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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **February 20, 2024**

Asset Allocation Spotlight

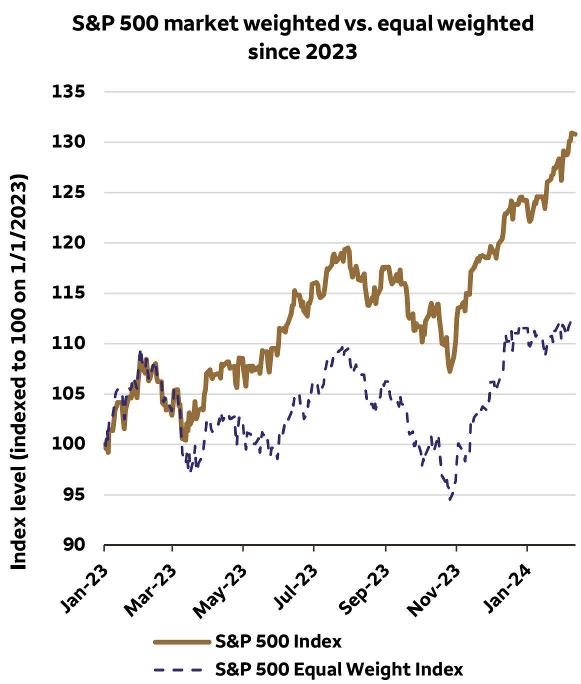
Veronica Willis
Global Investment Strategist

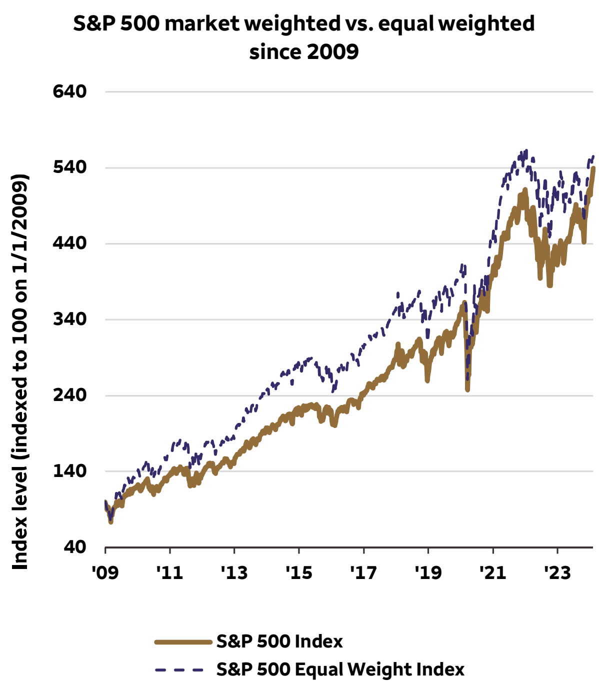
The risk in concentrated positions

In 2023, market breadth narrowed, and only a handful of stocks (dubbed the Magnificent 7 [1]) drove performance for the S&P 500 Index. The trend of narrow market breadth in the U.S. large-cap space has carried over into 2024, bringing about concerns over the efficacy of diversification both within equity markets and across various asset groups versus holding concentrated positions of those top performers.

Last year, the S&P 500 Equal Weight Index drastically underperformed the market-weighted index as the majority of the index's return was driven by the seven largest stocks in the index. Having exposure to those stocks certainly proved beneficial for investors, while excluding them would have led to broader underperformance. However, having exposure to only this handful of stocks, even though they have outperformed over the past year, can leave a portfolio exposed to concentration risk and the risk of sizable losses should those few assets pull back or leadership within the equity market change. Additionally, if a portfolio only holds concentrated positions of a few assets, it could miss growth and return opportunities as market breadth eventually improves as we expect.

Narrow markets are typically not long lived





Sources: Bloomberg and Wells Fargo Investment Institute. Left chart: daily data from January 1, 2023 to February 12, 2024. Right chart: Weekly data from January 1, 2009 to February 9, 2024. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Over the past 15 years, there have been time periods when the S&P 500 Equal Weight Index outperformed its market-weighted counterpart or when the two indexes tracked very closely. Had a portfolio held a concentrated position in only a few stocks over that time frame, it would likely have been hurt by missing exposure to the rest of the index as it performed well over time.

