WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **August 8, 2022**

Equities spotlight

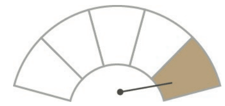
Chris Haverland, CFA
Global Equity Strategist

Recession playbook — stay defensive for now

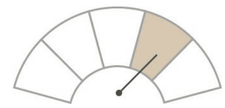
U.S. economic trends have worsened over the past few months, and we recently updated our base case to a moderate recession (from a mild recession). Our view is that the steepest contraction will occur later this year and that the recession could last through mid-2023. We expect an economic recovery to begin in the second half of 2023. In the near term, we expect the Federal Reserve (Fed) to continue tightening monetary policy, which likely will weigh on consumer and business spending in the coming quarters. We see borrowing costs rising, credit availability diminishing, and the possibility of higher unemployment. Businesses are cutting capital spending plans and announcing hiring freezes in anticipation of falling demand.

Our macro forecasts have a direct impact on our equity targets. We expect slowing revenue growth and higher costs to squeeze margins in the coming quarters, likely leading to an earnings recession over the next 12 months. We are seeing margins compress in the Consumer Discretionary and Consumer Staples sectors due to higher input costs and in the Information Technology sector due to higher labor costs. Energy is one of the few sectors where margins are expanding. Overall, we expect corporate earnings to decline this year, but to rebound late in 2023 as the economy emerges from recession. We expect equity markets to be volatile through the remainder of 2022. However, we forecast significant upside through year-end 2023 as the recovery takes hold in the second half and into 2024.

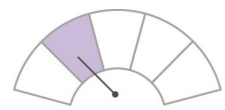
Historically, equity markets have been mixed prior to official recessions, but tend to bottom before the economic contraction ends. Likewise, equity markets also lead earnings, historically bottoming well before profits trough. The following table illustrates how equity market movements and economic recessions overlap, but are not always aligned. Bear markets (down greater than 20%) often coincide with recessions, but generally have not occurred within a recession. The exception is during the Great Financial Crisis — an event that we believe is not comparable to our 2022 – 2023 forecasted recession. Even more compelling is the equity market performance after recessions, where returns have generally been positive the majority of the time.



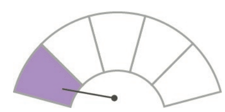
Most favorable
U.S. Large Cap Equities



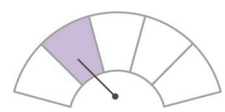
Favorable
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities



Unfavorable
Emerging Market Equities

S&P 500 Index price return around and during recessions

Recession start	Length (years)	12 months before recession start	6 months before recession start	During recession	6 months after recession end	12 months after recession end
1948	0.92	-1.5%	-11.6%	8.7%	12.0%	21.8%
1953	0.83	-2.6%	-6.2%	17.9%	17.3%	29.9%
1957	0.66	-4.8%	4.5%	-3.9%	18.2%	32.6%
1960	0.83	-5.6%	-5.5%	16.7%	7.3%	10.3%
1969	0.92	-11.4%	-5.8%	-5.3%	14.3%	7.8%
1973	1.33	-17.8%	-8.6%	-13.1%	0.6%	23.3%
1980	0.50	14.2%	10.0%	6.6%	6.5%	7.6%
1981	1.33	7.6%	1.1%	5.8%	17.2%	20.1%
1990	0.67	2.9%	8.2%	5.4%	3.4%	7.6%
2001	0.67	-22.6%	-19.2%	-1.8%	-6.3%	-17.8%
2007	1.50	3.5%	-2.3%	-37.4%	21.3%	12.1%
2020	0.17	6.1%	0.9%	-1.4%	12.3%	43.6%
Median	**0.83**	**-2.0%**	**-3.9%**	**2.0%**	**12.1%**	**16.1%**
% of time positive		**41.7%**	**41.7%**	**50.0%**	**91.7%**	**91.7%**

Sources: Bloomberg and Wells Fargo Investment Institute. August 4, 2022.

In our view, during late cycle and early recessionary periods, investors should consider moving up in quality (we prefer U.S. Large and Mid Cap Equities over Small Cap Equities) and reducing cyclical exposure in favor of defensive sectors. Earlier this year, we reduced risk and cyclicality in the portfolios with a focus on quality. This included downgrades to U.S. Small Cap Equities and Emerging Market Equities at the asset class level and downgrades to Consumer Discretionary, Industrials, and Financials at the sector level. In addition, we have added to defensive positions by upgrading Consumer Staples, Health Care, and Utilities.

