

# Investment Strategy

Weekly guidance from our Investment Strategy Committee November 20, 2023

## Alternatives Spotlight: Private capital performance: One year in review .2

- Many private assets, including both private debt and real assets, maintained strong returns relative to public markets over the 12-month period ending June 30, 2023, according to Pitchbook data.
- We believe investors should continue to prepare for the slowing economy and emphasize defensive and high-quality areas, such as infrastructure and secondaries.

## Equities: Adjusting some 2024 targets .....4

- We are maintaining our year-end 2024 S&P 500 Index earnings and price targets but lowered all other asset-class benchmark targets to reflect the likely challenging global economic environment we expect in the near term.
- Our guidance is unchanged. We continue to focus on quality and prefer U.S. Large Cap Equities over U.S. Mid Cap and Small Cap Equities.

## Fixed Income: TIPS around inflation trending lower .....5

- We have a neutral view on Treasury Inflation-Protected Securities (TIPS) relative to nominal government securities. With the Federal Reserve (Fed) continuing its fight to bring inflation down to its 2% goal, the probability of inflation re-accelerating is low, in our opinion.
- TIPS may be appropriate for clients looking to preserve their purchasing power if they are willing to hold to maturity.

## Real Assets: U.S. corn production expected to hit record highs .....6

- The world’s largest corn producer, the U.S., is expected to end 2023 with a record harvest.
- Not surprisingly, U.S. corn futures sit near 3-year lows at \$4.64 per bushel as of November 10.

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## Alternatives Spotlight

**Chao Ma, PhD, CFA, FRM**

Global Portfolio and Investment Strategist

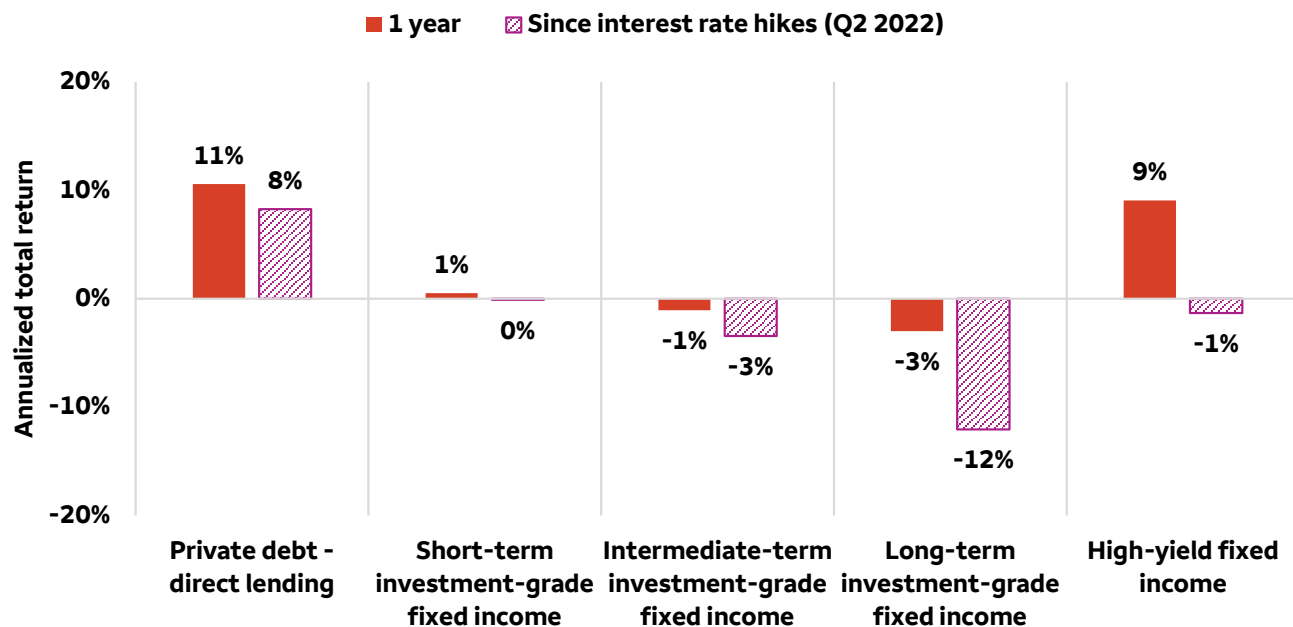
### Private capital performance: One year in review

