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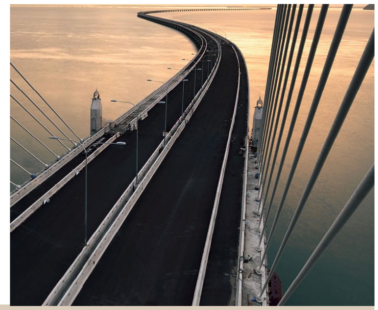
Investment Strategy



Weekly guidance from our Investment Strategy Committee **July 1, 2024**

Economic Spotlight

Jennifer Timmerman
Investment Strategy Analyst

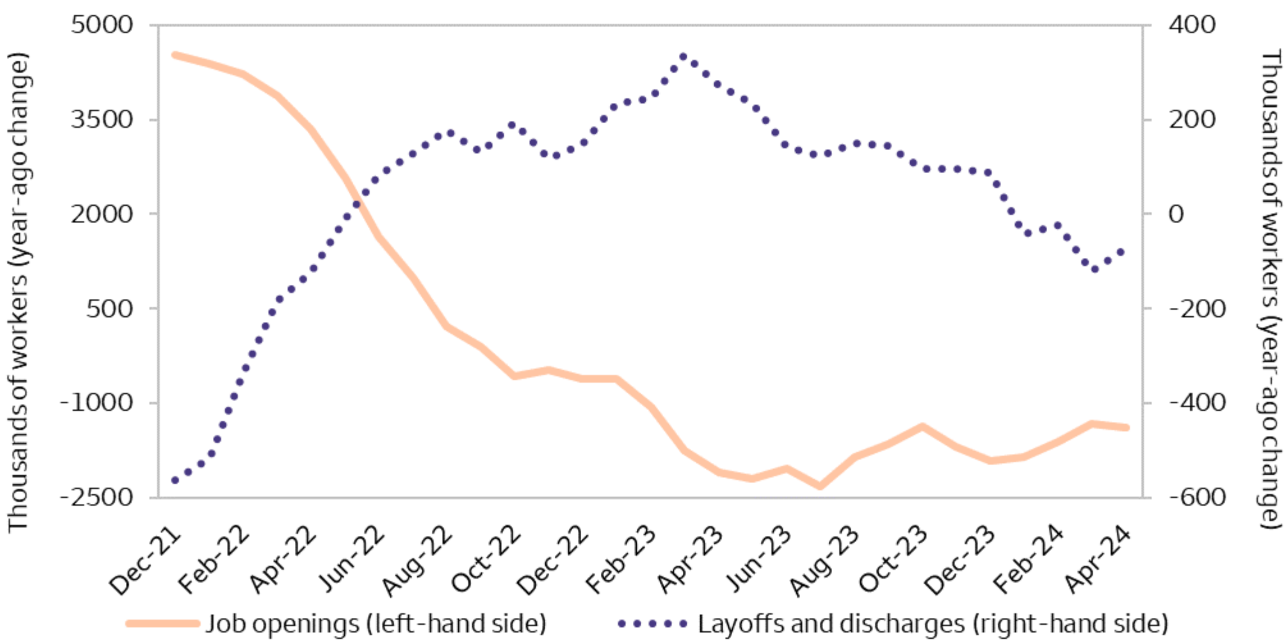
Pivoting toward a post-pandemic labor market

As we enter the summer doldrums, economic news is proving to be anything but slow or boring. In fact, as we outlined in our Midyear Outlook, we believe the economy is approaching a key pivot point in which a consumer-led slowdown eases inflation but does not drive a large increase in unemployment. [1] This mild slowdown in the economy should limit the weakness in household income and spending. Nonetheless, we believe that the economy's soft patch will be enough to trigger modest Fed interest rate cuts and support a consumer-led revival of jobs and economic growth.

