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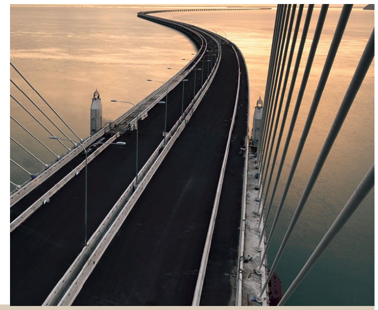
Investment Institute

Investment Strategy



Weekly guidance from our Investment Strategy Committee **June 17, 2024**

1. Organization of the Petroleum Exporting Countries plus allies.

Equities Spotlight

"You know more than you think you know, just as you know less than you want to know." — Oscar Wilde

Austin Pickle, CFA
Investment Strategy Analyst

Fed cuts? Careful what you wish for

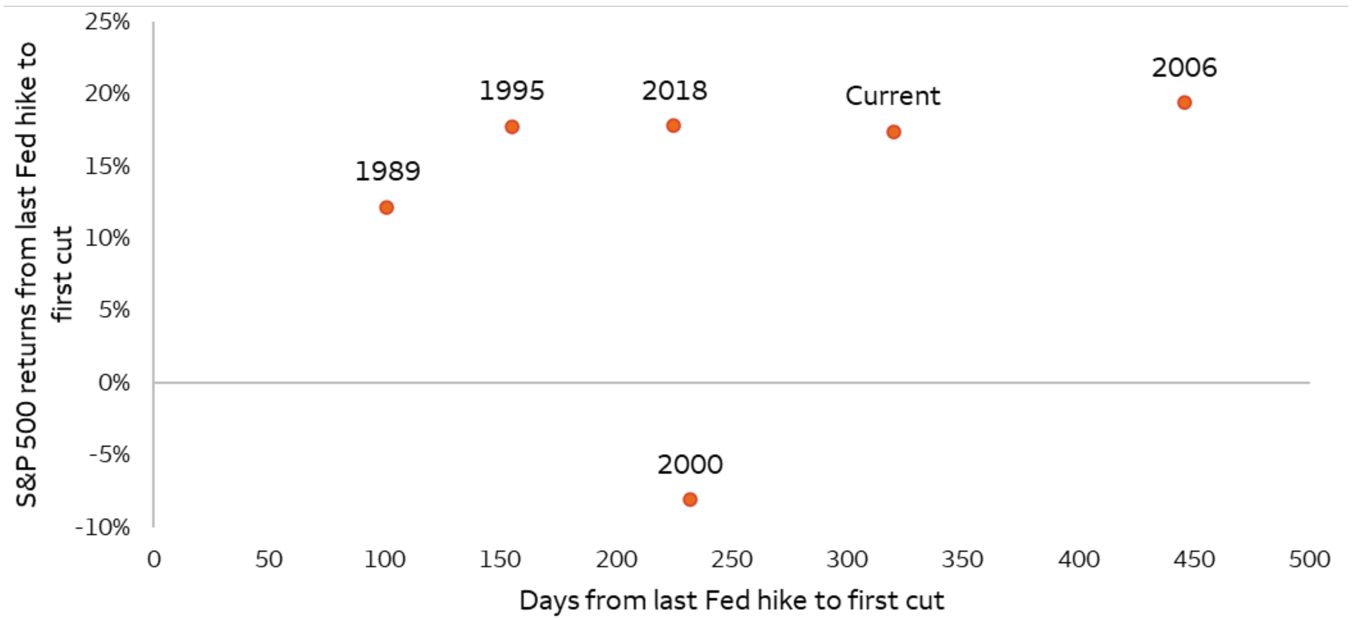
A major driver of returns this past year has been the progress made on bringing inflation down and the resultant switch in investor focus from fearing potential future Fed rate hikes to cheering potential future Fed rate cuts. In this report, we respond to two common questions: How does today's market action compare to history? And how has the market reacted to prior Fed rate cuts?

A typical long pause

The Fed last hiked rates on July 26, 2023. Over the past 320-plus days, the S&P 500 Index has rallied roughly 20%. Chart 1 illustrates how these returns compare to past Fed rate pauses (the period between the last Fed rate hike in a series and the first cut). Notably, outside of the 2000 – 2001 cycle — which was characterized by the bursting of the technology bubble — stocks posted double-digit returns during four of the past five pauses. This makes intuitive sense as a Fed on hold essentially signals that conditions are consistent with growth that is neither too hot nor too cold and that inflation is decelerating. This has been an environment in which stocks have typically performed well.

