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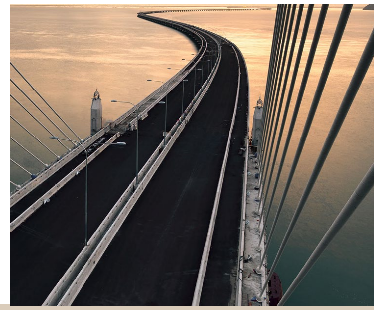
Investment Institute



Investment Strategy

Weekly guidance from our Investment Strategy Committee **February 5, 2024**

Fixed Income Spotlight

Luis Alvarado
Global Fixed Income Strategist

Direction of U.S. interest rates in 2024

Some major fixed-income index returns were negative in January as U.S. Treasury yields climbed slightly from where they finished last year. One of the major influences on the increase in yields was that markets started adjusting their bets on how fast the Federal Reserve (Fed) would begin to cut rates, pushing the date further back but aligning with what we heard from Chair Powell last week, that "it seems premature to try to pinpoint a date of when interest rates cuts will appear until inflation moves further lower towards the Fed's goal."

Still, the consensus seems to be that the Fed will be able to cut interest rates in 2024; however, the reason behind the cuts is not so clear. Is it because we will experience an economic slowdown or mild recession in 2024, or is it because real interest rates now seem too high as inflation continues to move lower? In our opinion, we could argue that it could be a function of both, but the influence of the former reason seems to be diminishing in favor of the latter.

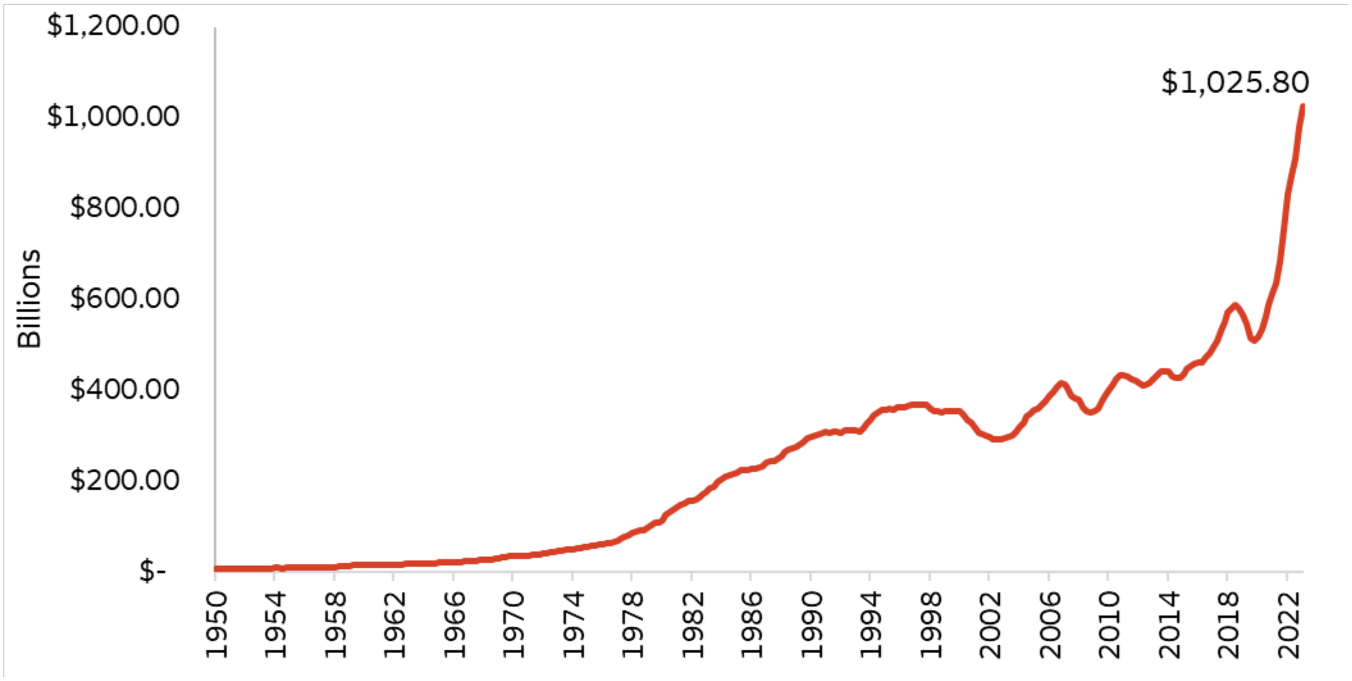
For now, there seems to be no urgency for the Fed to take any action. Inflation is moving in the right direction and the unemployment rate remains low while financial conditions have eased. If the U.S. economy manages to avoid a slowdown, then it seems reasonable to believe that the Fed will most likely cut policy rates to move away from being restrictive and aim toward a neutral policy rate stance. After all, the Fed's implicit objective has been to deliver an economic soft landing while taming inflation.