Pandemic distortions linger

Job growth[2] has moderated from its mid-2021 peak but, at a monthly average of nearly 250,000 in the March – May period, remains above its pre-pandemic average of 184,000 per month between January 2010 and February 2020. In our view, the slowdown in job growth is due more to businesses' reluctance to hire than to a willingness to fire after the difficulty and expense of obtaining workers immediately following the pandemic. For example, on a rolling three-month basis, the Job Openings and Labor Turnover Survey (JOLTS) showed hiring down 5.7% in April from its most recent peak in May 2023. Meanwhile, layoffs declined by 6.7% over that same time frame.

Chart 1: A reluctance to fire and hire*



Sources: Wells Fargo Investment Institute and U.S. Bureau of Labor Statistics. Data from December 2021 – April 2024. *Reflects year-ago change in number, calculated as a three-month moving average.

1. See Wells Fargo Investment Institute's Midyear Outlook, "Approaching the economy's pivot point," June 2024.
2. As measured by the Labor Department's non-farm payrolls report.

Further, May's labor-force participation rate[3] of 62.5% remains below the 63.3% on the eve of the pandemic, and that difference translates to over two million workers still on the sidelines. Coronavirus-related disruptions to labor supply have combined with more retirees in an aging workforce, and these factors together have nearly halved labor-force growth from 2007 (1.2%) to 2023 (0.7%). The lower participation rate in an aging workforce has prompted the Congressional Budget Office to predict additional slowing to come, with an uncertain outlook for immigration determining the extent of the slowdown.[4]

Approaching a transition to "normal"

We believe the U.S. labor market is rebalancing, albeit slowly. Weekly initial jobless claims remain historically low but did edge higher in June, suggesting a greater willingness by employers to lay off workers in a cooling economy. If the trend persists, the Fed could respond with interest-rate cuts even if inflation remains above its 2% target. Further, April data showed that even sectors experiencing ongoing post-pandemic worker shortages may be starting to cool. For example, vacancies in health care declined to a three-year low while manufacturing's job openings dropped to a level not seen since the aftermath of the deep economic slump at the end of 2020.[5]

Longer term, a lower unemployment rate and generally tighter labor market tied to slowing labor-force growth could buoy wage inflation, lifting labor's share of national income from a historically low level prior to the onset of COVID-19. With labor expenses generally the biggest cost for businesses, accelerated wage increases could trigger an unusually early return to firmer inflation and take some of the steam out of the earnings recovery next year, particularly in more labor-intensive services industries dominating the economy. At issue in the longer-term inflation outlook is the extent to which wage pressures can be mitigated by productivity gains tied to artificial intelligence, digitalization, and other advances in technology.

Investment implications

In the near term, we believe a shallow employment cycle and slowing labor-force growth will limit the rise in the U.S. unemployment rate to well below the jobless rate typical of even a mild recession, like the one in 2001. Still, we think the approaching labor-market pivot will feed back into slowing consumer-led growth. For now, this outlook contributes to our unfavorable view of the Consumer Discretionary equity sector. More generally, slowing consumer-spending growth combined with pressure from higher interest rates on housing and other credit-sensitive pockets of the economy support our preference for quality and liquidity in portfolio allocations, as illustrated in our tactical guidance tables (included on page eight).

3. Calculated as the labor force divided by the total working-age population.
4. Congressional Budget Office, "An update to the budget and economic outlook: 2024 to 2034," June 2024.
5. Enda Curran, "Another sunny jobs report, but clouds are gathering," Bloomberg, June 7, 2024.

