WELLS FARGO
Investment Institute

TIMELY GUIDANCE

Institute Alert

Timely guidance that may affect your investment strategy **June 11, 2024**

Global Investment Strategy Team

☑ Guidance change

☐ Forecast change

☐ Allocation change

Adjusting equity and fixed income sector guidance

Guidance changes

- **Global equities:** We are upgrading the S&P 500 Energy sector from favorable to most favorable and downgrading the S&P 500 Utilities sector from neutral to unfavorable. The move allows us to position for the higher oil prices we expect while fading a rally in Utilities that we suspect is overdone.
- **Global fixed income:** Our economic outlook anticipates lower inflation as well as a pivot from economic slowing to acceleration. On that basis, we are reorienting our fixed-income preferences toward sectors that we believe should benefit. We are downgrading the U.S. Government sector and Treasury Securities from favorable to neutral but upgrading the Securitized sector to favorable. This includes upgrades from neutral to favorable in Residential Mortgage-Backed Securities and from unfavorable to neutral in Commercial Mortgage-Backed Securities. Within the U.S. Municipal Bonds sector, we also are upgrading Essential Service Revenue from neutral to favorable.

Forecast changes

- No forecast changes

Allocation changes

- No allocation changes

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

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Summary

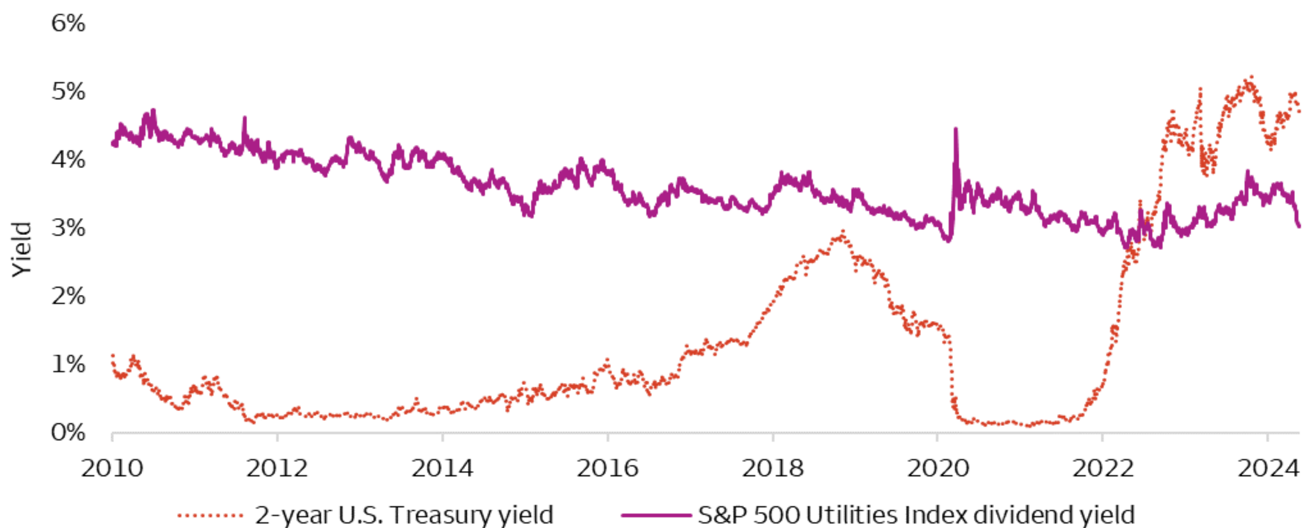
Our outlook for the coming 18 months remains for a gradually reaccelerating economy, cooler inflation, and lower interest rates. Now, while the economy is still slowing but seems to be approaching a pivot to stronger footing, we see value in making selected sector guidance changes. In particular, the energy markets look to be undersupplied in the event that demand picks up in line with faster economic activity, and we are upgrading the S&P 500 Energy sector. Likewise, securitized assets look likely to outperform U.S. government securities and, particularly, U.S. Treasury securities as investors look for more credit risk and spread exposure.

Fading the recent Utilities rally and positioning for higher oil and Energy sector prices

We are upgrading the S&P 500 Energy sector from favorable to most favorable while simultaneously downgrading the S&P 500 Utilities sector from neutral to unfavorable. We first turned favorable on the Energy sector in January. Since then, the sector has outperformed the S&P 500 Index composite, and the U.S. benchmark West Texas Intermediate crude oil price spiked to $87 per barrel on April 5. We believe that the consolidation in oil prices and the sector's performance since then provides an attractive opportunity to further upgrade the Energy sector from favorable to most favorable, especially as the fundamental case for the Energy sector remains attractive. The global oil supply remains tight, and OPEC+[1] seems committed to keeping it that way. Further, U.S. oil producers' capital discipline and prioritization of shareholder returns over production growth are likely to reinforce the supply shortage. We believe valuations within the Energy sector are attractive, and oil prices moving back into our target range would likely provide a sizeable tailwind.