What should we expect for the rest of the yield curve?

On the other hand, although the shape of the yield curve is currently inverted, we believe that the yield curve will flatten toward year-end. Our expectation is that the Fed will cut policy rates three times in 2024, bringing the federal funds target rate range between 4.50% and 4.75%. Our expectation is for the 2-year U.S. Treasury yield to remain range bound near the current level of 4.4%, but we do envision higher long-term yields from current levels, finishing the year around 4.50% and 4.75% for the 10-year and 30-year U.S. Treasury yields, respectively.

One of the major catalysts for higher rates, in our view, has to do with the amount of government debt outstanding and the expected issuance in 2024 to fund an increasing government deficit. Last week we heard from the Treasury on the amounts of borrowing expected for the next couple of quarters. The report mentioned that there was less issuance needed and this benefited bonds as we saw yields decline right after the announcement. In addition, we also learned that the Treasury planned to issue fewer Treasury bills (T-bills) but more front-end coupon securities, and our belief is that that a continued rebalancing between those two should also serve as a catalyst to move yields higher.

Cost of servicing U.S. debt (interest payments)



Sources: Bloomberg and Wells Fargo Investment Institute, as of January 30, 2024.

The chart above highlights that gross interest payments on federal debt have been increasing rapidly since 2020. Although this is worrisome, we have pointed out for some time that there is a history in Congress of reining spending when interest costs move beyond 15% of total revenue. For now, it appears that the bond market is not terribly worried, but bond investors could begin to require higher compensation for holding U.S. debt should the overall debt and deficit situation deteriorate.

Investment implications

In our view, it will be difficult for interest rates to go back to the low levels experienced during the decade following the global financial crisis. It is our assumption that over the next couple of years, interest rates will remain near current levels or even higher. It will mostly be a function of where inflation manages to settle at and how the Fed reacts to it, but a still resilient U.S. economy should be able to withstand relatively higher rates. We still believe investors are able to find value in fixed income. In our view, starting yields across the yield curve look attractive and still present investors with good entry points depending on the investor's objective and time horizon. We are most favorable short-term fixed income, and neutral intermediate and long-term. We still have a preference for high-quality investment-grade bonds.

Equities

Ian Mikkelsen, CFA
Equity Sector Analyst, Materials

Materials: Sticking with what worked in 2023

Although earnings growth for the Materials sector was mixed in 2023, our favored sub-sectors —Industrial Gases, Construction Materials, and Specialty Chemicals — showed impressive growth, driven by resilient demand and strong pricing power. Further, they have defensive characteristics combined with operating leverage to the global economy, a feature that could be advantageous in 2024 given our expectation for a moderate slowdown followed by a recovery. The overviews below provide details that are key to our ongoing preference for these sub-sectors.