Many private assets, including both private debt and real assets, maintained strong returns relative to public markets over the 12-month period ending June 30, 2023, according to Pitchbook data.

Private debt continued to be a bright spot in private capital. The senior-debt-oriented direct lending strategy saw growing opportunities and investor interest, as traditional lenders retreated from the lending space due to regulatory and business reasons and investors continued to search for higher yielding products. The strategy benefited from a yield premium relative to Treasury bonds as well as its low price-sensitivity to changes in interest rates.

As Chart 1 shows, direct lending boasted an 8% annualized return in the rising interest rate environment that started last year, whereas returns for other fixed income asset classes were flat to negative. Although direct lenders continue to gain traction by offering attractive income and low historical default rates, we believe the elevated interest rate environment may result in greater stress levels within the lowest quality segment of borrowers.

**Chart 1. Recent performance of private debt and public fixed income asset classes**

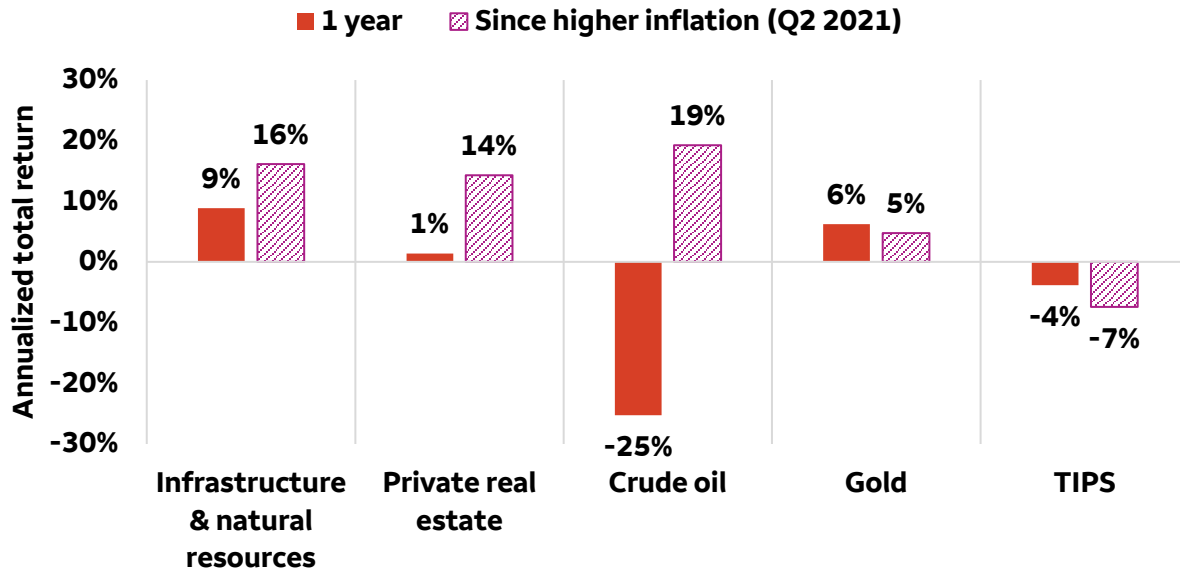


Sources: Bloomberg and Wells Fargo Investment Institute. As of June 30, 2023. Q2 = 2<sup>nd</sup> quarter. Short-term investment grade fixed income: Bloomberg U.S. Aggregate 1-3 Year Bond Index. Intermediate- term investment grade fixed income: Bloomberg U.S. Aggregate 5-7 Year Bond Index. Long-term investment grade fixed income: Bloomberg U.S. Aggregate 10+ Year Bonds. High yield fixed income: Bloomberg U.S. Corporate High-Yield Index. Private debt – direct lending: Pitchbook private debt direct lending index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Within real assets, infrastructure and natural resources fared well in recent quarters. Since the start of a higher inflation reading in second-quarter 2021, infrastructure and natural resources have generated a 16% annualized return (Chart 2). Owing to its necessity-based demand, and unlike other inflation-hedging assets shown in the chart, infrastructure is more defensive and less sensitive to changes in economic activity and interest rates. Private real estate, on the other hand, had more subdued performance in the recent quarters. Although cash flows for some

sectors are periodically adjusted for inflation, the rising interest rate environment and slowing economy negatively impacted private real estate valuations. Further, the office sector continued to see elevated vacancies due to the challenge employers faced in bringing the workforce back to office full time.

