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Investment Strategy

Weekly guidance from our Investment Strategy Committee **October 21, 2024**

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- The National Oceanic and Atmospheric Administration (NOAA) estimates that U.S. hurricanes have caused $1.3 trillion in damages since 1980 at an average cost of $22.8 billion per storm.[1]
- Even with a colossal price tag, historical data suggests that weather calamities have had a nominal impact on U.S. economic growth.

Equities: Energy sector turning higher efficiencies into profits 4

- The Energy sector has underperformed this year, but it has bounced recently on rising geopolitical concerns.
- Looking ahead, we believe the sector will benefit from an improved macro outlook and operating efficiencies. Therefore, we recommend trimming defensive areas such as Utilities in favor of growth-oriented or cyclical sectors such as Energy.

Fixed Income: Opportunity from run-up in long-term Treasury yields 5

- 10- and 30-year U.S. Treasury yields have run up significantly in the past month, and they now hover near the midpoint of our year-end 2024 targets.
- We think current levels represent an attractive buying opportunity for investors looking to redeploy excess cash holdings into longer maturities.

Real Assets: Geopolitical risks continue to be a top concern 6

- Open interest for call options on Brent crude has spiked to its highest level in a decade in response to geopolitical tensions.
- We suspect that ongoing tensions in the Middle East and Ukraine will continue to contribute to price volatility — this volatility may present attractive opportunities to gain exposure.

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- After a strong start to the year, Macro Trend-Following strategies had a bumpy ride from May through August.
- Despite the choppiness in the middle of the year, Macro Trend-Following strategies demonstrated their diversification potential for a portfolio of equities and fixed-income investments.

Current tactical guidance 8

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

1. NOAA, Hurricane Costs, October 4, 2024.

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Asset Allocation Spotlight

Michael Taylor, CFA
Investment Strategy Analyst

The economics of natural disasters

Hurricanes are notorious for their destructive power and widespread devastation. Helene and Milton were particularly devastating hurricanes from both a humanitarian and economic perspective given the short interval between them. While the human toll is immeasurable for many families, early estimates put the collective economic damage from the storms in the tens of billions of U.S. dollars. Add to that the storms that clobbered Texas last spring along with summer flooding in the Midwest, and 2024 is likely to be a costly year for natural disasters.

The National Oceanic and Atmospheric Administration (NOAA) estimates that the cumulative cost of damages from U.S. weather-related disasters between 1980 and August 2023 exceeded $2.6 trillion.[2] Even with a colossal price tag, history suggests that weather calamities have had only a nominal impact on U.S. economic growth. Below we explore the potential economic costs of weather disasters.

The one, two punch of Helene and Milton

The economic toll from hurricanes Helene and Milton will no doubt be enormous. Although it will take time to tally the property and casualty costs, current estimates vary widely, appraising each storm at roughly $30 billion to $50 billon. Compare these estimates to the more than $60 billion in damages incurred by Hurricane Ian in 2022 or the more than $100 billion in damages from Katrina (2005) and Harvey (2017).[3] Although these are preliminary figures, they may serve as a proxy for estimating the potential economic impact of Helene and Milton.

The NOAA estimates that since 1980, hurricanes have caused the lion's share of damage among the 363 weather disasters that reached or exceeded one billion dollars in costs — their total cost topped $1.3 trillion with an average cost per storm of $22.8 billion.[4] Yet, quantifying the aggregate cost of weather-related disasters poses a challenge. Several methodologies purport to estimate the cost of a natural disaster. Although the approaches do not necessarily produce equivalent dollar amounts, each one distinguishes between "direct" and "indirect" losses. *Direct losses* refer to the loss of physical assets and factors of production (such as houses, buildings, and vehicles) while *indirect losses* refer to the reduction in economic output stemming from losses of income, consumption, and economic activity.

For purposes of forecasting the potential impact of Helene and Milton on U.S. growth, we believe more weight should be given to indirect losses than to direct losses, which largely impact wealth and net worth. For simplicity, we use average damage estimates for both hurricanes ($40 billion + $40 billion = $80 billion), recognizing that these figures will likely change. Considering that the size of the U.S. economy is nearly $29 trillion, we estimate that damage may trim roughly 0.28% ($80 billion/$29 trillion) from U.S. gross domestic product (GDP), likely over the next two quarters.

Given the relatively small effect, the U.S. economy is unlikely to be adversely impacted in a meaningful way. In fact, using history as a guide, the table shows that U.S. GDP growth historically has increased in the two quarters

2. NOAA, October 4, 2024.
3. Bloomberg, "Hurricane Milton Damage May not reach Ian's $60 Billion," October 10, 2024.
4. NOAA, October 4, 2024.