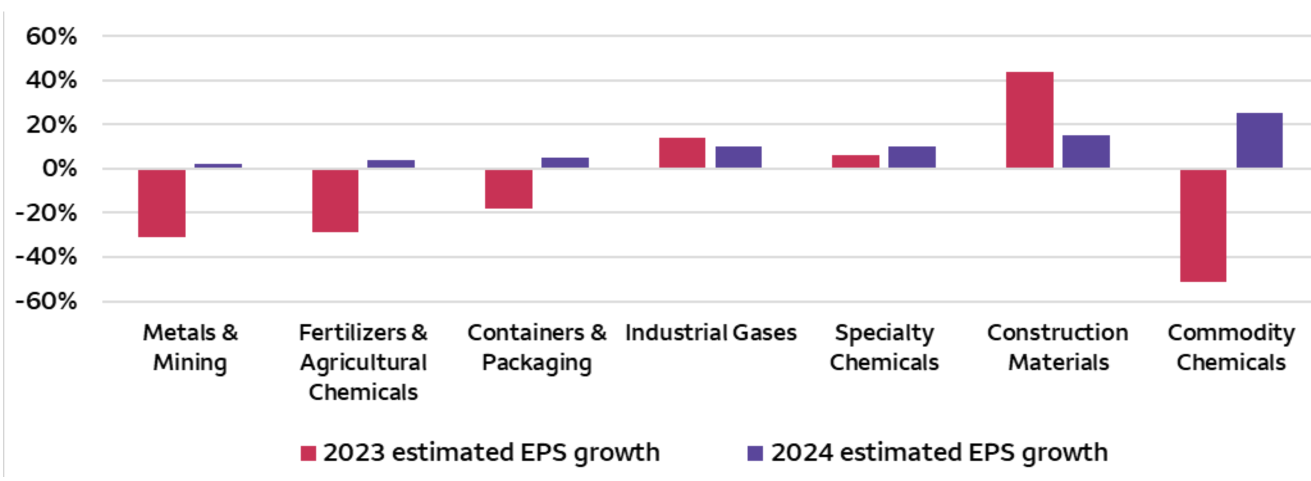
Industrial Gases: Companies in this sub-sector produce and deliver critical molecules required for a variety of processes along with ancillary infrastructure and services. The contractual nature of the business protects downside risk from both a volume and pricing perspective, and the industry maintains strong operating leverage to growth in global industrial production.

Construction Materials: These companies produce and distribute aggregates (gravel, cement, etc.) for construction. The majority of business comes from infrastructure and heavy private nonresidential construction, and competition is limited and regional in nature. A surge in demand from new construction has been driven by growth in onshoring and infrastructure investments and has been further accelerated by large-scale government stimulus.

Specialty Chemicals: Companies in this sub-sector produce a wide range of specialized intermediate products that typically add value at a relatively small incremental cost for the customer. Strong pricing power is driven by sticky customer relationships and the ability to deliver a unique value proposition. Further, volumes may see upside later in 2024 from an improving economy.

Finally, as shown in the chart below, our expectation for outperformance is supported by 2024 consensus earnings per share (EPS) estimates. While the Commodity Chemicals sub-sector (neutral) is expected to see elevated growth, we note that it tends to exhibit very high earnings volatility, evidenced by its 51% EPS decline for 2023.

Estimated 2024 EPS growth within the Materials sector



Sources: Factset and Wells Fargo Investment Institute. Estimated EPS growth represents current consensus estimates as of January 29, 2024. Each category represents an industry or sub-industry in the S&P 500 Materials Index, as classified by Global Industry Classification Standards. Forecasts and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.