Equities

Greg Simpson, CFA
Equity Sector Analyst

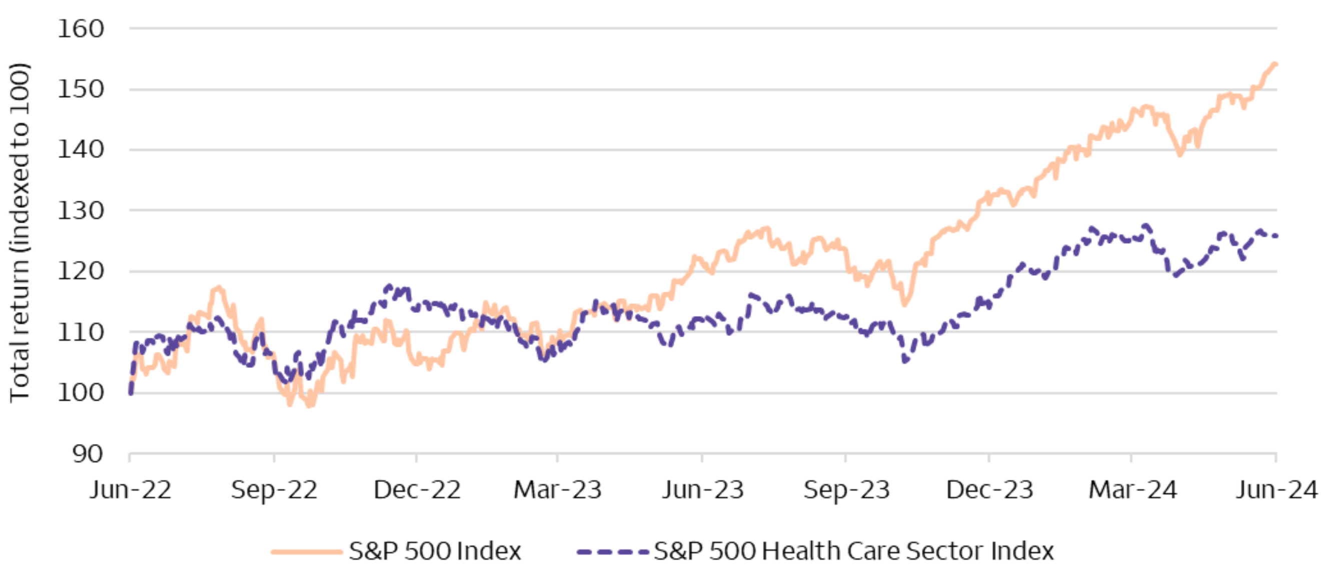
Health Care underperformance offers buying opportunity

The Health Care sector has consistently lagged the S&P 500 Index for the past 12 months. Like the broader market, the Health Care sector has experienced very narrow breadth, with few stocks performing well during this period. The market's preference for growth has been evident over the past year, with significant outperformance of technology stocks and companies related to artificial intelligence (AI) in particular. While AI plays are currently limited in the Health Care sector, bright spots do exist — of these, the most notable have been manufacturers of GLP-1 obesity drugs. In fact, the outperformance of these few stocks has driven a significant portion of overall sector gains during the past year. A small number of higher-growth medical device companies have also enjoyed strong performance, though most of the sector continues to underperform.

We believe the underperformance of Health Care reflects the higher-for-longer interest-rate environment, a key factor in the weakness of defensive health care stocks, small caps, and rate-sensitive sub-sectors such as Biotechnology. This period of underperformance also closely reflects the growing popularity of GLP-1 drugs for obesity and investor concerns over the potentially negative impact on certain key markets within Health Care.

On a positive note, we believe this could present investors with an attractive buying opportunity and see eventual rate cuts from the Fed as a likely catalyst for improved performance. Given our favorable guidance on the sector and optimism about its outlook, we believe the current environment offers long-term investors the opportunity to build core positions in health care names.

Health Care sector has underperformed broader market



Sources: Wells Fargo Investment Institute and FactSet. Data from June 20, 2022, through June 20, 2024. **Past performance is no guarantee of future results.**

Fixed Income

Eric Jasso, CFA
Taxable Analyst

Risks and opportunities of debt-funded acquisitions

A company's bond prices typically decline when a debt-funded acquisition is rumored or has been announced as credit metrics are likely to trend downward initially after a deal's completion. Further, M&A activity does not always lead to increased profitability that justifies the purchase price, and unexpected integration and legal issues can further strain an acquirer's credit quality. Typically, credit-rating agencies will allow investment-grade (IG) companies 12 – 24 months to integrate an acquisition and begin reducing debt with improved profitability before issuing a downgrade where appropriate. However, in rare occasions where the new debt load is substantial and the business rationale weak, a downgrade can be issued straight away.