Interestingly, S&P 500 Index returns during the past five pauses have maxed out near 20%. Is it likely the current rally will do so as well? Each environment is different, and there certainly is no rule limiting gains. However, we see several headwinds weighing on returns in the near term, not least of which is the uncertain path of inflation and timing of future Fed actions.

Chart 1. Current Fed rate pause versus history



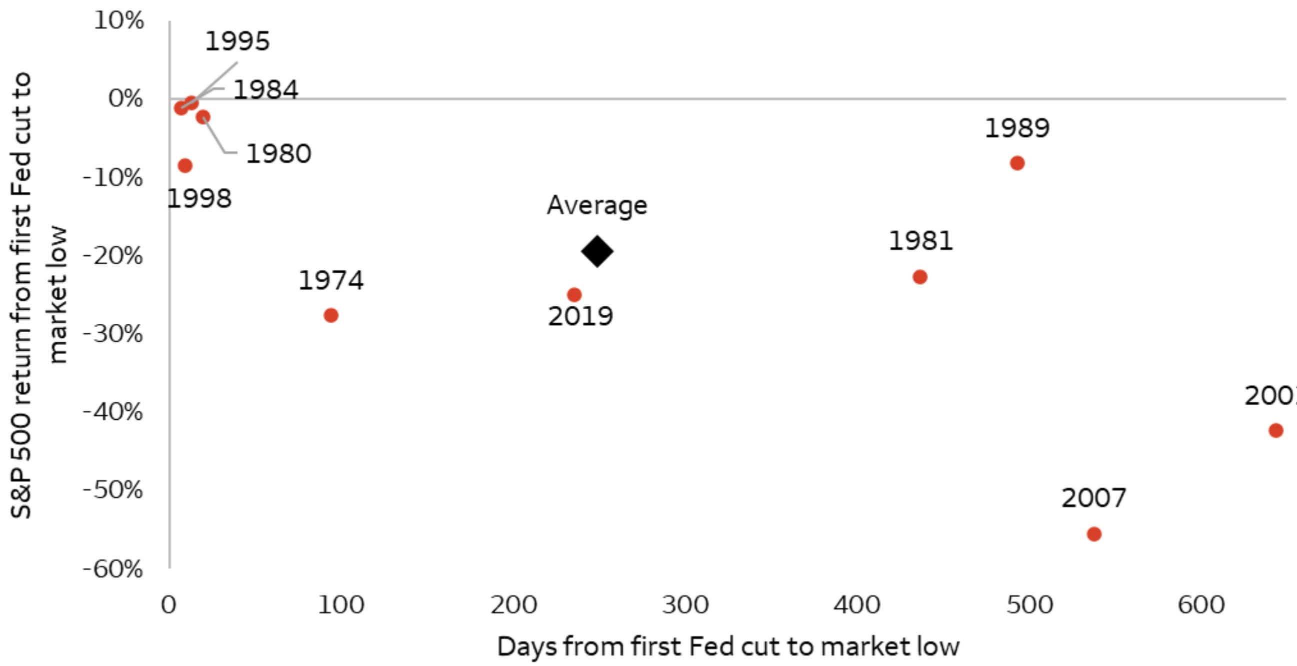
Sources: Bloomberg, Strategas, and Wells Fargo Investment Institute. Data labels indicate the year the Fed pause began (the last Fed rate hike in a series). As of June 10, 2024. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results**.

Why are investors clamoring for cuts?

The longer the Fed keeps rates elevated, the greater the risk becomes that something will eventually break and cause a significant economic or market disruption. The hope is that Fed rate cuts arrive before that happens.

Historically, though, the arrival of a Fed rate cut cycle has tended to coincide with a sizable stock market drawdown. Chart 2 illustrates this by plotting the S&P 500 Index return and days between the first Fed rate cut in a cycle to the subsequent index low. Since 1974, the average drawdown has been roughly 20% over 250 days following the first Fed rate cut. In other words, investors should not equate the first cut as an all-clear stock market signal.

Chart 2. Fed rate cuts have tended to coincide with stock drawdowns



Sources: Bloomberg, Strategas, and Wells Fargo Investment Institute. Data labels indicate the year of the initial Fed rate cut. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Instead, in our view, investor focus should be on the rationale for the cut. If the Fed tweaks policy to adjust real rates for falling inflation, we believe stocks will likely perform well over the tactical time frame (6 to 18 months). On the other hand, if the Fed is forced to cut aggressively in response to a macro or market disruption, we would expect stock performance to suffer.

What do we expect?