We are currently favorable on the Energy, Health Care, and Information Technology sectors. We believe improving fundamentals and tight oil supply will support Energy sector prices. We expect the sector to lead earnings growth in the coming quarters and, while prices have rallied, valuations remain relatively inexpensive versus history and the S&P 500 Index. The Health Care sector fits nicely into our quality theme with relatively low leverage and high return on equity. Also, its defensive characteristics should continue to serve it well during market volatility and as the economy slows (it has outperformed the S&P 500 Index in each of the past seven U.S. recessions). Information Technology is one of the highest-quality sectors in the S&P 500 Index, ranking high in quality metrics such as earnings stability, return on equity, and low debt levels. Heading into a recession, we believe investors likely will gravitate toward consistently growing, high-quality companies that can be less sensitive to cyclical slowdowns.

We believe that a defensive posture is still an appropriate strategy in this late cycle and early recessionary period. Risks to the downside remain as the economic data worsens, the Fed continues to tighten monetary policy, and earnings expectations recede. However, given that the equity market is likely to anticipate the recovery before the recession ends, we will look to tactically add risk as opportunities present themselves.

Fixed Income

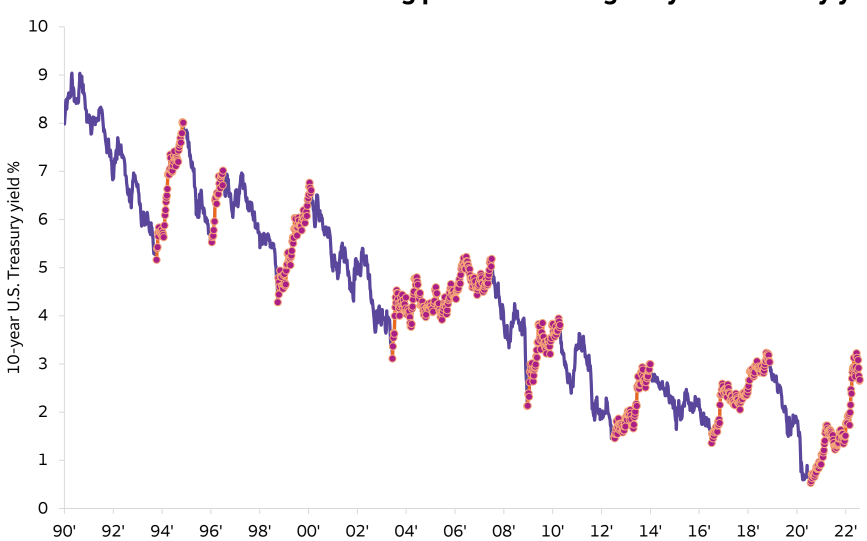
Can the 10-year U.S. Treasury yield rally continue?

All major fixed-income classes managed to recover and displayed positive performance in July as U.S. Treasury yields declined from the strong yield hike experienced in the first and second quarters. As we look at the current level of the 10-year Treasury yield hovering below 2.7%[1], we believe Treasury yields could remain range-bound over the next two months while markets await more signs on the direction of the economy. However, we expect yields to resume their move higher eventually. Our year-end 2022 target is between 3.25% and 3.75% and our year-end 2023 is between 2.75% and 3.25%.

These are the reasons we believe yields will move higher:

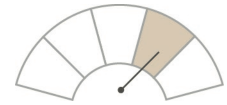
1. In the past five Fed tightening cycles since 1990, yields peaked before the end of the tightening cycle but did not begin a declining trend until the tightening cycle was over. Our belief is that the Fed's tightening cycle is still underway and that the Fed will continue to hike rates aggressively.
2. Inflation still remains elevated. More important than reaching peak headline inflation is determining if core inflation components are going to remain sticky, and how long it will take the Fed to get inflation back to 2%.
3. Looking back over the past 50 years, U.S. recessions have not occurred while the Fed is still hiking rates.
4. Although some yield curves have begun inverting (for example, 10-year U.S. Treasury minus 2-year U.S. Treasury) not all tenors in the yield curve have inverted yet. Furthermore, the near-term forward spread[2], which the Fed prefers, remains firmly positive for now.