Opportunities can appear after prices have sold off in cases where an acquisition produces profitability and business strength that, over the long run, more than offset increased financing costs. While higher interest rates have raised the bar for potential deals, Moody's has forecast that well-financed IG companies that have de-risked over the past few years will increase their pursuit of incremental (rather than transformational) acquisitions in the coming 12 – 18 months. In particular, Moody's highlights the pharmaceutical, technology, oil and gas, and packaged food industries as areas where strategic considerations may drive increased M&A activity.

While increased M&A activity may not materially impact the performance of broader IG credit, it may create attractive entry points for specific credits. Global Securities Research's Credit Opportunities List aims to take advantage of such situations, in which quality companies have experienced a sell-off due to an acquisition that the list's managers view favorably.

Real Assets

Ian Mikkelsen, CFA
Equity Sector Analyst, Energy

Data-center demand supports energy infrastructure

The buildout of data-center capacity in the U.S. to support AI ambitions is in its very early stages. Data centers consume a lot of electricity, and approximately 43% of electricity today is generated from natural gas, which represents the largest resource for power generation by far.[6] Within the Energy sector, we view midstream energy companies focused on natural gas as visible long-term beneficiaries of this trend.

We believe that U.S. natural gas production capacity and reserves are sufficient to meet growing demand, with infrastructure being the key constraint in balancing supply with this demand growth over time. We expect this to provide midstream companies with incremental growth opportunities and higher utilization of existing assets, ultimately extending the terminal value of natural gas infrastructure.

We would be remiss not to acknowledge that many developers have a preference to power new data centers using renewable energy, and we do expect significant growth in renewable energy generation as well. However, we expect that the share of natural gas generation in the power mix will remain fairly steady in the intermediate term due to limitations on the pace of renewable development. Additionally, the intermittent nature of renewable energy generation requires natural gas as a backup source, which still employs significant natural gas infrastructure. A number of midstream companies have reported higher utilization of natural gas storage assets in conjunction with increased renewable generation.

Lastly, we note that the growing importance of data centers is only one of several ongoing trends highlighting the importance of natural gas infrastructure within the U.S. Other supportive trends include the reshoring of industrial manufacturing facilities and the buildout of additional export capacity for liquefied natural gas. We believe these trends are secular in nature and, in our view, large companies in the Midstream Energy sub-sector that are focused on natural gas and have broad interstate operations are well positioned to benefit.

6. Preliminary data for 2023 according to Energy Information Administration, "What is U.S. electricity generation by energy source?", February 29, 2024.

Alternatives

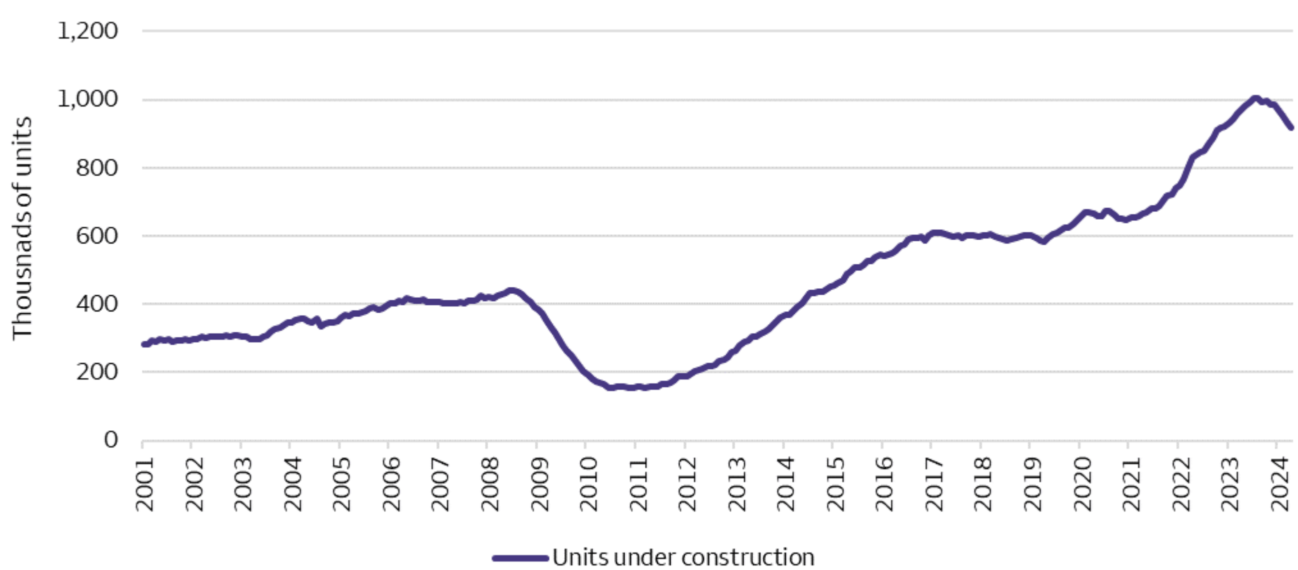
Chao Ma, PhD, CFA, FRM
Global Portfolio and Investment Strategist

