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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **August 19, 2024**

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- While market volatility has moved above recent low levels, investors should not react by abandoning or reducing equity exposure.
- Tactical and strategic investors benefit from looking past immediate and near-term market volatility and uncertainty by setting diversified allocations that have exposure to assets that we expect to perform well over the tactical and strategic time frames.

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- The S&P 500 Index has fallen sharply and now sits between key support and resistance levels.
- We believe markets will remain range bound until the November elections and that investors should be dynamic when positioning portfolios.

Fixed Income: Dollar to remain elevated in spite of rate cuts....................5

- We believe that more Federal Reserve (Fed) rate cuts may blunt some of the dollar's strength but not remove it entirely.
- Our expectation for the dollar to remain elevated may be a tailwind to dollar-denominated currencies, and it supports our preference for U.S. over international and emerging markets in both equities and fixed income.

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- The current bull super-cycle[1] that began in March 2020 is up 80% since its inception, but performance has stalled over the past year.
- Though not the norm, super-cycles have stalled in the past for extended periods before rising again. We see current price weakness as an opportunity to gain exposure.

Alternatives: Private equity exits remain stuck in low gear 7

- The environment for private equity exits remains challenged as few public or private buyers emerge, due in part to a backdrop of higher interest rates and uncertain economic growth.
- Forecasts for lower interest rates and further confirmation of firming economic growth may incent buyers from the sidelines in the coming quarters.

Current tactical guidance 8

Investment and Insurance Products: ➤ NOT FDIC Insured ➤ NO Bank Guarantee ➤ MAY Lose Value

1. Bull super cycles are an extended period of time, historically 15 – 20 years, where commodity prices move upward together.

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Asset Allocation Spotlight

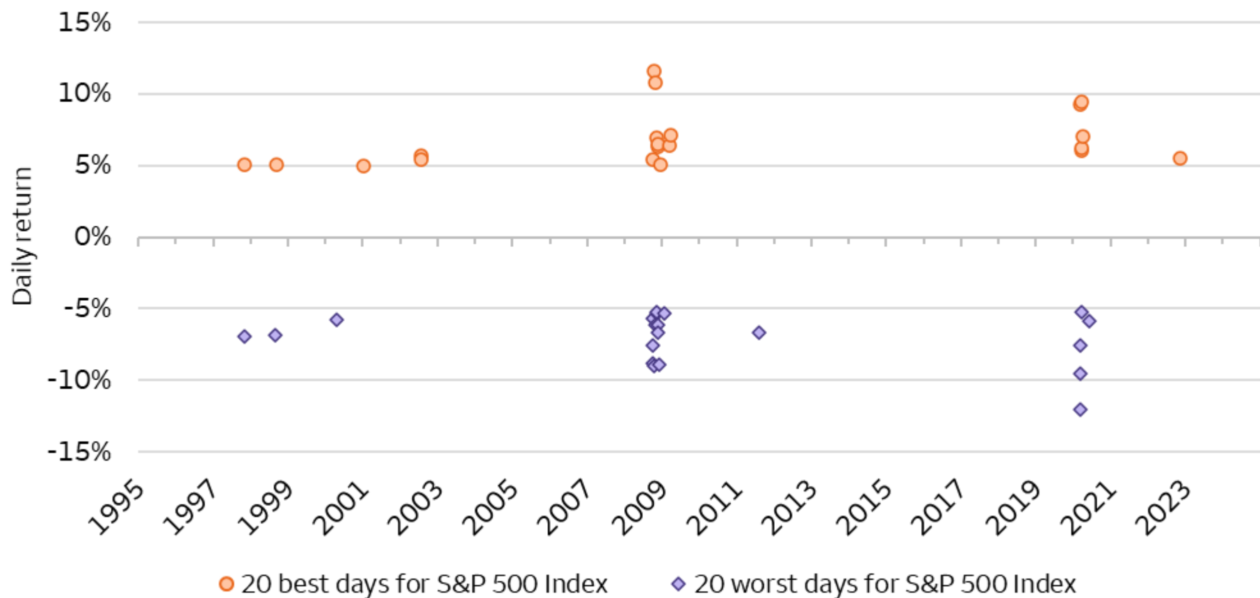
Veronica Willis
Global Investment Strategist