Consolidation has occurred during periods of rising 10-year Treasury yields

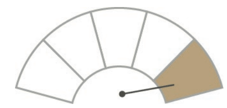


Sources: Wells Fargo Investment Institute and Bloomberg, August 4, 2022. Weekly data from January 2, 1990 to August 4, 2022. Rising yield periods highlighted by outlined orange markers. **Past performance is no guarantee of future results.**

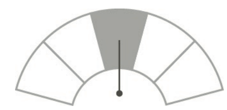
Luis Alvarado
Investment Strategy Analyst



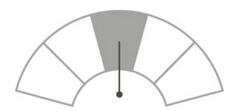
Favorable
U.S. Taxable Investment Grade Fixed Income



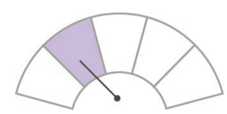
Most favorable
U.S. Short Term Taxable Fixed Income



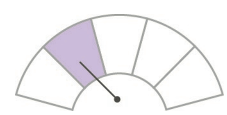
Neutral
U.S. Intermediate Term Taxable Fixed Income



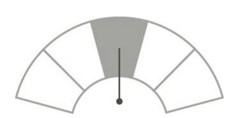
Neutral
U.S. Long Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



Unfavorable
Developed Market Ex.-U.S. Fixed Income



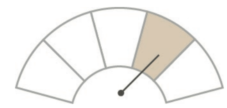
Neutral
Emerging Market Fixed Income

1. As of August 4, 2022.
2. The indicator that Fed policymakers consider more indicative of an impending recession is the spread between the current 3-month T-bill and projections on where it will be in 18 months.

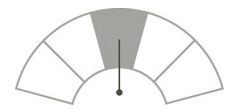
Real Assets

John LaForge
Head of Real Asset Strategy

"A wise man does at once, a fool does at last." — *Baltasar Gracián*



Favorable
Commodities



Neutral
Private Real Estate

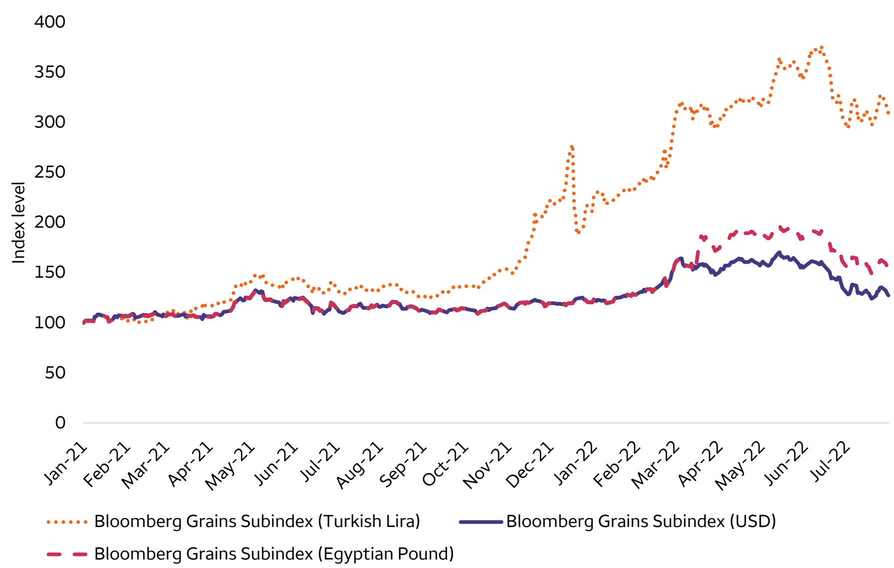
The breadbasket of Europe begins to reopen ports

Ukraine is regarded as the breadbasket of Europe, and rightfully so, considering that in 2021 it was the fourth-largest exporter of corn (14% of global exports) and fifth-largest exporter of wheat (10% of global exports). Other countries in Europe such as France and Germany also export large amounts of grain, but certainly not to the extent of Ukraine. The Russia-Ukraine war and the closing of Ukrainian ports sparked substantial grains price rallies during the first half of 2022.

In recent weeks, though, prices have started to subside. The Bloomberg Grains Subindex has dropped 23% from its 2022 peak (Chart 1). Prices have declined due to declining energy prices and the anticipation that key Ukrainian ports would soon open up. The first Ukrainian shipment of grain left the port of Odesa last Monday.

It is important to note, though, that global grains price fundamentals remain relatively strong. Additional price declines will be hard to come by during the remainder of 2022. Also, not all countries are seeing the same price relief. Select emerging markets that do not use the U.S. dollar as the main currency could continue to be pressured by high commodity prices. The reason is that the U.S. dollar continues to be strong, and global commodities are often priced in U.S. dollars. This makes buying commodities — from fuel, to fertilizer, to grains — more expensive for emerging countries paying with weaker currencies (Chart 1).