**Chart 2. Recent performance of private real assets and other inflation-hedging assets**



Sources: Bloomberg and Wells Fargo Investment Institute. As of June 30, 2023. Crude oil: West Texas Intermediate crude oil. Infrastructure & natural resources: Pitchbook private real asset index. Private real estate: Pitchbook private real estate index. TIPS: Treasury Inflation-Protected Securities. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Private equity performance was a notable exception to broader private capital performance trends. One-year returns (ending June 30, 2023) fell materially below longer-term averages, which were elevated in part by deal and initial public offering (IPO) activities during 2020 and 2021. For venture capital, the soft exit environment, driven by low public market prices and business confidence, has significantly limited managers’ ability to realize gains and generate distributions. Many venture capital managers had to mark down valuations that now seem less realistic, resulting in an 8% loss in the one-year period ending June 30, 2023. Buyouts fared better — with an 8% gain over the same period. However, the buyout strategy lagged its longer-term trend and public market performance, owing to the impact of slower earnings growth, rising interest rates, and soft exit conditions. We expect private equity to continue this stream of moderated returns, until public asset prices further improve and exit opportunities re-emerge.

Going forward, we believe investors should continue to prepare for the slowing economy and seek to capitalize on the opportunities that historically present themselves during economic downturns. In particular, we favor the distressed credit strategy and emphasize defensive and high-quality areas, such as infrastructure and secondaries.

## Equities

**Chris Haverland, CFA**

Global Equity Strategist

### Adjusting some 2024 targets

We are maintaining our 2024 S&P 500 Index earnings and price targets, while adjusting lower all other asset-class benchmark targets. Avoiding a recession in 2023 likely allows for S&P 500 Index earnings per share (EPS) to come in at around \$215, so our steady 2024 S&P 500 Index EPS target reflects that the economy's pivot from a growth trough to recovery will raise EPS. Our S&P 500 Index price target range for year-end 2024 is unchanged at 4600 – 4800, reflecting upside from today's levels. We expect price increases to be driven by price-to-earnings (P/E) multiple expansion, which has been typical in past early-cycle recoveries.

We have reduced our year-end 2024 earnings targets for the Russell Mid Cap Index and the Russell 2000 Index (small caps) to reflect lower growth potential and a greater sensitivity of U.S. mid- and small companies to economic weakness. We expect early-2024 weakness in both indexes, followed by an earnings recovery later in 2024. Our lower index targets reflect the downshift in earnings potential and to account for market movements to date.

We have also lowered our MSCI EAFE Index and our MSCI Emerging Markets (EM) Index earnings and price targets for year-end 2024 to better align with our near-term global economic forecast. Even with the downward adjustments, all year-end 2024 index price targets show upside from current levels. However, we believe the path is likely to be choppy. Earnings and sentiment could be tested as the global economy weakens into the first part of 2024.