Navigating volatility with asset allocation

Market volatility is a normal part of investing, but much of the past couple of years has been characterized by below-average volatility as markets have continued to move higher from October 2022 lows. That narrative drastically changed two weeks ago, when the S&P 500 Index fell by 3% on Monday August 5 and the CBOE Volatility Index (VIX) surged to an intraday high of 65.73. For context, the VIX has only reached this level two times in the past 35 years (during the financial crisis and at the onset of the pandemic). The VIX mainly stayed below its 30-year average of 20 this year, outside of a brief period of volatility in April when it peaked at 21.36. While volatility has moderated since August 5, it remains closer to the long-term average as opposed to the much lower volatility experienced since January. And while it is elevated compared to earlier this year, we do not recommend abandoning or reducing exposure in the equity market.

The market volatility and pullback provided us an opportunity to adjust tactical guidance and reallocate from investment-grade fixed income into equities and high-yield fixed income in anticipation of an improved outlook over the next 12 – 18 months, even as near-term uncertainties remain.[2] Investors may be tempted to exit the market completely or attempt to time the market — choosing the days to be invested and the days to pull out during market swings — as volatility is most often associated with downturns. However, equity volatility is not unidirectional, and sharp upswings following a down day can also contribute to volatility.

Chart 1. The best and worst market days have often occurred close together



Sources: Bloomberg and Wells Fargo Investment Institute. Data from August 14, 1994, to August 13, 2024. Analysis uses S&P 500 Index price returns. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

2. For additional details please see our August 6 Institute Alert, "Rebalancing portfolio allocations".

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Our research suggests that missing only a handful of the market's best days can drastically reduce the long-term average return.[3] Additionally, over the past 30 years, two of the three most recent bear markets comprised almost all of the worst 20 days and half of the 20 best days, further illustrating that the market's best days often come when volatility is at its highest. And lastly, as the chart shows, the best and worst days tend to happen close together, often back-to-back during times of elevated market volatility associated with an economic recession or a bear market. For example, the eight trading days between March 9, 2020, and March 18, 2020, comprised two of the best days and four of the worst days.

Behavioral biases can influence decision making

Investing through volatility can be difficult for both tactical (6 – 18 months) investors and longer-term, strategic investors as behavioral biases may influence decision-making. Being aware of these biases and the potential implications may help avoid making a rash decision that has long-term investment implications.

Some common behavioral biases and their investing-related risks include the following:

- *Loss aversion*: The tendency to avoid losses more than pursuing gains. During volatile markets, this bias can lead to panic selling as investors fear further losses. However, selling during a downturn often results in locking in losses and missing out on a potential recovery.
- *Herd behavior*: The tendency to follow the actions of other investors rather than making decisions based on sound analysis. This can lead to the formation of bubbles or exaggerated market declines. During periods of uncertainty, herd behavior can exacerbate volatility as investors collectively rush to sell or buy assets.
- *Overconfidence*: The tendency of investors to overestimate their ability to predict market movements or time the market effectively. This bias can lead to excessive trading and an underestimation of risk, particularly during volatile periods.
- *Recency bias*: The tendency to give more weight to recent events when making decisions. In the context of investing, this can cause investors to overreact to short-term market movements and lose sight of their long-term goals.

Even for tactical investors, it is crucial to look past the present and short term when developing an investing strategy as short-term volatility can cause significant fluctuations. Examples include the dot-com bubble burst in the early 2000s, the 2008 financial crisis, and the coronavirus pandemic in 2020 — each event was followed by eventual recoveries as the market rebounded, often moving to new highs. Investors can maintain a longer-term perspective and avoid attempts to time the market by taking advantage of market dislocations through tactical shifts, reducing exposure to the areas of the market expected to underperform and adding to the areas that are expected to better weather the storm of volatility and economic uncertainties.

Longer term, strategic investors can often afford to look past the near-term conditions and focus on maintaining a long-term investment perspective. Markets tend to move higher over time, and the stock market in particular has proven resilient through various downturns, economic recessions, and other disruptive events that have triggered short-lived bouts of volatility. For the long-term investor, time is on their side to potentially recover from these downturns if they remain disciplined. In our view, both tactical and strategic investors can benefit by utilizing a diversified allocation that includes a selection of asset classes with varying degrees of correlation to one another. In addition, setting a rebalancing approach to maintain allocations at those weightings can help keep the allocation on target and in line with the investor's goals.