Our forecast through 2025 more closely resembles the former scenario than the latter. We expect modest Fed rate cuts, contained inflation, and solid economic growth after a near-term slowdown. Credit conditions remain benign and liquidity ample, while the modest recovery we forecast should support accelerating earnings growth and a resumption of the equity rally next year. Our 2025 year-end S&P 500 Index target is 5600 – 5800.

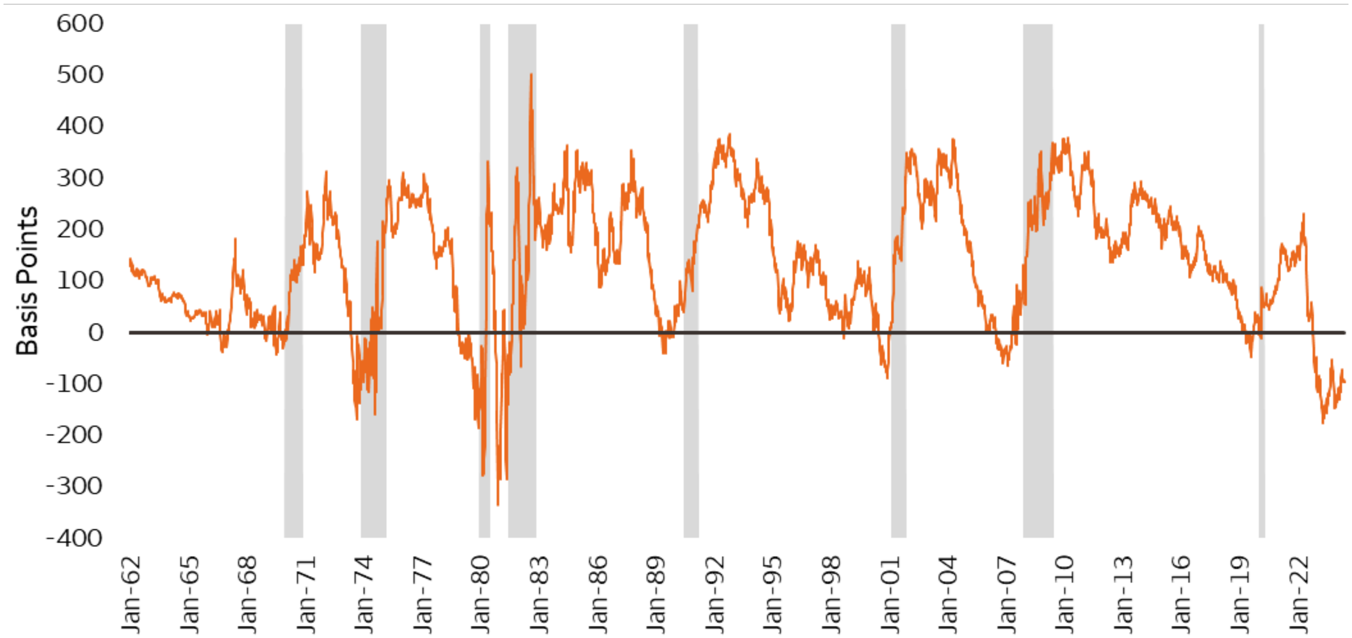
Fixed Income

Brian Rehling, CFA
Head of Global Fixed Income Strategy

Yield curve keeps setting records

Last week, the Fed left short-term interest rates unchanged, and short-term interest rates remain higher than those found in longer maturities. When short-term rates are higher than long-term rates, the yield curve is inverted. The current yield curve inversion (3-month U.S. Treasury bills – 10-year U.S. Treasuries, as of June 12, 2024) has continued for 83 weeks, since November 11, 2022, the longest inversion in the modern Fed era. It is most likely that when the yield curve does finally un-invert, it will be because the Fed is cutting short term rates, finally moving short-term rates below longer-term rates.

Chart: 3-month – 10-year Treasury yield curve



Sources: Bloomberg. Data as of 6/11/24. 100 basis points equal 1%. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. **Past performance is no guarantee of future results.**

We are currently most favorable on U.S. Short Term Taxable Fixed Income, and we are likely to retain our current positioning until either long-term rates move close to or above the upper end of our 2024 year-end target range for the 10-year Treasury yield of 4.75% or Fed rate cuts appear imminent. While we reiterate our most favorable short-term fixed income guidance, we believe investors, especially those focused on income generation, should be considering how they may position portfolios for eventual Fed rate cuts.