### 2023 and 2024 equity targets

Equity targets	2023 year-end targets	New year-end 2024 targets	Previous year-end 2024 targets
S&P 500 Index	4000-4200	4600-4800	4600-4800
S&P 500 EPS	\$205	\$220	\$220
Russell Midcap Index	2700-2900	<b>2900-3100</b>	3200-3400
Russell Midcap EPS	\$145	<b>\$155</b>	\$160
Russell 2000 Index	1650-1850	<b>1800-2000</b>	2000-2200
Russell 2000 EPS	\$70	<b>\$65</b>	\$80
MSCI EAFE Index	2000-2200	<b>2000-2200</b>	2300-2500
MSCI EAFE EPS	\$145	<b>\$150</b>	\$160
MSCI EM Index	850-1050	<b>900-1100</b>	1000-1200
MSCI EM EPS	\$75	<b>\$70</b>	\$80

Source: Wells Fargo Investment Institute. Data as of November 15, 2023. Bold type indicates changes. EPS=Earnings per share. EM = Emerging Markets. Forecasts and targets are based on certain assumptions and on our current views of market and economic conditions, which are subject to change. See page 8-9 for index definitions.

# Fixed Income

**Brian Rehling, CFA**

Head of Global Fixed Income Strategy

## TIPS around inflation trending lower

Just like traditional nominal Treasury securities, Treasury Inflation-Protected Securities (TIPS) are issued with a defined coupon rate that does not change over the course of the bond’s life. However, the income an investor receives while holding a TIPS security will change over time as the underlying principal value of a TIPS security adjusts, depending on the index ratio — a calculation that factors in inflation. At maturity, a TIPS holder receives the original principal value multiplied by the index ratio.

The index ratio is important because this is the “inflation protection.” New-issue TIPS initially start with an index ratio near 1.00. The ratio is then adjusted daily for inflation, using the non-seasonally adjusted CPI (Consumer Price Index) for all Urban Consumers (CPI-U).

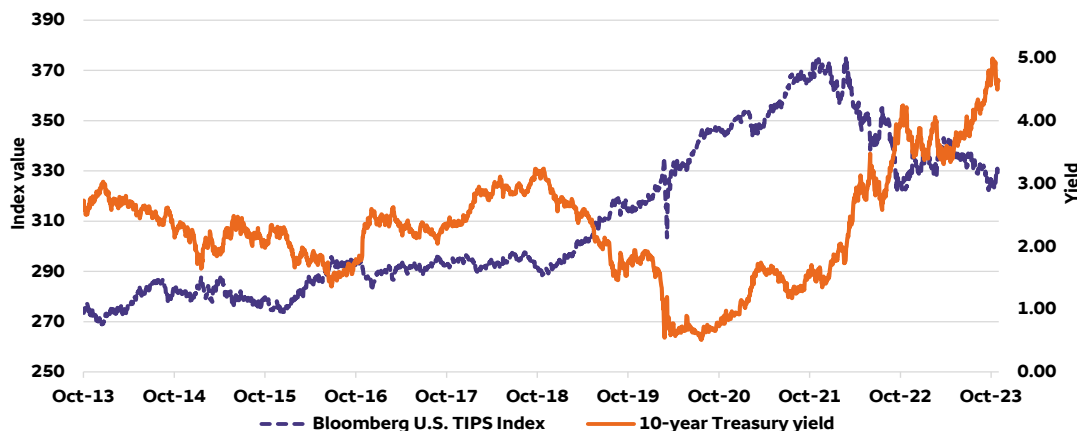
### TIPS performance

Simply put, the market value of a standard nominal U.S. Treasury security fluctuates based on changes in market yield. TIPS, however, have two primary components that impact price — inflation expectations and market yield. Many investors focus on the inflation expectation component of TIPS and underestimate the power interest rate movements have on TIPS performance.