3. For additional details please see our February 29 Special Report, "The perils of trying to time volatile markets".

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Equities

Sameer Samana, CFA
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No man's land

In the past few weeks, the S&P 500 Index fell 9.7% from its high on July 17 to its low on August 5. The pullback was due to weak economic data, divergence in central-bank policy, and the unwinding of crowded short positions in the Japanese yen, which had been used to purchase higher-yielding assets elsewhere. While we believe the S&P 500 Index remains in an uptrend, it now finds itself stuck in no man's land between support at the 200-day moving average (5,044) and resistance at the 50-day moving average (5,452).

Given the uncertainty around geopolitics in the Middle East, the neck-and-neck U.S. elections, and the fluid U.S. economic and monetary outlook, we find it unlikely that the S&P 500 Index will make meaningful moves either up or down in the coming months. However, range-bound markets present opportunities for dynamic investors. If markets move up toward resistance and the recent high (5,452 – 5,670), we believe that investors should trim unfavorable areas such as emerging-market equities as well as the Consumer Discretionary, Real Estate, Consumer Staples, and Utilities sectors. If markets decline toward support and the recent low (5,044 – 5,119), we believe that investors should look to add U.S. Large Cap Equities (which we favor) and U.S. Small Cap Equities (which we recently upgraded to neutral from most unfavorable). We would also look for opportunities in the Energy, Communication Services, Financials, Materials, and Industrials sectors.

The chart below suggests the S&P 500 Index remains in an uptrend and should find support at the 200-day moving average (5,044). Resistance on the way up will be found at the 50-day moving average (5,452).

S&P 500 Index is in no man's land

Sources: Bloomberg and Wells Fargo Investment Institute. Daily data from August 13, 2021, through August 13, 2024. SPX = S&P 500 Index. SMAVG (50) = 50-day simple moving average. SMAVG (200) = 200-day simple moving average. RSI = relative strength index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Fixed Income

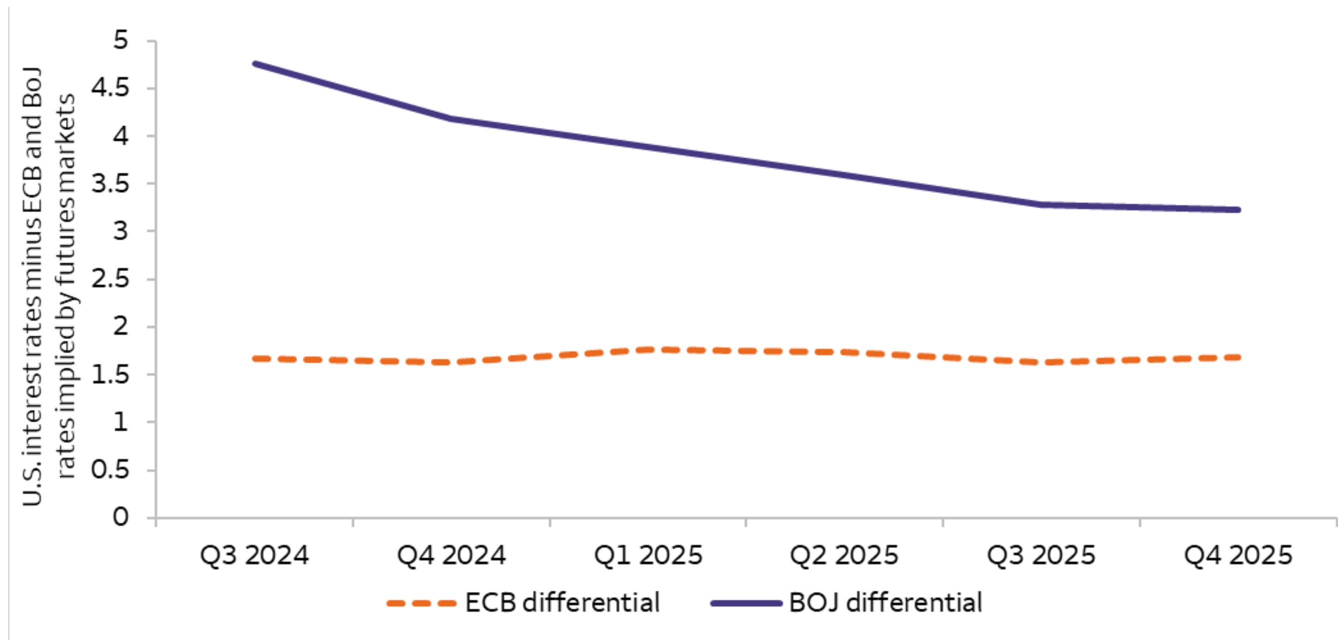
Tony Miano, CFA
Investment Strategy Analyst

