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Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee **June 27, 2022**

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- Federal Reserve (Fed) Chair Jerome Powell told the Senate banking committee last week that achieving a soft landing could be difficult.
- We believe the Fed will continue an aggressive path of rate hikes, despite an increasingly challenging economic narrative.

Equities: Second-quarter earnings preview 4

- After growing by 9% in the first quarter of 2022, S&P 500 Index earnings are expected to have grown by 5.7% in the second quarter of 2022.
- The Energy sector is expected to lead growth for the quarter. However, excluding the Energy sector, overall S&P 500 Index earnings likely contracted.

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- Politicians have begun to consider gas tax solutions for relief at the pump.
- Tax-related gasoline solutions are more likely to lead to higher gasoline prices in the long term, not lower.

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- Given our forecast of an expected mild recession, now is not the time to use hedge fund strategies to dial up risk or increase market exposure, but rather to provide diversification.
- We are favorable on the Global Macro strategy, which has limited the downside of this recent economic downturn and provided strong absolute returns.

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Fixed Income spotlight

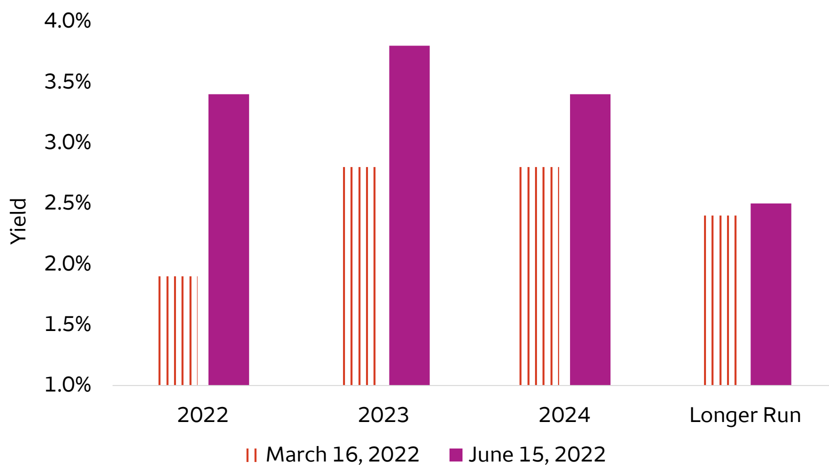
Full steam ahead for the Fed

In the weeks before the June 15 Federal Open Market Committee (FOMC) meeting, markets were expecting a 50-basis-point increase (100 basis points equal 1 percent), but a year-over-year Consumer Price Index print of 8.6% the Friday before the Federal Reserve (Fed) announcement forced the Fed to rethink its planned pace of monetary tightening. By Monday, the Fed had upshifted, and began to prepare the markets for a 75-basis-point increase. The Fed followed through with a 75-basis-point hike when the decision was announced. This marks the first time the Fed had increased the federal funds rate by 75 basis points since 1994, and signaled that the Fed is going all in on its attempt to bring inflation trends down to more acceptable levels.

Not only did the Fed increase rates by 75 basis points (bps), but it also meaningfully increased its rate hike projections as members plot a more aggressive path of monetary tightening. The urgency for the Fed is high, and investors should expect the Fed to focus on bringing inflation trends down to acceptable levels above all else. We believe it is unlikely that the Fed will allow liquidity to deteriorate to a point that causes extreme financial stress. It is also unlikely, in our opinion, that the Fed will pause rate hikes as growth moves into negative territory, absent an acceptable moderation of inflation.

Given new incoming data, we believe inflation will remain elevated through the remainder of the year and into 2023, pushing the Fed to continue with its aggressive tightening policies. While we acknowledge the ultimate path of Fed decisions is data dependent, with inflation appearing more elevated and stickier than expected, we recently increased our rate hike forecast projections. We expect an aggressive path of rate increases will be necessary if the Fed is going to restore its market credibility and exert control over inflation. Our current base case path is for the FOMC to raise interest rates by an additional 75 bps in July and September, and by 25 bps in November and December. Our year-end 2022 federal funds target rate range is 3.50% – 3.75%. We also expect two additional 25 bps interest rate hikes early next year; our year-end 2023 federal funds target rate is 4.00% – 4.25%.

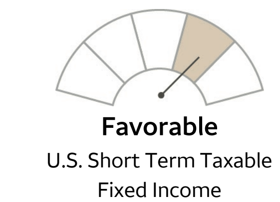
Median forecast of FOMC rate projections



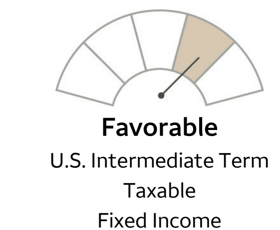
Source: FOMC summary of economic projections as of June 15, 2022.