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following a hurricane (except for Hurricane Ike, which struck during the Great Recession) as reconstruction efforts begin to make a demonstrable impact on the afflicted economies.

Restoration efforts from a single hurricane can support about 90,000 jobs, generating $6.2 billion in labor income and adding $9.8 billion to GDP. Considering the broader economic impact through supply chains and household spending, rebuilding from one storm can indirectly support nearly 250,000 jobs, generate $17.3 billion in labor income, and contribute over $30 billion to GDP.[5]

U.S. GDP growth before and after major hurricanes

Event date	Hurricane	Real GDP % change Two quarters before hurricane	Real GDP % change One quarter before hurricane	Real GDP % change One quarter after hurricane	Real GDP % change Two quarters after hurricane
8/24/1992	Andrew	2.3	1.1	0.99	2.04
9/16/2004	Ivan	1.35	0.73	0.95	1.98
8/25/2005	Katrina	1.61	0.49	0.78	1.34
10/24/2005	Wilma	1.28	0.78	0.56	1.91
9/13/2008	Ike	0.17	0.6	-0.53	-2.7
10/29/2012	Sandy	0.59	0.14	0.12	1.1
8/25/2017	Harvey	1.05	0.56	0.79	1.92
9/28/2022	Ian	-0.19	0.07	0.67	1.53
Average		**1.02**	**0.56**	**0.54**	**1.14**

Sources: Ned Davis Research and Event Study Tool. Data as of October 11, 2024. Copyright 2024 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved

Economic indicators and sector effects

Weather calamities tend to impact certain economic indicators, particularly in the geographical proximity of the event. Yet, the impact typically is short lived as economic activity in the affected areas often surges once the rebuild is underway. Historically, data on sizable hurricanes indicates that the average recovery period is 14 months with remodeling peaking three months after the storm.[6]

The increase in initial jobless claims for the week of October 5 was likely overstated from the disruptive effects of Helene on the labor market. For historical context, in the week after Harvey hit, initial unemployment claims rose by 62,000; they rose by 12,000 a week after Irma. Yet, claims after both storms reverted to average levels within a few months. Similarly, in our view, Helene and Milton will likely put a dent in October activity, but we expect this to reverse course as reconstruction efforts begin in earnest during the closing months of this year. At the sector level, although sales at home-improvement retailers tend to pick up ahead of a storm, our research shows that discretionary spending on larger ticket items typically lags for six to nine months, until homeowners receive their insurance adjustments.

5. "Navigating the Economic Impacts of Hurricane Season 2024," Implan, May 21, 2024.
6. "Post-hurricane recovery: how long does it take?" Build Fax Property History, October 2017.

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Equities

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Investment Strategy Analyst

Energy sector turning higher efficiencies into profits

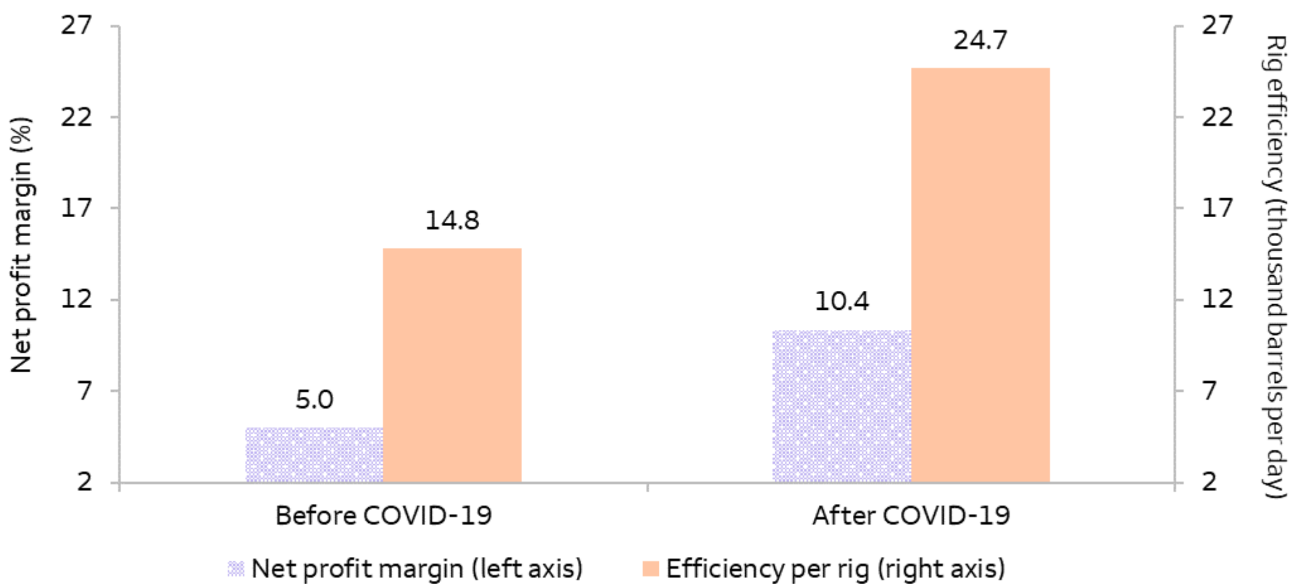
Rising tensions in the Middle East are sparking fears of a broader conflict and potential supply disruptions in oil markets. As a result, both global crude oil prices and the S&P 500 Index's Energy sector regained some strength after months of volatility and lackluster performance that stemmed from concerns of a slowing global economy. As of October 16, the Energy sector is up 8.5% year to date, and we suspect the sector could continue to show positive performance in the coming months from two important trends.