When the Fed eventually decides to cut short-term rates, investors should expect the yield in short-term fixed income securities to decline. To prepare, income-oriented investors may consider dollar cost averaging into longer term maturities to lock in current yield levels as short-term securities mature. We currently have a neutral guidance recommendation on U.S. Long Term Taxable Fixed Income; however, if the economy were to unexpectedly deteriorate faster than expected, then longer term bonds may not reach our 2024 year-end target range for the 30-year Treasury yield of 4.50% – 5.00%.

Real Assets

Mason Mendez
Investment Strategy Analyst

John LaForge
Head of Real Asset Strategy

OPEC+ to start unwinding oil production cuts

During the first week of June, OPEC+ announced plans to begin unwinding a portion of its production cuts, originally set in place to tighten global supply. The group will begin raising production in October 2024 and continue through September 2025. All in all, this decision will add roughly 2.2 million barrels per day of crude oil to global supply.

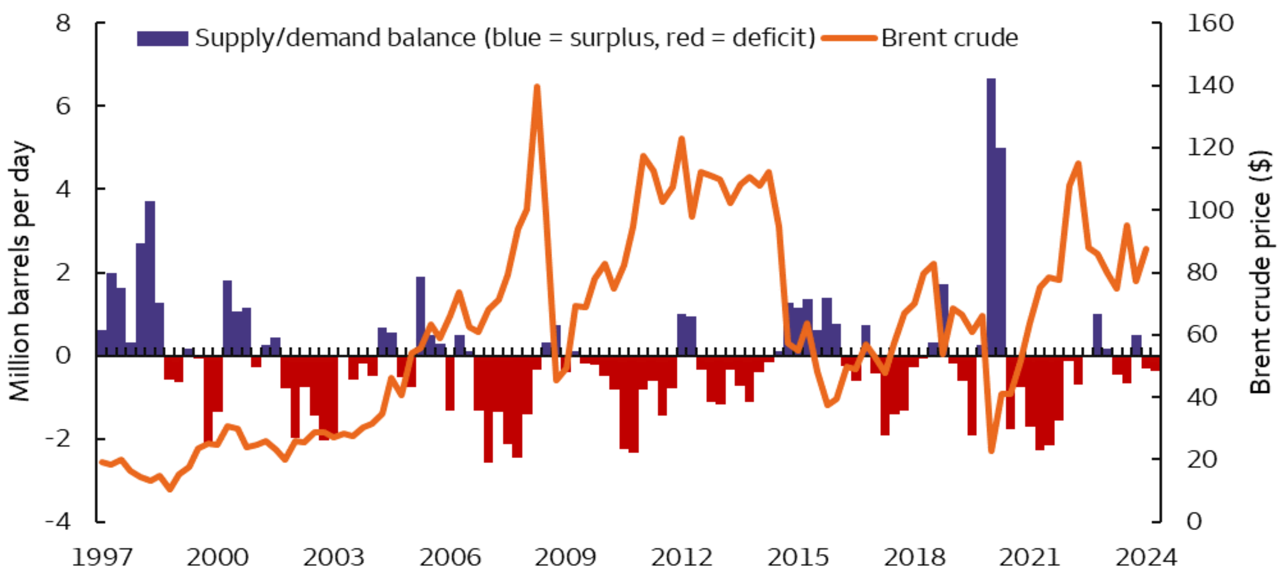
In response, oil markets swiftly turned bearish. The price of West Texas Intermediate (WTI) retreated to $73 per barrel on June 4 — its lowest since January. In our view, though, oil markets may be overreacting to OPEC+'s decision, and we believe recent price lows have presented an attractive opportunity to gain commodity exposure.

As shown by the red bars in the chart below, global crude supply has been tight, mostly in a deficit since 2020 — resulting in higher prices (orange line). We expect this trend of tight global supply to remain in the coming months, as seasonal demand picks up, and producers outside OPEC+ continue enforcing capital discipline through slower production growth. While OPEC+ says it will begin to raise production later this year, it's important to note that the increase will likely be gradual to prevent a supply glut.

We also expect emerging markets to continue be a strong driver of demand, supporting global oil prices. Over the last decade, emerging markets have become the dominant driver of global demand growth, as countries like India and China rapidly expanded their economies, outpacing demand growth in developed economies.

The bottom line is that OPEC+'s decision to begin unwinding production cuts later this year is likely not ideal for oil prices. That said, we believe that the cuts will be gradual, and emerging market demand will likely absorb the extra supply, supporting our 2024 and 2025 WTI and Brent oil price targets.