Our expectation is that inflation will move lower next year as the economy weakens, then move higher later in the year as the economy recovers. With the Federal Reserve (Fed) focused on bringing inflation back down to its 2% target, we expect that inflation will continue to drift lower. Lower interest rates often accompany low inflation, and while this could lead to positive absolute performance, under such a scenario we would expect long-term fixed income to outperform TIPS.

It is important for investors to remember that the inverse relationship between bond prices and bond yields generally holds true for TIPS as well. This relationship is most pronounced in longer maturity securities. Most TIPS tend to be longer duration securities. The strong influence of duration (a measure of a bond’s interest rate sensitivity) in TIPS returns can be seen in the chart – which demonstrates that TIPS total return often has been most impacted by the movement of long-term interest rates.

### 10-year Treasury Yield vs. Bloomberg U.S. TIPS Index



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of November 14, 2023. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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## Real Assets

*“If agriculture goes wrong, nothing else will have a chance to go right” – M.S. Swaminathan*

**John LaForge**

Head of Real Asset Strategy

**Mason Mendez**

Investment Strategy Analyst

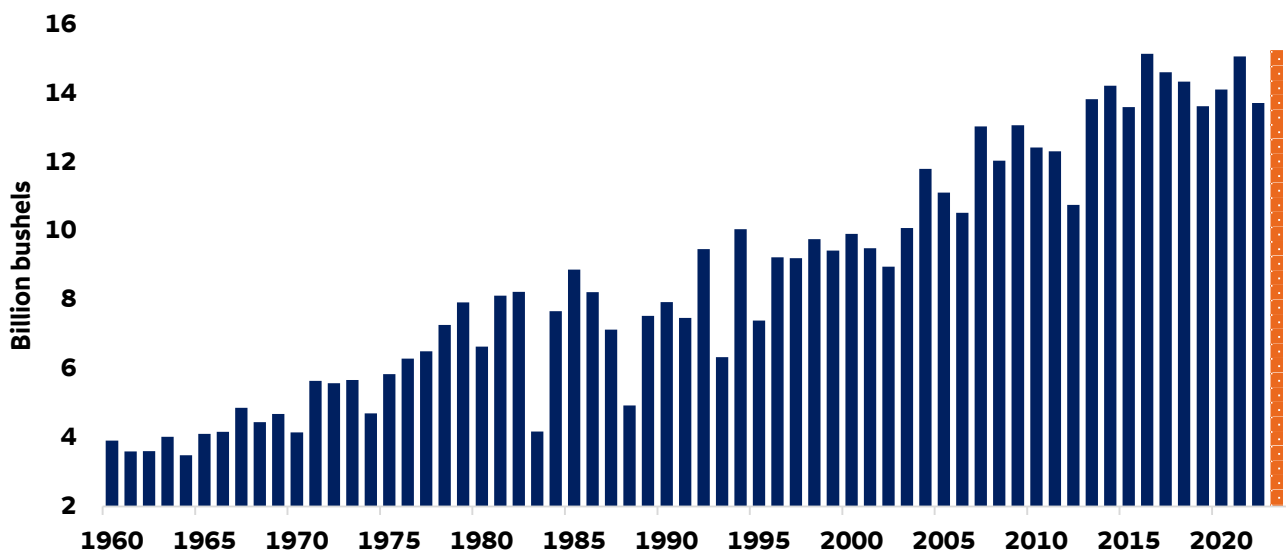
### U.S. corn production expected to hit record highs

When the final kernels are counted for 2023, U.S. corn production is expected to hit an all-time record harvest, according to the U.S. Department of Agriculture (USDA). Despite challenges such as minimal rainfall and high temperatures, U.S. farmers likely will have harvested in the neighborhood of 15.23 billion bushels of corn this year, compared to 13.7 billion bushels last year (see chart).