The first trend, as shown in the chart below, is higher efficiencies among energy producers. U.S. producers have become more efficient in their operations relative to their pre-pandemic levels as average U.S. rig efficiency is up roughly 67%. More importantly, producers have been able to translate these higher efficiencies into higher profit margins (also shown in the chart).

Secondly, we believe that concerns over a slowing economy will fade in 2025 and support higher oil prices. Arguably, these economic concerns have been one of the strongest headwinds this year for both oil prices and the Energy sector. Nonetheless, valuations remain relatively inexpensive, providing an attractive opportunity to add exposure as the sector potentially benefits from higher crude oil prices in 2025.

We expect this combination of higher crude oil prices and stronger operating efficiencies to support profitability and sector performance. We remain most favorable on the Energy sector, and we recommend trimming defensive areas such as Utilities in favor of growth-oriented or cyclical sectors — these include Energy, Communication Services, Financials, Industrials, and Materials.

Average U.S. oil rig efficiency versus profit margins



Sources: Bloomberg and Wells Fargo Investment Institute. Quarterly data is from September 30, 2016 – June 30, 2024. Averages of net profit margins and rig efficiencies include the 14 quarters prior to and after COVID-19. 2020 data is excluded in the averages due to large distortions. Rig efficiency is calculated as a ratio of daily U.S. production and the number of active crude oil rigs.

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Fixed Income

Anthony Miano, CFA
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Opportunity from run-up in long-term Treasury yields

The past month has been an almost perfect storm of factors helping to drive long-term bond yields higher. Since the Federal Reserve's (Fed's) September 18 meeting, 10- and 30-year Treasury yields are up almost 50 basis points (100 basis points equals 1%).[7] Recent economic data has surprised to the upside, diminishing near-term recession risks. This has caused fixed-income investors to reduce the number of expected Fed rate cuts for the remainder of the year and into 2025, effectively aligning more with our own view.

The Fed is still poised to decrease policy rates over the coming months, meaning investors who have held excess cash at relatively high ultra-short-term interest rates may see their income generation decrease once those investments mature and need to be reinvested. We think investors may benefit from extending the maturity profile of their bond holdings, especially when the 10-year U.S. Treasury yield is hovering above 4%. We currently favor extending duration, and we are favorable on the intermediate portion of the curve (that is, bonds with maturities between three and seven years) and neutral on the long end of the curve.

The chart below shows 10-year Treasury yields over the trailing 10 years. While yields are not as high as they were in April 2024 or October 2023, they remain high in comparison to historical averages following the global financial crisis. Investors who have previously ignored the income-generating capabilities of longer-term bonds may find new opportunities in the space as the era of high ultra-short-term yields begins to fade.