Dollar to remain elevated in spite of rate cuts

The dollar has been a key beneficiary of the post-pandemic interest-rate environment, with the U.S. dollar index (DXY)[4] remaining at levels significantly above historical averages since rate hikes began in March 2022. As a result, some may expect the dollar to fall significantly with rate cuts in 2024 and 2025, but we believe the dollar should stay in its current range. Our outlook is now for less strength in the dollar and to remain close to — if not slightly above — its recent range of values.

The reason for our outlook is the same one that drove the dollar higher in the first place — interest-rate differentials. Rates in the U.S. were significantly higher than most other developed nations, which we believe benefited the dollar. While the Fed is set to begin delivering significant interest rate cuts, most other major central banks are also expected to cut rates. The chart below demonstrates two key expected interest-rate differentials, with the European Central Bank (ECB) relatively flat and rate hikes from the Bank of Japan (BOJ) showing a lower but still notable differential.

U.S. interest rates versus the European Central Bank and Bank of Japan



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of August 12, 2024. U.S. interest-rate differentials are derived from WFII's federal funds rate targets. ECB = European Central Bank. BOJ = Bank of Japan. ECB and BOJ differentials are derived from futures market pricing of three-month EURIBOR (Euro Interbank Offered Rate) and TONA (Tokyo Overnight Contract Rate) contracts.

The eurozone may also struggle with lower export demands driven by continued weakness in the Chinese economy, which would weigh on the euro exchange rate. We continue to express a preference for U.S. fixed income and equities over international or emerging markets, partially as a result of this continued dollar strength.

4. A measure of the value of the dollar, calculated through weighted averages of the exchange rates of currencies for six major trading partners of the U.S.

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Real Assets

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Super-cycle update

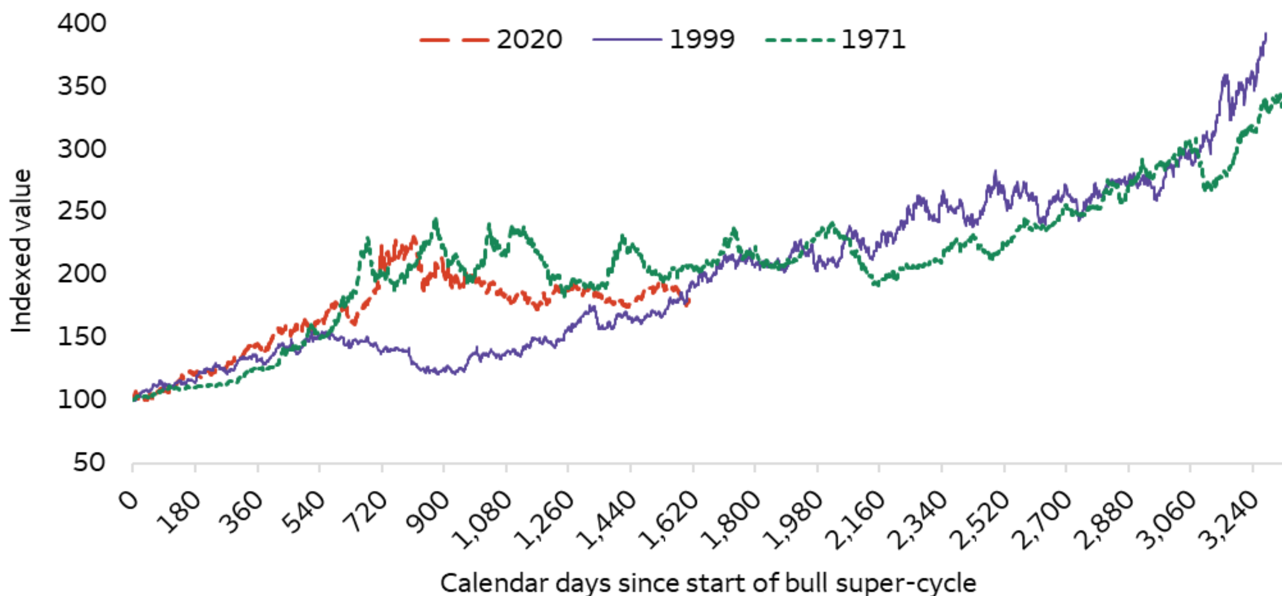
We are four years into the current bull super-cycle that began in March 2020, and if history is a guide, we suspect this cycle could last another four to six years. From the super-cycle's inception to August 12, 2024, commodity prices (as measured by the Bloomberg Commodity Index) are up 80%. Over the past two years, however, performance has largely stalled with the Bloomberg Commodity Index experiencing a -7.5% return in 2023 and relatively flat performance year to date (1.3% as of August 12).