Record U.S. harvests matter because the U.S. is already the largest producer of corn globally, accounting for 32% of total production according to the USDA World Agricultural Supply and Demand Estimates Report. Interestingly, U.S. farming conditions were not ideal to start the season. Earlier in the season, high temperatures and minimal rainfall sparked fears of a drought across the corn belt. While the corn belt did experience adverse weather conditions, technological advancements in seeding and farming practices helped farmers overcome these challenges. As a result, harvest yields were strong at 174.9 bushels per acre — slightly above the 5-year average of 173 bushels per acre. This strong harvest, on top of already elevated global supplies, pushed corn prices lower. Year to date, 2023 corn prices have fallen nearly 32%. Even today’s prices, near \$4.64 per bushel (as of November 10) are some of the lowest seen in three years.

Overall, most grains and oilseeds have been well supplied in 2023, resulting in softer prices across the board. Year to date, the Bloomberg Agriculture sub-index has produced a respectable -0.68% total return (as of November 10), but only because select crops had supply issues, such as cocoa, sugar, and coffee. With the major grains and oil seeds globally oversupplied, we remain neutral on agriculture. We continue to favor adding a broad basket of commodities to portfolios, due to the benefits of the ongoing commodity bull-super cycle.<sup>1</sup>

### U.S. corn production since 1960



Sources: Bloomberg, United States Department of Agriculture, and Wells Fargo Investment Institute. Annual data is from 1960 - 2023. 2023 data is an estimate and shown by the orange dotted bar.

<sup>1</sup>Super-cycle = If you look at commodity prices over the very long term (hundreds of years), it becomes evident that they tend to move in overall bull and bear cycles, some lasting decades. These are super-cycles.

## Current tactical guidance

### Cash Alternatives and Fixed Income

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
	U.S. Intermediate Term Taxable Fixed Income High Yield Taxable Fixed Income	Cash Alternatives Developed Market Ex-U.S. Fixed Income Emerging Market Fixed Income	U.S. Taxable Investment Grade Fixed Income	U.S. Long Term Taxable 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, November 20, 2023.

\*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. **Treasury Inflation-Protected Securities (TIPS)** are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond to fluctuate more than other fixed income securities. TIPS have special tax consequences, generating phantom income on the “inflation compensation” component of the principal. A holder of TIPS may be required to report this income annually although no income related to “inflation compensation” is received until maturity. 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

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 U.S. Aggregate 1-3 Year Bond Index is composed of the Bloomberg U.S. Government/Credit Index and the Bloomberg U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 1-3 years.

Bloomberg U.S. Aggregate 5-7 Year Bond Index is composed of the Bloomberg U.S. Government/Credit Index and the Bloomberg U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 5-7 years.

Bloomberg U.S. Aggregate 10+ Year Bond Index is composed of the Bloomberg U.S. Government/Credit Index and the Bloomberg U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 10 years or more.

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

Bloomberg U.S. TIPS Index is an unmanaged market index comprised of all U.S. Treasury Inflation-Protected Securities rated investment grade, have at least one year to final maturity, and at least \$500 million par amount outstanding.

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

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.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is 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. The 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 US stock market.

Pitchbook Private Debt Direct Lending Index is a quarterly return benchmark built with Pitchbook's fund cash flow and net asset value data. The index includes private debt direct lending funds classified by Pitchbook. The index is capital weighted and provides estimates of asset class performance that are subject to updates by Pitchbook.

Pitchbook Private Real Asset Index is a quarterly return benchmark built with Pitchbook's fund cash flow and net asset value data. The index includes infrastructure and natural resources funds classified by Pitchbook. The index is capital weighted and provides estimates of asset class performance that are subject to updates by Pitchbook.

Pitchbook Private Real Estate Index is a quarterly return benchmark built with Pitchbook's fund cash flow and net asset value data. The index includes private real estate funds classified by Pitchbook. The index is capital weighted and provides estimates of asset class performance that are subject to updates by Pitchbook.

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