10-year Treasury yields from 2014 through 2024

Source: Bloomberg. Data as of October 14, 2024. 10-year U.S. Treasury yields represented by the mid yield of the generic 10-year U.S. Treasury bond. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those quoted above. **Past performance is no guarantee of future results.**

7. According to Bloomberg. Data as of October 14, 2024, and measured by the generic 10- and 30-year Treasury bonds.

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Real Assets

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Geopolitical risks continue to be a top concern

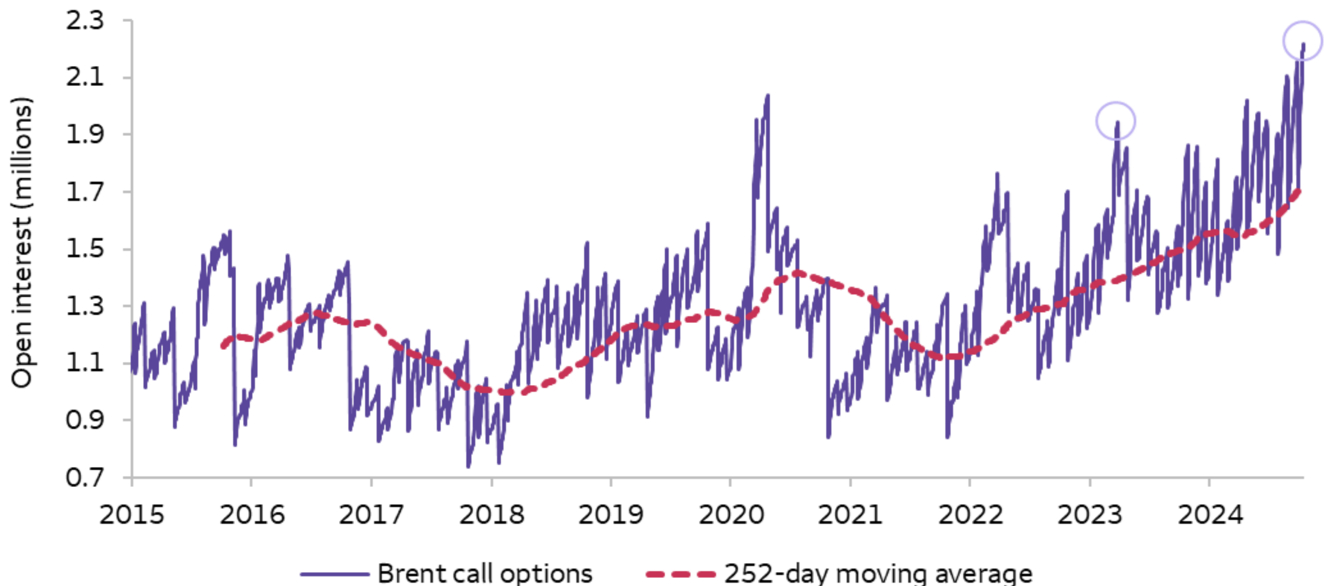
Crude oil markets remain on edge as a result of rising geopolitical tensions in the Middle East and the risk of potential supply disruptions. In response, crude oil prices have been volatile in recent weeks —Brent crude prices have bounced between a low of $69 per barrel and a high of $81 per barrel.

One method that market participants use to hedge against this risk of spiking prices in response to sudden supply shocks is through call options. This is also one way for us to get a sense of the severity of these concerns as well as how pervasive they are throughout the market.

Looking back to Russia's invasion of Ukraine in 2022, open interest for Brent call options spiked to the highest level seen since the onset of COVID-19 as market participants looked to hedge against the risk of a supply disruption. We are seeing a similar spike today as open interest rises to its highest level in over a decade (see chart). It is also worth noting that the long-term trend, shown by the 252-day moving average, has also been persistently rising since 2022. We believe this rising trend is attributable to the rising tensions we have seen in the Middle East and Ukraine over recent years.

In the coming months, we suspect that tensions will continue to be a top concern for oil markets and that bouts of volatility in response to geopolitical events will continue to persist. We view this volatility as an opportunity to gain exposure to Energy commodities, particularly as we see upside from current prices over the tactical horizon amid an improved macro outlook in 2025.

Open interest in Brent call options reaches record highs on geopolitical tensions



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data is from January 1, 2015 – October 14, 2024. Open interest for call options represents the total number of outstanding call option contracts that are active, and not settled or closed. The chart aggregates all active call option contracts for Brent crude that are currently traded.