1. The magnificent 7 stocks include Apple, Microsoft, Amazon, Alphabet (Google), Tesla, Nvidia, and Meta Platforms.

Narrow market breadth was not only an equities story last year. The divergence in the top and bottom performers across asset groups and geographical regions was wide in 2023. Having exposure to the worst-performing asset would have drastically reduced performance, while exposure to the highest-performing asset would have proved very fruitful. For example, Emerging Market (EM) Equities were up 10.3% in 2023. The top performing EM was Hungary, up nearly 51%, while China declined 11%, leaving a 62% dispersion between the top and bottom performer. It is not apparent ahead of time exactly which asset class, asset style, or country will be the top or bottom performer. But when dispersion is so great, maintaining a strategic allocation and tactically tilting toward those asset classes or sectors that appear to have the best opportunities for gains could be a good way to take advantage of the variation. Meanwhile, having broader exposure to various assets reduces the risk of choosing only the worst-performing assets in a concentrated portfolio, which could be very costly.

There were wide dispersions in performance within asset groups in 2023

Asset group	Global fixed income	U.S. equities	Developed market equities	Emerging market equities	Commodities	Hedge funds*
Top performer	High Yield Fixed Income (Bloomberg U.S. Corporate High Yield Index): 13.4%	U.S. Large Cap Growth Equities (Russell 1000 Growth Index): 42.7%	MSCI Italy Index: 38.8%	MSCI Hungary Index: 50.9%	Bloomberg Precious Metals Subindex: 9.6%	HFRI Event Driven Activist Index: 18.1%
Index total return	Bloomberg Multiverse Index: 6.0%	Russell 3000 Index: 26.0%	MSCI World Index: 24.4%	MSCI Emerging Markets Index: 10.3%	Bloomberg Commodity Index: -7.9%	HFRI Fund Weighted Composite Index: 8.1%
Bottom performer	DM ex-U.S. Fixed Income (JPM GBI Global ex-U.S. Index): 4.0%	U.S. Large Cap Value Equities (Russell 1000 Value Index): 11.5%	MSCI Hong Kong Index: -14.8%	MSCI China Index: -11.0%	Bloomberg Energy Subindex: -21.6%	HFRI Macro Systematic Diversified Index: -3.8%
Difference between top and bottom performer	9.5%	31.2%	53.6%	61.9%	31.3%	21.8%

Sources: Bloomberg and Wells Fargo Investment Institute. 2023 calendar year total returns as of December 31, 2023. *Alternative investments, such as hedge funds, private equity 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. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

As the old adage goes, "don't put all your eggs in one basket." Diversification among asset groups is an important tool in portfolio construction to reduce the risk of significantly underperforming the asset group. Often in a diversified allocation, losses in some assets can be offset by the gains in others. During strong equity rallies like in 2023, performance from equities helps to boost returns even as fixed income, commodities, or hedge fund returns may lag. Conversely, when the equity market corrects, exposure to those diversifiers may help in an effort to limit losses, often providing a smoother return path over the long term.

Similar to asset group diversification, diversifying within asset classes is also crucial. Having exposure to only one type of equity, fixed-income instrument, or commodity can leave a portfolio vulnerable to being left behind once leadership within an asset class inevitably changes.

Instead of concentrating portfolios in a handful of assets, we believe making tactical (6 – 18 month) adjustments to increase or reduce exposure to certain sectors of the market based on the market and economic environment is a good way to take advantage of current trends. Meanwhile for longer-term focused investors, maintaining broad-based exposure within asset classes is prudent to ensure exposure to assets that may take leadership over shorter periods.

Equities

Sameer Samana, CFA
Senior Global Market Strategist

Markets look stretched

A strong start to the year has left the markets stretched to the upside and overbought on a variety of measures, with the NASDAQ 100 Index serving as the best example of the froth in markets. We have seen investors of all stripes have felt compelled to chase recent performance in a small group of names and sectors, mainly due to fear of missing out or underperforming their benchmarks. While we acknowledge that there are favorable fundamental factors that are underpinning some of these Information-Technology-related names and sectors (that may have the potential to benefit from secular growth trends, strong balance sheets, and healthy profitability), we believe much of the good news is now discounted.