Chart: Crude oil's global supply and demand balance



Sources: Energy Information Administration, Bloomberg, and Wells Fargo Investment Institute. Quarterly data is from Q1 1997 – Q1 2024. **Past performance is no guarantee of future results.**

Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

Growing case for long/short equity

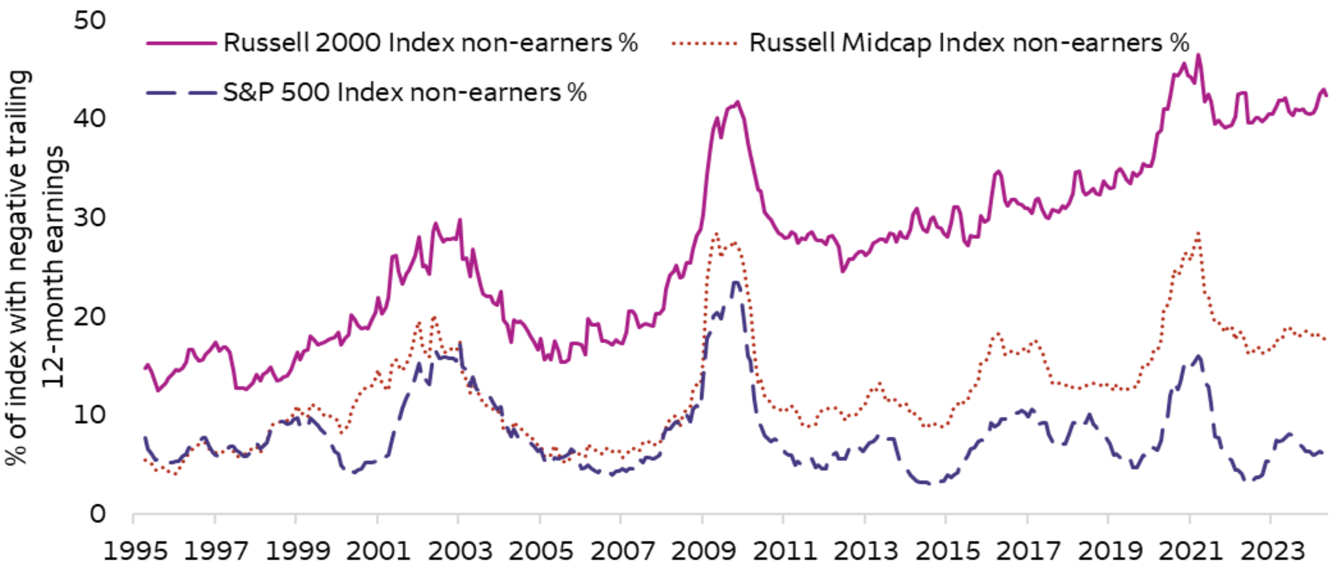
Long/short equity strategies employ both long and short positions. A long position is when the manager buys the stock, and a short position is when the manager sells a borrowed stock, a practice known as "short selling." Short sellers seek to profit when a stock declines in value, as they attempt to purchase the stock back at a lower price in the future to repay the loan.

These strategies can profit by successfully identifying the winners and losers, often based on analysis of company fundamentals. However, when all stocks move up (or down) in tandem, or stocks with weaker fundamentals outperform their stronger counterparts, long/short equity strategies often perform poorly relative to traditional long-only strategies. Conversely, as markets begin to reward the strong operators and punish the overly indebted or non-earners, skilled long/short equity managers should be poised to capitalize on this dispersion.

As shown in the chart below, the percentage of companies without earnings continues to grow and, as of May 31, 2024, registered at 42% of a small company index (Russell 2000 Index). The recent era of ultra-low interest rates allowed many weaker companies to extend their life spans. Over time, as the tide of free money retreats, we believe the strong companies will likely outperform, and those that are unable to adjust to the new environment will likely experience declining valuations. The growing universe of small company non-earners suggests to us that the slowing economic environment and higher interest costs are taking their toll, and we believe the stock price performance will eventually reflect the underlying business fundamentals.

While we remain neutral on long/short equity strategies (also known as Equity Hedge – Directional), we expect the strategies to be able to increasingly generate returns on both long and short positions and have greater opportunities to outperform the traditional long-only equity benchmarks.

Non-earners continue to grow as a percentage of a small company index (Russell 2000 Index)



Sources: Bloomberg, Wells Fargo Investment Institute, Monthly data: February 28, 1995, to May 31, 2024. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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, June 17, 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

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

A periodic investment plan such as dollar cost averaging does not assure a profit or protect against a loss in declining markets. Since such a strategy involves continuous investment, the investor should consider his or her ability to continue purchases through periods of low price levels.

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. 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. 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

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.

Russell Midcap Index measures the performance of the 800 smallest companies in 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 U.S. stock market.

An index is unmanaged and not available for direct investment.

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