It is not uncommon for super-cycles to stall before performance picks back up again, though we do admit that the current cycle has stalled for longer than expected (see the chart below). Despite the stalling performance, we still believe that the bull super-cycle is in effect as fundamentals remain in-tact with tepid supply growth across most commodities. We also believe that we are not seeing the typical signs that accompany the end a bull super-cycle. Global money supply continues to grow, real rates remain low, global inflation remains elevated, and valuations are not yet stretched. Historically, the inverse of these factors has led to the end of bull super-cycles, but today we just are not seeing those signs.

Therefore, we suspect that price weakness today is mostly driven by weak sentiment on global demand and economic growth. However, given our expectation for an economic slowdown followed by an improved economic environment in 2025, we believe demand and prices will get a lift alongside better economic conditions.

We remain favorable on Commodities and view price weakness today as an attractive opportunity to gain commodity exposure. For 2024, our Bloomberg Commodity Index target is 235 – 255, and our 2025 target of 250 – 270 anticipates the effects of an improved macroeconomic environment. In our view, both of these target ranges provide attractive expected returns from a current value of 229, as of August 12.

Modern commodity bull super-cycles



Sources: Bloomberg and Wells Fargo Investment Institute. Commodity performance measured by our Commodity Composite and is indexed to 100 as of the start of the bull super cycle. Performance measured from October 4, 1971 – November 20, 1980, July 13, 1999 – July 2, 2008, and March 18, 2020 – August 12, 2024. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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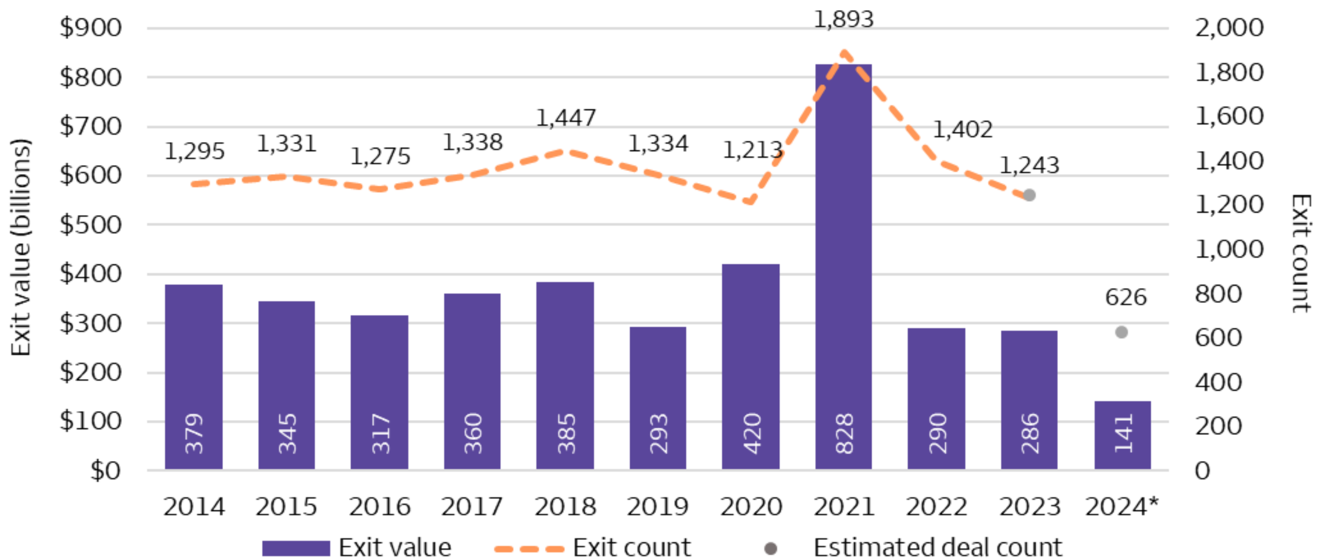
Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

Private equity exits remain stuck in low gear

U.S. Private Equity continues to experience low levels of exit activity. The outsized number of investments exited during a rather frothy 2021 may have pulled sales forward, but the lackluster environment since that time is midway through its third year, and there are few signs of accelerating activity in the second half of 2024.