The factors capping further appreciation should include long-term interest rates, which remain close to multi-decade highs, worsening geopolitics, and a sluggish economic outlook. In addition, we believe the Federal Reserve's goal of taming inflation will keep monetary policy tighter for much longer than markets expect. We believe where the NASDAQ 100 Index may trade to the downside will be a function of the length and severity of an economic slowdown, which now seems to be unfolding and should adversely impact corporate profits.

We believe it would be fair to describe the risk-reward at current levels as unfavorable, and disciplined investors may potentially take profits in Information-Technology-related companies. On a pullback, the NASDAQ 100 Index may find support at the 50-day (16895) and 200-day (15394) moving averages. Also, we would focus on putting excess cash to work within the Energy, Industrials, Materials, and Health Care sectors.

NASDAQ 100 Index with moving averages

Sources: Bloomberg and Wells Fargo Investment Institute. Daily data from February 12, 2021, through February 13, 2024. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Fixed Income

Eric M. Jasso, CFA
Taxable Analyst

Attractive yields and price upside remain for low-coupon IG bonds

Since March 1, 2022, long-term investment-grade (IG) corporate bonds have seen the steepest selloff among fixed income asset classes. This has been a function of these bonds' higher duration — the measure of a security's sensitivity to a change in interest rates — due to their longer time to maturity. Among IG bonds with 10 years or more to maturity, low-coupon bonds have seen the most substantial sell-off. This is because the price must decline further below par for the effective yield to mirror those of higher coupons.

In the past, low-coupon bonds trading near par would have been viewed as modest income sources with substantial downside should interest rates rise. However, now that many long-dated, low-coupon bonds are trading at deep discounts, we think they should be viewed as an opportunity to lock in attractive current yields with substantial price appreciation potential should longer-term rates experience a material decline. Considering that yields are nearly identical across the maturity spectrum, we prefer lower-priced, low-coupon bonds over higher-priced, higher-coupon bonds of the same credit quality.

Investors should be aware that long-dated maturities will have greater exposure to the underlying issuer's business and financial strength through economic cycles. When taking credit risk over a long-term horizon, we believe investors should favor market leaders within industries expected to be less susceptible to substantial disruption that have a track record of prudent financial policies. Please see our February 14 Corporate Credit Sector Insights piece titled "A low price, high quality opportunity" for implementation ideas.

Investment-grade bonds with 10+ years to maturity

Coupon rate	Average yield	Average price	Price return since March 1, 2022
2.5% – 3.0%	5.26%	$66.60	-31.0%
3.0% – 3.5%	5.44%	$71.40	-29.9%
3.5% – 4.0%	5.51%	$78.40	-28.6%
4.0% – 4.5%	5.50%	$84.80	-27.5%
4.5% – 5.0%	5.56%	$90.90	-25.9%
5.0% – 5.5%	5.67%	$95.60	-24.8%
5.5% – 6.0%	5.66%	$102.00	-22.7%

Source: Wells Fargo Investment Institute. Data reflects all investment-grade bonds with 10+ years – maturity within the Bloomberg US Aggregate Statistics Index. Pricing as of February 9, 2024. Yields represent past performance and fluctuate with market conditions. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Real Assets

John LaForge
Head of Real Asset Strategy

Mason Mendez
Investment Strategy Analyst

The U.S. decides to halt LNG export permits

Our Real Assets team remembers May 2011 well, when the Obama Administration approved the first large U.S. LNG export terminal at Sabine Pass, Louisiana. It was a historic moment because up until then, the majority of U.S. LNG terminals were licensed to import only. Ten years later, the U.S. accounts for 19% of global LNG exports.