Bloomberg Grains Subindex in EM currencies



Sources: Bloomberg and Wells Fargo Investment Institute. Daily Data: January 4, 2021 – August 3, 2022. Daily data is indexed to 100 starting on January 4, 2021. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

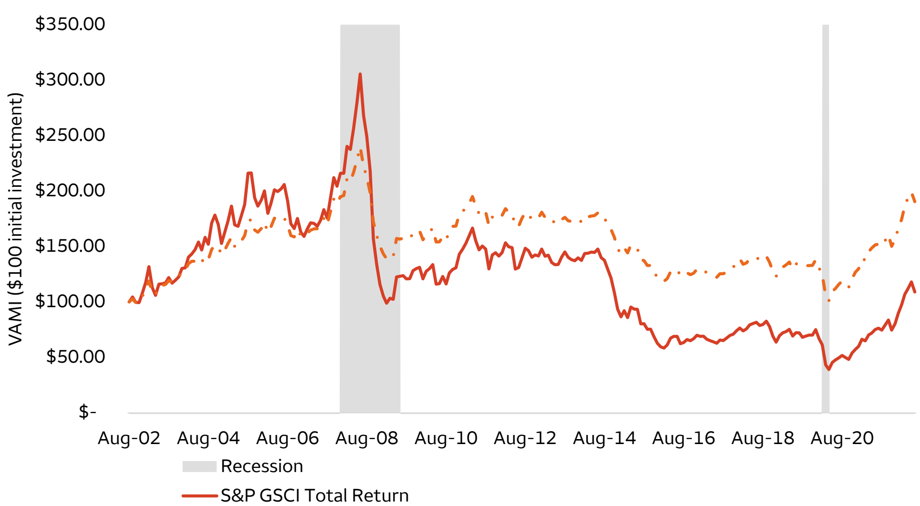
Alternatives

Playing commodity super cycle with Macro hedge funds

We often position Macro hedge funds as an actively managed, global asset allocation solution. It is actively managed in that portfolio managers have the flexibility to take trend-following (long and short) as well as non-trend-following (relative value) positions across countless assets. Because of its scope, clients with exposure to Macro strategies inherently have exposure to interest rates, currencies, equities, and commodities, the entire gamut of global assets. Very few investment strategies provide the breadth of exposure that Macro offers.

While access to commodities is often accomplished through our real asset solutions, we think it is important to remember that commodities are a key driver within many discretionary as well as systematic Macro portfolios. In other words, clients can gain access to commodities through real assets as well as alternative investments. Moreover, while the commodity super cycle* should be beneficial to a broad basket of commodities, we also recognize that not all commodities move in tandem during the super cycle, and that opportunities exist for both long and short commodity trading. This is where the Macro strategy shines, as it has the potential to benefit when commodity trends reverse, and thereby provide valuable diversification to a long-only commodity investment. As seen below, combining it with a stand-alone commodity index allocation has historically generated better returns with less volatility. While the commodity super cycle has room to run, we like combining a long-only real asset allocation with an actively managed alternative investment approach.

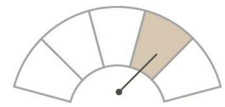
Commodity exposure through real assets and hedge funds



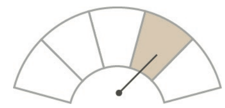
Sources: Bloomberg. Data as of June 30, 2022.

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

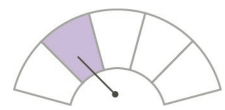
Justin Lenarcic
Lead Wealth Investment Solutions Analyst



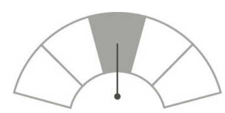
Favorable
Hedge Funds – Relative Value



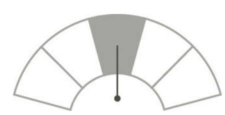
Favorable
Hedge Funds – Macro



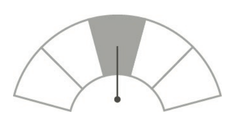
Unfavorable
Hedge Funds – Event Driven



Neutral
Hedge Funds – Equity Hedge



Neutral
Private Equity



Neutral
Private Debt

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.

Risk Considerations

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

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is appropriate only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

Bloomberg Grains Subindex is a commodity group subindex of the Bloomberg Commodity Index. It is composed of futures contracts on corn, soybeans and wheat. It reflects the return of underlying commodity futures price movements only and is quoted in USD.

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.

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.

An index is unmanaged and not available for direct investment.

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