Exit values and counts on pace for third consecutive year of below-average totals



Sources: Pitchbook. Data from January 1, 2014, to June 30, 2024. *2024 figures represent the first six months of the year, from January 1, 2024, to June 30, 2024.

Declining valuations over the past couple of years have led to a significant gap between what sellers believe their investments are worth and what buyers are willing to pay. On one hand, the rebound in public-market prices may lead to a bottoming in private-market valuations and spur greater exit activity in the future. However, the recent market volatility may also keep potential buyers on the sidelines as investors seek further confirmation that economic growth will resume in earnest.

In reviewing types of exits, the market has yet to provide indications that a pickup in deal activity is nearing:

1) Initial public offerings (IPOs): The IPO market remains essentially closed given the uncertain economic outlook and declining valuations.
2) Other Private Equity fund buyers: Potential buyers remain hesitant to pay current asking prices. In addition, the tighter lending environment has made it more difficult to secure financing for these deals.
3) Strategic public buyers: While existing public companies may look to expand into a new market or grow an existing market, higher interest rates and a lack of confidence among corporate leaders has dampened activity for this type of private equity exit.

Though conditions for a rebound in exits remain elusive, we believe the forecasted interest-rate cuts in 2024 and 2025 may provide enough incentive for buyers to become more active.

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.
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Tactical guidance*

Cash Alternatives and Fixed Income

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

Equities

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
	Emerging Market Equities	Developed Market Ex-U.S. Equities U.S. Mid Cap Equities U.S. Small Cap 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, August 19, 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.

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Risk considerations

Forecasts, estimates, and projections are not guaranteed and are based on certain assumptions and 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. 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. The **Energy** sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. 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. **Communication services** companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. Investing in the **Financial** services companies will subject an investment to adverse economic or regulatory occurrences affecting the sector. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio's performance. **Materials** industries can be significantly affected by the volatility of commodity prices, the exchange rate between foreign currency and the dollar, export/import concerns, worldwide competition, procurement and manufacturing and cost containment issues.

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 comprised of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity.

CBOE Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

Commodity Composite: Measures a basket of commodity prices as well as inflation. It blends the historical commodity index introduced by George F. Warren & Frank A. Pearson, former academics at Cornell, collected and published commodity price data in their book, Prices, and the producer price index for commodities (PPI-Commodities), and the National Bureau of Economic Research (NBER) Index of Spot Market Prices of 22 Commodities and the Reuters Continuous Commodity Index. The index components and weightings, from Warren and Pearson's Prices, change over time but the 11 commodity groups used from 1786-1932 are: Farm Products, Foods, Hides and Leather products, Textile Products, Fuel and Lighting, Metals and Metal Products, Building Materials, Chemicals and drugs, Spirits (stopped tracking 1890), House furnishing Goods, and Miscellaneous. The PPI-Commodities is compiled by the Bureau of Labor Statistics and shows the average

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price change from the previous month for commodities such as energy, coal, crude oil and the steel scrap. The NBER Index of Spot Market Prices of 22 Commodities is a measure of price movements of 22 sensitive basic commodities whose markets are presumed to be among the first to be influenced by changes in economic conditions. The Reuters Continuous Commodity Index comprises 17 commodity futures that are continuously rebalanced: cocoa, coffee, copper, corn, cotton, crude oil, gold, heating oil, live cattle, Live hogs, natural gas, orange juice, platinum, silver, soybeans, sugar no. 11, and wheat.

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.

U.S. Dollar Index measures the value of the U.S. dollar relative to majority of its most significant trading partners. This index is similar to other trade-weighted indexes, which also use the exchange rates from the same major currencies.

An index is unmanaged and not available for direct investment.

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