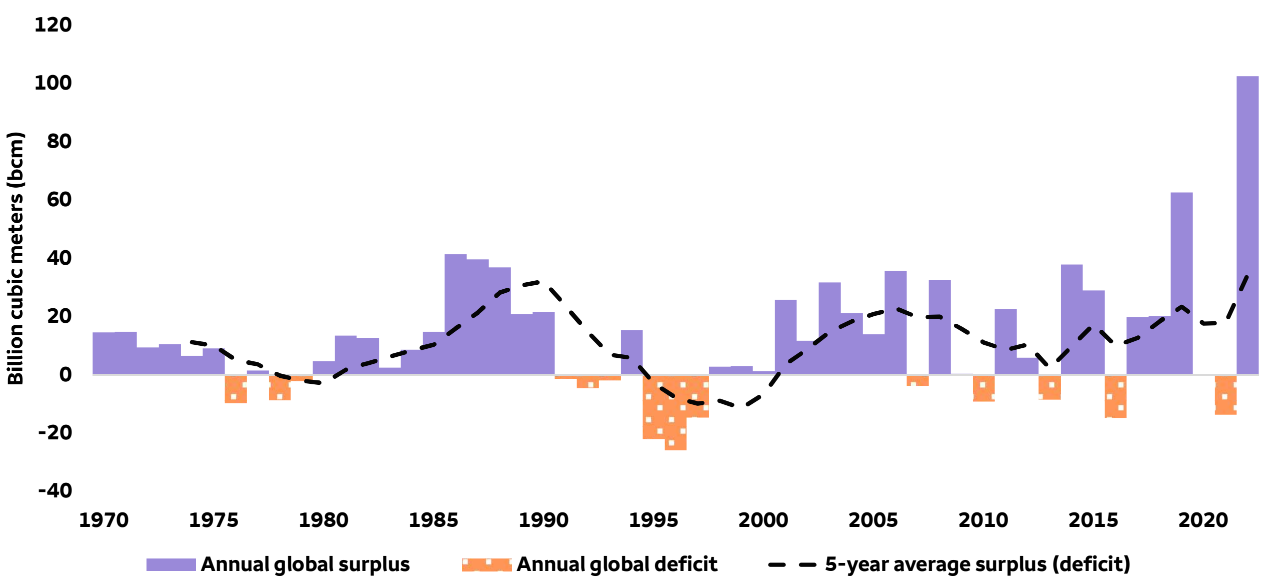
No matter reasons for pausing U.S. approvals, there will be consequences, inside the U.S., and out. Inside the U.S., energy companies will, of course, be impacted the most. The U.S. is now among the top three largest suppliers of LNG globally. As for the rest of the globe, Europe is most at risk of seeing disruptions, as 64% of U.S. LNG exports were shipped to Europe in 2023.

Some market participants view the U.S. administration's decision as a worrying sign for global energy security. Our view is yes, it could be, but not for a few years. The U.S. has five approved projects already in the pipeline that will not be impacted by the pause. And these projects are expected to nearly double U.S. export capacity by 2027.

Looking outside the United States, global natural gas supplies are well above their five-year average (see chart). For Europe specifically, we do not have natural gas supply concerns for 2024, as much of the continent continues to implement the same conservation efforts initiated in 2022.

In our view, the bottom line is that the U.S. decision to pause future LNG export facility approvals is not likely to have immediate impacts on U.S. LNG exports, European LNG imports, or global natural gas prices, as global markets appear sufficiently supplied. Therefore, the decision does not impact our current guidance, and we continue to remain favorable on the Energy sector. Now, there is no official date as to when the pause on LNG export permits will be lifted, but current estimates are that it could last for up to 15 months. If the pause lasts longer than expected, then we could expect to see material changes in production growth. U.S. producers would likely face an uncertain demand outlook and respond by scaling back production. In that case, we would expect to see strong energy price performance, further supporting our favorable guidance.

Global natural gas supply balance vs. 5-year average



Sources: Energy Institute 2023 Statistical Review of World Energy and Wells Fargo Investment Institute. Annual data is from 1970 – 2022.