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Alternatives

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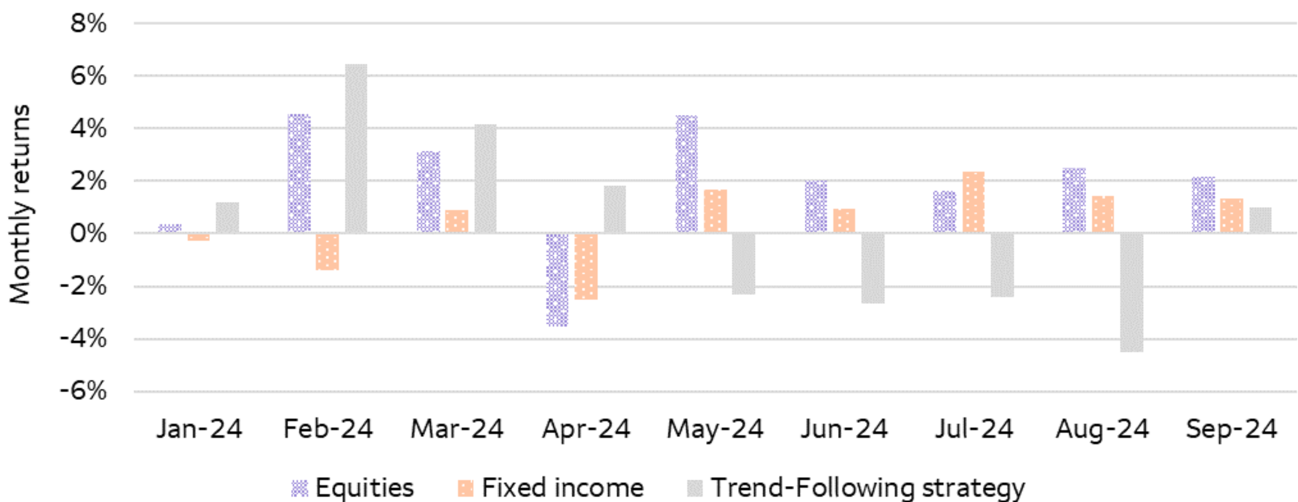
State of Macro Trend-Following strategies

As the economy has slowed and inflation has declined unevenly, equity and commodity markets have trended higher while fixed-income prices have slid. The Macro Trend-Following strategy can benefit from such divergent trends, and throughout 2024 it has been among our favored approaches to diversifying portfolios. Here we review the year-to-date performance in the Macro Trend-Following strategy. The chart presents the monthly returns for the Trend-Following strategy (represented by the Societe Generale Trend Index) along with equities (represented by the MSCI All Country World Index) and fixed income (represented by the Bloomberg US Aggregate Bond Index). During the first four months of this year, Trend-Following outperformed both equities and fixed income. April 2024 was notable as both equities and fixed income reported their worst losses while Trend-Following reported a sizable gain, demonstrating its ability to complement equities and fixed income during a challenging period.

During April, the Trend-Following strategy generated gains from the Japanese yen after the yen trended to a 34-year low. The strategy also gained from uptrends in gold and coffee prices and downtrends in bond markets. During May, uptrends in crude oil prices reversed, resulting in losses for the strategy. During June, there were losses for Trend-Following as gold fell while copper prices also came under pressure. During July, bond yields fell, which led to negative returns for the strategy. The downtrend in the Japanese yen reversed sharply in August, resulting in losses for Trend-Following. By September, however, Trend-Following had repositioned for an uptrend in Japanese yen and benefited from its continued strength. A steady uptrend in gold drove additional gains for Trend-Following as prices climbed to new record highs. It is notable that the Trend-Following strategy is driven by idiosyncratic market events, which results in its ability to diversify traditional equities and fixed-income investments.

Comparing performance of equities, fixed income, and Trend-Following strategy in 2024



Sources: Morningstar, Societe Generale (SG), and Wells Fargo Investment Institute. Data from January to September 2024. Equities represented by MSCI All Country World Index. Fixed income represented by Bloomberg US Aggregate Bond Index. Trend-Following strategy represented by SG Trend Index. The SG Trend Index calculates the net daily rate of return for the largest Trend-Following based hedge fund managers by assets under management. **Past performance is no guarantee of future results.**

Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not appropriate for all investors and are only open to “accredited” or “qualified” investors within the meaning of U.S. securities laws.

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Tactical guidance*

Cash Alternatives and Fixed Income

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
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. Long Term Taxable Fixed Income	U.S. Intermediate Term Taxable 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—Equity Hedge Hedge Funds—Relative Value Private Equity Private Debt	Hedge Funds—Event Driven Hedge Funds—Macro	

Source: Wells Fargo Investment Institute, October 21, 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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Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

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. **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. 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. 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. **Utilities** are sensitive to changes in interest rates, and the securities within the sector can be volatile and may underperform in a slow economy.

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.

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Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

MSCI All Country World Index (MSCI ACWI) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of 23 developed and 26 emerging markets.

SG Trend Index is equal-weighted and reconstituted annually. The index calculates the net daily rate of return for a pool of trend following based hedge fund managers.

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

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