Bloomberg Agriculture Subindex** is a commodity group subindex of the Bloomberg Commodity Index. It is composed of futures contracts on coffee, corn, cotton, soybeans, soybean oil, soybean meal, sugar, and wheat. It reflects the return of the underlying commodity futures and is quoted in USD.

**Bloomberg Commodity Index** is comprised of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity.

**Bloomberg Energy Subindex** is a commodity group subindex of the Bloomberg Commodity Index. The index is composed of futures contracts on crude oil, heating oil, unleaded gasoline, and natural gas. It reflects the return on fully collateralized futures positions and is quoted in USD.

**Bloomberg Industrial Metals Subindex** is a commodity group subindex of the Bloomberg Commodity Index. The index is composed of longer-dated futures contracts on aluminum, copper, nickel, and zinc. It reflects the return on fully collateralized futures positions and is quoted in USD.

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**Bloomberg U.S. Corporate Bond Index** measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility, and financial issuers.

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

Arbitrage. **HFRI RV: Multi-Strategy Index:** multi-strategies employ an investment thesis predicated on realization of a spread between related yield instruments in which one or multiple components of the spread contains a fixed income, derivative, equity, real estate, MLP or combination of these or other instruments. Strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager.
MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets and the Far East, excluding the U.S. and Canada.

MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia, and the Far East, excluding the U.S. and Canada.

J.P. Morgan Emerging Markets Bond Index (EMBI Global) currently covers more than 60 emerging market countries. Included in the EMBI Global are U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

J.P. Morgan GBI Global ex-U.S. Index (Unhedged) in USD is an unmanaged index market representative of the total return performance in U.S. dollars on an unhedged basis of major non-U.S. bond markets.

J.P. Morgan Non-U.S. Global Government Bond Index (Hedged) is an unmanaged market index representative of the total return performance, on a hedged basis, of major non-U.S. bond markets. It is calculated in U.S. dollars.

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Russell Midcap Index measures the performance of the 800 smallest companies in the Russell 1000 Index.

Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 90% of the total market capitalization of the Russell 3000 Index.

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 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market.

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