We are funding the Energy sector upgrade with a downgrade to the Utilities sector, which has seen an impressive rally over the past few months. We believe that this relative outperformance, driven by power-demand optimism related to artificial intelligence and a response to deeply oversold levels, is likely to prove fleeting. Higher-for-longer interest rates present multiple headwinds to the sector, including heightened competition for yield flows from fixed-income investments (see chart) as well as elevated interest costs for the highly levered Utilities sector.

Fixed-income investments finally offer a reasonable alternative for yield



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data: January 1, 2010 – May 17, 2024. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

1. The Organization of Petroleum Exporting Countries and other oil-producing countries.

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Downgrading perceived safe havens in favor of more credit risk and spread exposure

U.S. Government sector and Treasury Securities (both downgraded to neutral from favorable): Such high-quality government securities have tended to bring stability to a portfolio during economic slowdowns or recessions. However, our outlook for a pivot toward renewed economic growth through 2025 leads us to seek better opportunities in other fixed-income sectors.

Securitized sector (upgraded to favorable from neutral): We anticipate that an improving economic backdrop will drive investor appetite for credit risk and spread exposure, and we expect that securities considered to be safe havens will tend to underperform as the risk-on environment develops. Our upgrade to the Securitized sector should offer better value relative to government securities (like U.S. Treasuries) while still providing access to high credit quality and liquidity.

> **Residential Mortgage-Backed Securities (upgraded to favorable from neutral):** A large portion of the Securitized sector is made up of Residential Mortgage-Backed Securities (RMBS). We believe RMBS spreads should narrow further relative to investment-grade bonds alongside the economy's likely pivot to accelerating growth. Finally, increased demand but stable supply reinforces our preference for RMBS. RMBS issuance in 2024 has remained steady while elevated mortgage rates have persisted, dampening refinancing activity. Meanwhile, on the demand side — banks tend to add RMBS at the turn of economic cycles, when economic and loan growth start to slow. We are seeing that combination now, with demand from banks increasing given stronger deposits and lower loan growth.

> **Commercial Mortgage-Backed Securities (upgraded to neutral from unfavorable):** Lenders have been willing to provide relief to borrowers by either extending or modifying maturing loans, which has helped Commercial Mortgage-Backed Securities (CMBS) withstand pressure. Looking ahead, we believe any downward pressure on CMBS prices will be less severe. Declining lender tightening standards suggest a slowdown in the price decline of commercial real-estate properties.

Essential Service Revenue Municipal Bonds (upgraded to favorable from neutral): Alongside what we see as the economy's pivot to a stronger outlook, we believe that fundamentals are either stable or improving in most areas within Essential Service Revenue. Specifically, we have seen lower leverage, relatively consistent operating margins, and lower vulnerability to broader budgetary concerns relative to recent periods. At this time, we prefer to focus on electric as well as water and sewer essential-service revenue bonds. Meanwhile, we remain unfavorable on niche, private higher-education institutions and smaller health-care providers.

Allocation preferences

We favor reallocating toward our favored sectors at the expense of cash or of less-favored sectors — particularly in equity sectors where portfolio-allocation shares exceed the market weights of those non-favored sectors. Thus, the downgrade to the Utilities sector adds a new potential funding source for equities. In fixed income, we favor reallocating from either cash or the U.S. Government sector (particularly Treasury securities) into the Securitized sector (especially RMBS) and, within the U.S. Municipal Bonds sector, into Essential Service Revenue.

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Risk Considerations

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

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** are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. There is no guarantee that **dividend-paying stocks** will return more than the overall stock market. Dividends are not guaranteed and are subject to change or elimination. **Sector investing** can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. **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. **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. Although **Treasuries** are considered free from credit risk, they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. **Mortgage-backed securities** are subject to prepayment, extension, and call risks. Changes in prepayments may significantly affect yield, average life and expected maturity. Extension risk is the risk that rising interest rates will slow the rate at which mortgages are prepaid. Call risk is the risk that if called prior to maturity, similar yielding investments may not be available to purchase. These risks may be heightened for longer maturity and duration securities. **Commercial Mortgage-Backed Securities (CMBS)** are a type of mortgage-backed security backed by commercial mortgages rather than residential real estate. CMBS tend to be more complex and volatile than residential mortgage-backed securities due to the unique nature of the underlying property assets.

Definitions

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

S&P 500 Utilities Index comprises those companies included in the S&P 500 that are classified as members of the GICS utilities sector.

An index is unmanaged and not available for direct investment.

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