Fixed Income

Dorian Jamison
Municipal Analyst

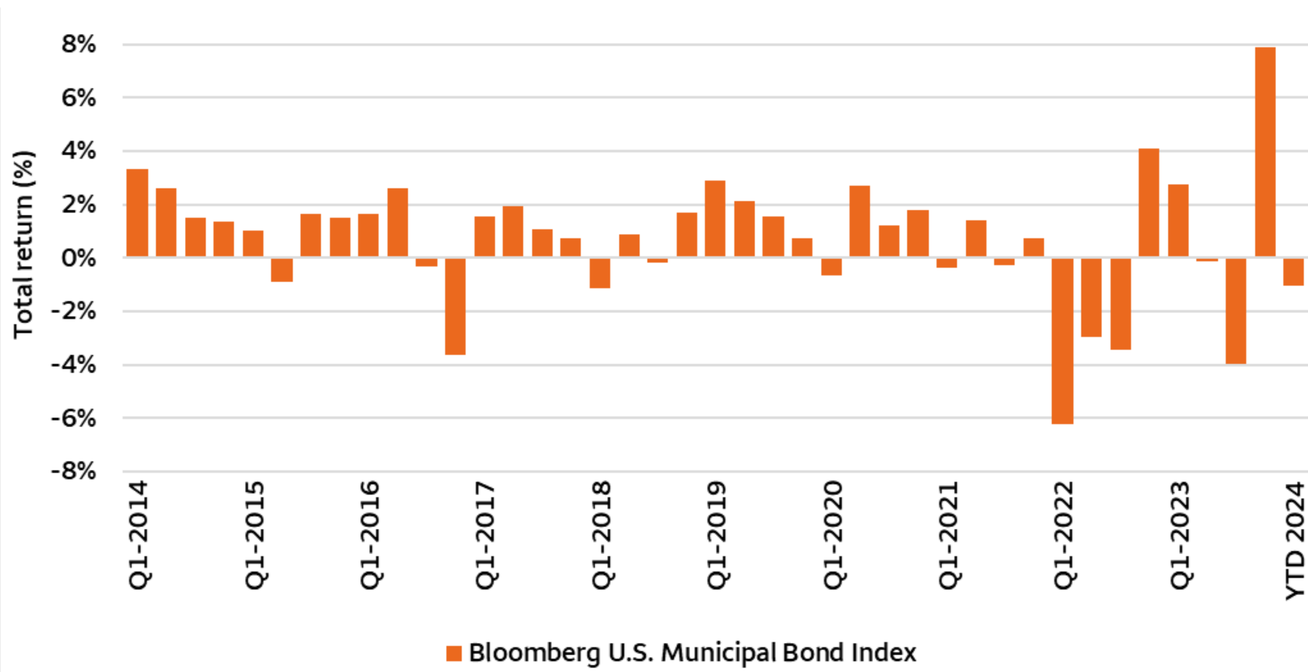
Early pullback could offer an attractive entry point for investors

The municipal bond market saw its best quarter of performance in the past 10 years during the fourth quarter of 2023 by a wide margin, shown in the chart below. The Bloomberg U.S. Municipal Bond Index returned 7.9%, nearly double the next-highest returning quarter during the period and well above the 10-year average of 0.8%. This has, however, given way to a slow start in the new year, with year-to-date returns through January 29 falling to -1.05%.

The pullback aligns with historical patterns as municipal bond returns have often seen first-quarter declines — over the past 10 years, returns have averaged 0.5% during the first quarter compared to 1.7% during the fourth quarter. This trend is driven primarily by increased supply as new issuance typically rebounds after the fourth quarter holiday season and profit taking following a historically strong fourth quarter. Ultimately, we expect that the resulting lower returns could translate to lower prices for investors.

We think a pullback in municipal bond prices would offer an attractive entry point for investors. We remain favorable on U.S. Municipal Bonds, especially as they have historically been resilient during economic slowdowns. In our view, the short and intermediate portions of the curve offer attractive value while mitigating duration risk (duration is a measure of interest rate sensitivity). We continue to prefer A-rated or higher general obligation bonds in the traditional tax-free sector. Compared with the broader municipal market, we believe general obligation bonds have the potential to offer an attractive opportunity for outperformance in 2024.

Muni market starts year slow after hitting record highs



Sources: Bloomberg and Wells Fargo Investment Institute. Data from January 1, 2014 through January 29, 2024. YTD 2024 = year to date through January 29, 2024. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results**.