Alternatives

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

Credit markets show signs of life

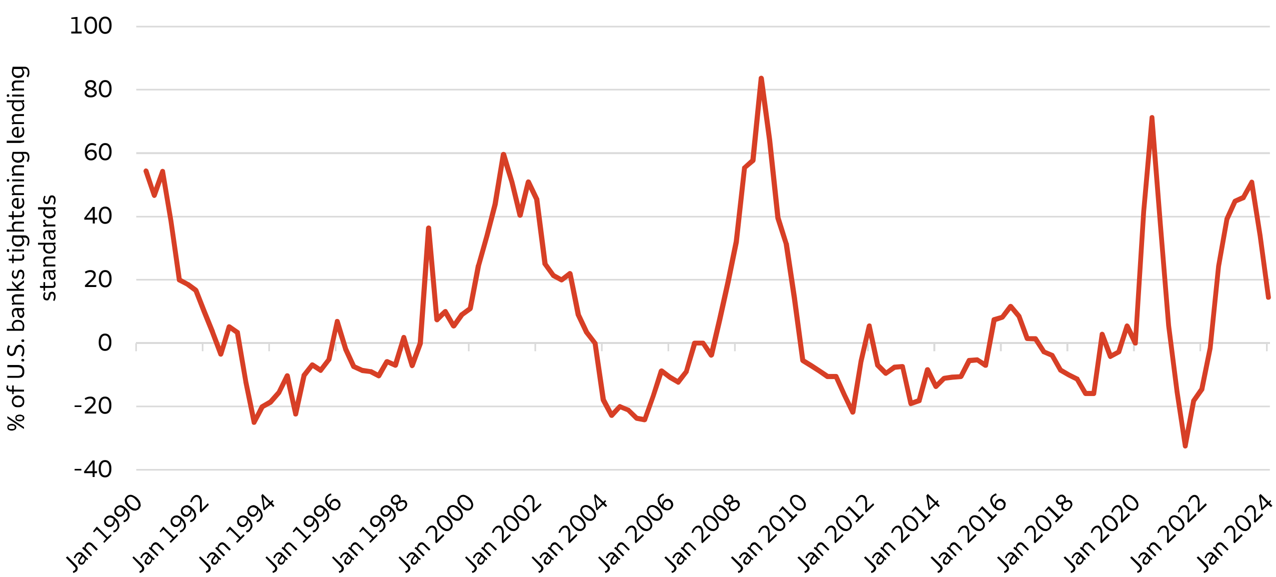
Since the fourth quarter of 2023, corporate loan issuance has been on the rise on the backs of stabilized policy rates and retreated U.S. Treasury yields. Other indicators of credit condition also showed signs of life. Spreads have tightened across major sub-investment-grade credit markets, including high-yield bonds, leveraged loans, and private credit. Among new high-yield bond issuances, a discernible growing proportion are unsecured bonds. Further, banks are reportedly relaxing lending standards, as shown in the chart below.

Under this backdrop, private credit continued to take hold of loan market share. Private lenders not only maintained their dominance in the middle market, but also increasingly financed large leveraged buyout transactions. One current focus for private credit is to refinance the sizable amount of outstanding leveraged loans and high-yield bonds maturing in 2024 and 2025 — an area that we expect should continue to drive deals. At the same time, investors are drawn to private credit by the spread premium, a greater covenant protection, lower default rates, as well as growing accessibility. Since the second quarter of 2023, the private loan default rate published by Proskauer has fallen to near 1.5%, while leverage loans continued to hover at a higher level.

Although we believe early signs of credit market recovery are encouraging and could catalyze improvements in business confidence and private capital activities, we see that the elevated interest rate environment continued to add stresses to small and mid-sized businesses. According to Pitchbook, some companies struggled to make payments on their debts and had to resort to their private equity sponsors and private lenders for help.

We believe private credit is on a potentially promising growth path. However, short-term credit risks remain.

Percentage of domestic banks tightening standards for commercial loans to large and middle-market firms



Source: Wells Fargo Investment Institute and St. Louis Federal Reserve. As of January 1, 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, February 20, 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

Asset allocation and diversification do not guarantee investment returns or eliminate risk of loss including in a declining market.

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.

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

Bloomberg Commodity Index is calculated on an excess return basis and reflects commodity futures price movements. The index rebalances annually, weighted two-thirds by trading volume and one-third by world production, and weight-caps are applied at the commodity, sector, and group level for diversification.

Bloomberg Energy Subindex is a commodity group subindex of the Bloomberg Commodity Index. It is composed of futures contracts on crude oil, heating oil, unleaded gasoline and natural gas. It reflects the return of underlying commodity futures price movements only and is quoted in U.S. dollars.