Oversupply issue is unfolding for apartments

After remarkable rent growth during 2021 and 2022, the residential real estate sector is going through a period of normalization. This is due to the significant volume of new apartments that has been under development over the past few years (chart below), especially in the southern Sun Belt region. This new apartment inventory is expected to come to market in 2024 and 2025, according to Green Street. As a result, apartment rent growth will likely be elusive in the short term, and many Sun Belt landlords may need to accept declining rents and rising vacancies. The oversupply issue may be temporary as apartment construction has started to decline this year, owing to climbing debt costs, low financing availability, and pressured development profits. Nonetheless, we believe the residential sector may struggle over the next 18 months.

Over the longer term, we think that the growth in population, jobs, and wages should bode well for residential real estate. Furthermore, the affordability gap between owning and renting has widened significantly in recent years due to the remarkable appreciation of house prices and high mortgage rates. As a result, we believe the relative affordability of renting will likely drive demand for single-family and apartment rentals over the coming years. What is also notable is the rapid growth of the population between the ages of 35 and 44 relative to the broader U.S. population. We believe that this growth will be another tailwind over the longer term, especially for the single-family rental market as this age group is the most likely to start a family and transition to single-family housing.

Record growth in apartment supply is coming



Sources: Wells Fargo Investment Institute and Green Street. Data from January 2001 through April 2024.

Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not appropriate for all investors and are only open to “accredited” or “qualified” investors within the meaning of U.S. securities laws.

Tactical guidance*

Cash Alternatives and Fixed Income

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
	High Yield Taxable Fixed Income	Cash Alternatives Developed Market Ex-U.S. Fixed Income Emerging Market Fixed Income U.S. Long Term Taxable Fixed Income U.S. Intermediate Term Taxable Fixed Income	U.S. Taxable Investment Grade Fixed Income	U.S. Short Term Taxable Fixed Income

Equities

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
U.S. Small Cap Equities	Emerging Market Equities	U.S. Mid Cap Equities Developed Market Ex-U.S. Equities	U.S. Large Cap Equities	

Real Assets

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
		Private Real Estate	Commodities	

Alternative Investments**

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
		Hedge Funds—Event Driven Hedge Funds—Equity Hedge Private Equity Private Debt	Hedge Funds—Relative Value Hedge Funds—Macro	

Source: Wells Fargo Investment Institute, July 1, 2024.

*Tactical horizon is 6-18 months

**Alternative investments are not appropriate for all investors. They are speculative and involve a high degree of risk that is appropriate only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. Please see end of report for important definitions and disclosures.

Risk considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

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. Risks associated with the **Consumer Discretionary** sector include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players, reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. The **Energy** sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. Some of the risks associated with investment in the **Health Care** sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is appropriate only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

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Definitions

An index is unmanaged and not available for direct investment.

Job Openings and Labor Turnover Survey (JOLTS) is conducted by the Bureau of Labor Statistics of the U.S. Department of Labor. The program involves the monthly collection, processing, and dissemination of job openings and labor turnover data. The data, collected from sampled establishments on a voluntary basis, include employment, job openings, hires, quits, layoffs and discharges, and other separations.

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.

S&P 500 Health Care Index comprises those companies included in the S&P 500 that are classified as members of the GICS® health care sector.

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