Real Assets

John Sheehan, CFA
Equity Sector Analyst, Real Estate

The importance of positioning in the Real Estate sector

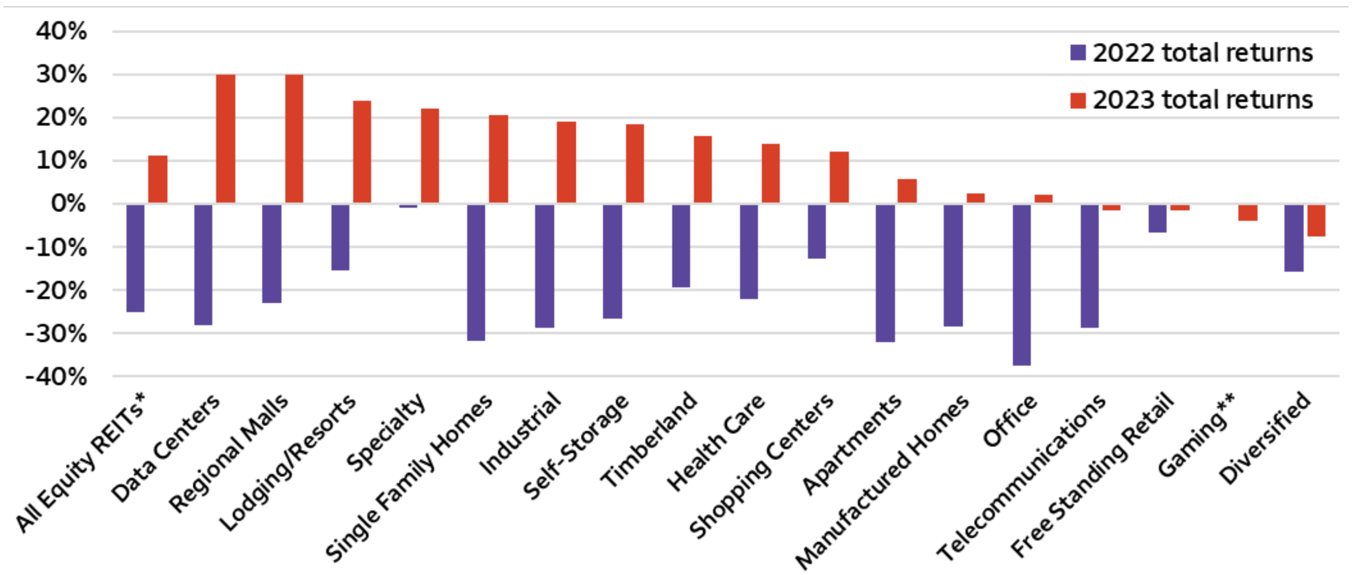
We have noted in the past that REIT performance often varies significantly from one sub-sector to another, and 2023 was no exception — total returns across the 17 REIT sub-sectors again demonstrated variability, ranging from 30.1% (Data Center REITs) to -7.6% (Diversified REITs).

As the chart shows, Data Center REITs were the top performing sub-sector in 2023. We believe this reflected investor optimism regarding the impact of artificial intelligence on customer demand for data centers. We attribute the stronger relative returns for Regional Mall and Lodging/Resort REITs to reasonable U.S. economic growth along with a low unemployment rate, factors that have given consumers the confidence to continue spending on discretionary goods and travel. Finally, Industrial REITs appeared to have benefited from continued solid tenant demand for modern warehouse space in many major cities.

In terms of REIT sub-sectors with weaker performance, we think higher interest rates negatively impacted both Telecommunications and Free-Standing Retail REIT returns. In our opinion, Office REITs continue to be negatively impacted by reports of relatively low office utilization, large users reducing their office footprints, and, more recently, rising corporate layoff announcements.

Although total returns were relatively solid in 2023, particularly when compared to 2022, we remain unfavorable on the Real Estate sector given our preference for defensive positioning. Further, we would highlight the significant variability in returns by sub-sector. We recommend investors considering REITs focus on Data Center and Industrial REITs given positive long-term demand drivers. Looking ahead, we believe Telecommunication REITs could be a beneficiary of potential interest rate reductions in 2024 given the sub-sector's relatively weak total returns in 2022 and 2023 despite good earnings and dividend growth.

REIT total returns have improved from 2022 but remain highly variable



Sources: National Association of Real Estate Investment Trusts (Nareit). Data as of December 29, 2023. Returns represent annual total returns for equity REIT sub-sectors, as defined by Nareit. *All Equity REITs = FTSE Nareit All Equity REITs Index. **Gaming sub-sector created as of June 2023. **Past performance is no guarantee of future results.**