Bloomberg Multiverse Index provides a broad-based measure of the global fixed-income bond market. The index represents the union of the Global Aggregate Index and the Global High-Yield Index and captures investment grade and high yield securities in all eligible currencies.

Bloomberg Precious Metals Subindex is a commodity group subindex of the Bloomberg Commodity Index. It is composed of futures contracts on gold and silver. It reflects the return of underlying commodity futures price movements only and is quoted in U.S. dollars.

Bloomberg U.S. Corporate High Yield Bond Index covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market. J.P. Morgan EMBI Global (USD) is a U.S. dollar-denominated, investible, market cap-weighted index representing a broad universe of emerging market sovereign and quasi-sovereign debt.

HFRI Event Driven Activist Index: Strategies may obtain or attempt to obtain representation on the company's board of directors in an effort to impact the firm's policies or strategic direction and in some cases may advocate activities such as division or asset sales, partial or complete corporate divestiture, dividends or share buybacks, and changes in management. Strategies employ an investment process primarily focused on opportunities in equity and equity-related instruments of companies that are currently or prospectively engaged in a corporate transaction, security issuance/repurchase, asset sales, division spin-off or other catalyst-oriented situation. These involve both announced transactions and situations in which no formal announcement is expected to occur. Activist strategies would expect to have greater than 50 percent of the portfolio in activist positions, as described.

HFRI Fund Weighted Composite Index is a fund-weighted (equal-weighted) index designed to measure the total returns (net of fees) of the approximately 2,000 hedge funds that comprise the Index. Constituent funds must have either $50 million under management or a track record of greater than 12 months. Sub-strategies include: HFRI Event-Driven, Distressed/Restructuring Index, and HFRI Event-Driven (Total) Index.

HFRI Macro Systematic Diversified Index: Diversified strategies employing mathematical, algorithmic and technical models, with little or no influence of individuals over the portfolio positioning. Strategies are designed to identify opportunities in markets exhibiting trending or momentum characteristics across individual instruments or asset classes. Strategies typically employ quantitative processes which focus on statistically robust or technical patterns in the return series of the asset, and they typically focus on highly liquid instruments and maintain shorter holding periods than either discretionary or mean-reverting strategies. Although some strategies seek to employ counter-trend models, strategies benefit most from an environment characterized by persistent, discernible trending behavior. Typically have no greater than 35 percent of portfolio in either dedicated currency or commodity exposures over a given market cycle.

J.P. Morgan Government Bond Index (GBI) Global ex-U.S. (Unhedged) in USD is an unmanaged index market representative of the total return performance in U.S. dollars on an unhedged basis of major non-U.S. bond markets.

MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs).

MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets countries, including Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Kuwait, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

MSCI Hong Kong Index is designed to measure the performance of the large and mid cap segments of the Hong Kong market.

MSCI Hungary Index is designed to measure the performance of the large and mid cap segments of the Hungarian market.

MSCI Italy Index is designed to measure the performance of the large and mid cap segments of the Italian market.

MSCI World Index captures large and mid-cap representation across 23 Developed Markets (DM) countries, including Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the U.K., and the U.S.

NASDAQ 100 Index consists of the 100 biggest companies listed on the NASDAQ Composite Index. The list is updated quarterly and companies on this Index are typically representative of technology-related industries, such as computer hardware and software products, telecommunications, biotechnology and retail/wholesale trade.

Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.

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 3000® Index is composed of 3000 large U.S. companies, as determined by market capitalization. This portfolio of Securities represents approximately 98% of the investable U.S. equity market. The Russell 3000 Index is comprised of stocks within the Russell 1000 and the Russell 2000 Indices.

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

S&P 500 Equal Weight Index (EWI) is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance.

An index is unmanaged and not available for direct investment.

The HFRI indexes are based on information self-reported by hedge fund managers that decide, on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indexes may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways.

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Investment Grade bonds - A rating that indicates that a municipal or corporate bond has a relatively low risk of default. Bond rating firms, such as Standard & Poor's, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ('BB', 'B', 'CCC', etc.) are considered low credit quality, and are commonly referred to as "junk bonds".

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