Alternatives

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

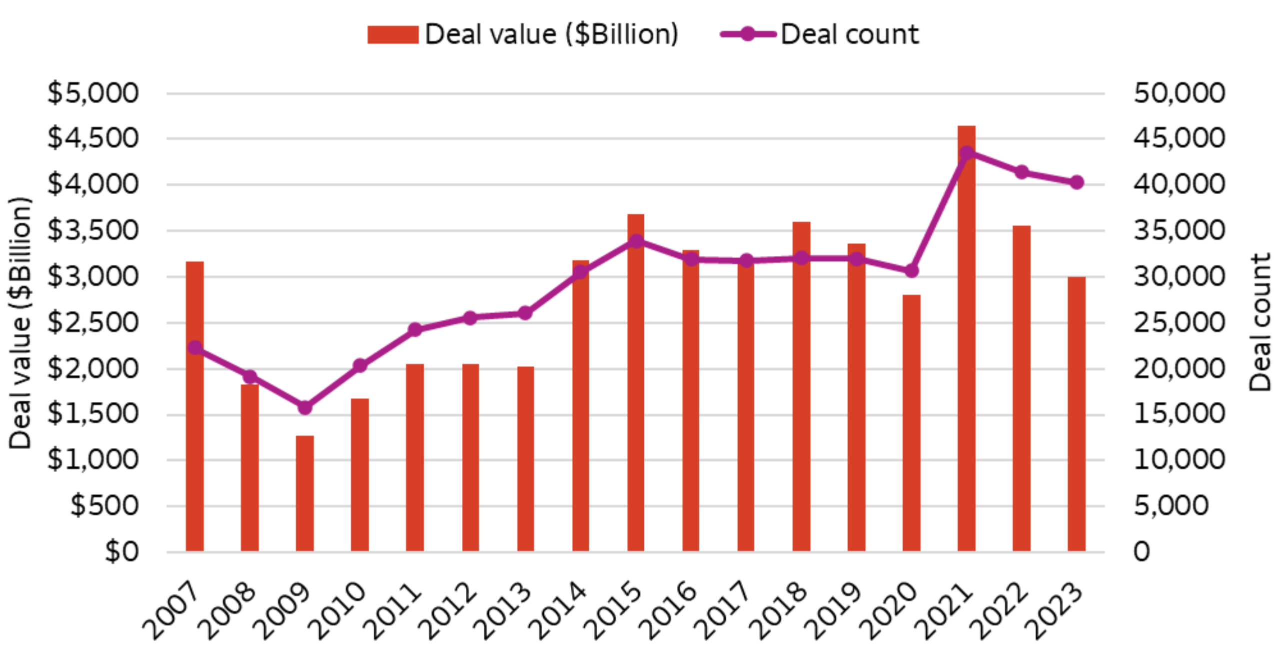
Downtrend slowed in mergers and acquisitions

Global merger and acquisition activity declined for a second consecutive year in 2023, representing a drop of 35% in deal value from the all-time high (see chart). Elevated interest rates, a disconnect in buyer and seller price expectations, and mounting geopolitical tensions continue to serve as headwinds. However, the recent year-over-year decline suggests that the downtrend has slowed. In addition, a rebound in deal activity was also visible in the fourth quarter.

Smaller deals continued to gain traction as a share of total volumes, as many megadeals were put on hold due to higher financing costs and economic uncertainty. On the sector level, Energy, Materials, and Financials were the bright spots in 2023, with elevated deal activities driven by their more affordable valuations, growing investor interest in renewal energy and energy security, as well as continued industry consolidations. On the other hand, Technology deals were down significantly due to material disagreements in bid and ask prices.

These recent developments in the merger and acquisition market continued to support our favorable views on the Small-Mid Buyout and Secondary strategies . Further, we have gained more optimism that the deal environment may bottom and start to recover in 2024 as corporate executives gain more confidence on the interest rate and macro outlook, as well as the evolving antitrust regulation policies. As we observe positive developments, we may turn more constructive on Merger Arbitrage and Activist strategies , which are positioned to benefit from the expanding opportunity set.

Merger and acquisition activities from 2007 to 2023



Sources: Wells Fargo Investment Institute and Pitchbook. Data as of December 31, 2023. 2023 deal value and count are based on Pitchbook's estimation.

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.

Current guidance over tactical horizon (6-18 months)

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, February 5, 2024.

*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 are not guaranteed and 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**, 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. **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. 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.

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

An index is unmanaged and not available for direct investment.

Bloomberg Municipal Bond Index represents municipal bonds with a minimum credit rating of at least Baa, an outstanding par value of at least $3 million and a remaining maturity of at least one year. The index excludes taxable municipal bonds, bonds with floating rates, derivatives and certificates of participation.

FTSE NAREIT Equity REIT Index is a market-capitalization-weighted index of all publicly traded REITs that invest predominantly in the equity ownership of real estate. The index is designed to reflect the performance of all publicly traded equity REITs as a whole.

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

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