Brian Rehling, CFA
Head of Global Fixed Income Strategy

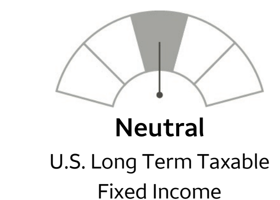
Favorable
U.S. Taxable Investment Grade Fixed Income



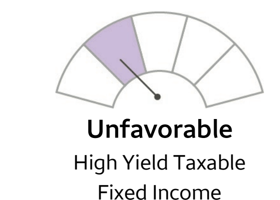
Favorable
U.S. Short Term Taxable Fixed Income



Favorable
U.S. Intermediate Term Taxable Fixed Income

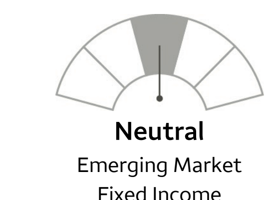


Neutral
U.S. Long Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income

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



Neutral
Emerging Market Fixed Income

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With inflation likely to remain elevated, we see longer-term rates also nudging higher until there is evidence that the Fed will be successful in its inflation fight. We do think the Fed will succeed, but until the data confirms this likelihood, there remains risk that longer-term rates will continue to rise. However, once inflation begins to moderate, we expect longer-term rates will move lower in acknowledgement of both a more moderate inflation picture and what is expected to be a slowing growth outlook. With this in mind, we recently upgraded long-term bonds to neutral from most unfavorable. Still, it is conceivable that long-term rates move into the high 3% area or even flirt with 4% as the market tests the Fed's will.

For now, short- and intermediate-term maturities are our current maturity preference for investment-grade fixed-income investors. However, we emphasize that we are now favoring investors to bring long-term maturity allocations up to a benchmark (neutral) level. While this positioning retains a defensive posture in our overall fixed-income positioning, we view this as a step toward a more constructive view on duration (duration is a measure of a bond's interest rate sensitivity). Our duration guidance remains unchanged at neutral. Once we have confidence that we have turned the corner on inflation, we will likely shift into a more offensive duration posture and anticipate that longer-term bonds could be further upgraded at that time.

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Equities

Chris Haverland, CFA
Global Equity Strategist

Second-quarter earnings preview

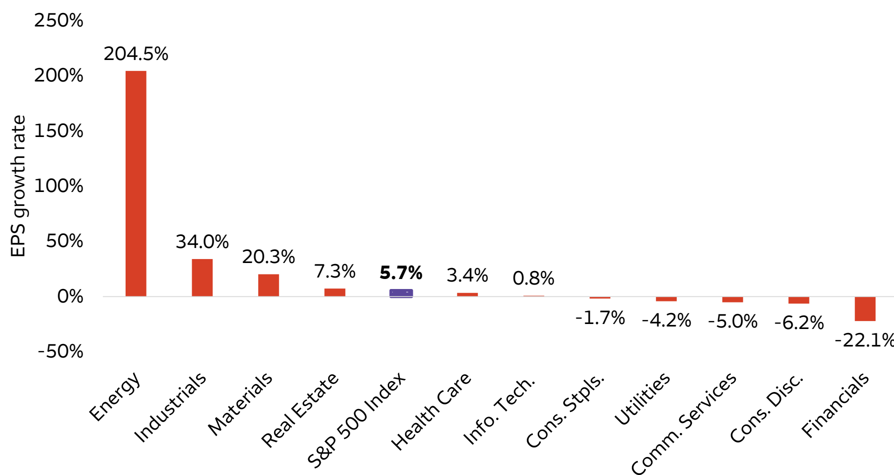
After growing by 9% in the first quarter of 2022, S&P 500 Index earnings are expected to have grown by 5.7% in the second quarter of 2022. If actual second-quarter earnings are in line with estimates, it would be the slowest quarter for growth since the fourth quarter of 2020. Although growth rates have declined from 2022 highs, the median historical earnings growth rate is 6.5% — close to the second-quarter forecast.

The Energy, Industrials, and Materials sectors should lead the way, with Energy earnings expected to grow by a remarkable 205%. Excluding the Energy sector, overall S&P 500 Index earnings are expected to contract by 2%. Financials likely saw earnings fall in the quarter on tough comparisons to last year, which included the release of loan loss reserves. Consumer Discretionary also could see earnings decline as costs rise.

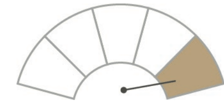
Forward guidance will be key as many companies continue to deal with rising input prices, a tight labor market, and continued global supply-chain constraints. These factors likely will lead to modest margin compression in the quarter. Despite the difficult environment, consensus earnings estimates for 2022 have been steady, with upward revisions to the Energy and Materials sectors offsetting downward revisions to the Consumer Discretionary and Communication Services sectors.

Looking forward, we expect earnings growth to slow and potentially contract as recession risks rise. In this environment, we suggest focusing on high-quality companies with consistent earnings growth, low debt levels, and high return on equity.

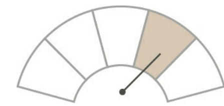
S&P 500 Index second-quarter earnings-per-share (EPS) growth estimates



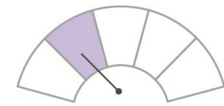
Sources: Wells Fargo Investment Institute, Bloomberg as of June 21, 2022. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.



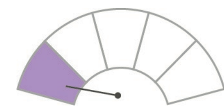
Most favorable
U.S. Large Cap Equities



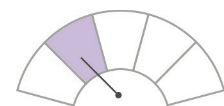
Favorable
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities



Unfavorable
Emerging Market Equities

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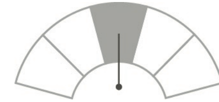
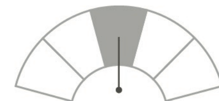
Real Assets

John LaForge
Head of Real Asset Strategy



Neutral
Commodities



Neutral
Private Real Estate

"Wherever we look upon this earth, the opportunities take shape within the problems." — Nelson A. Rockefeller

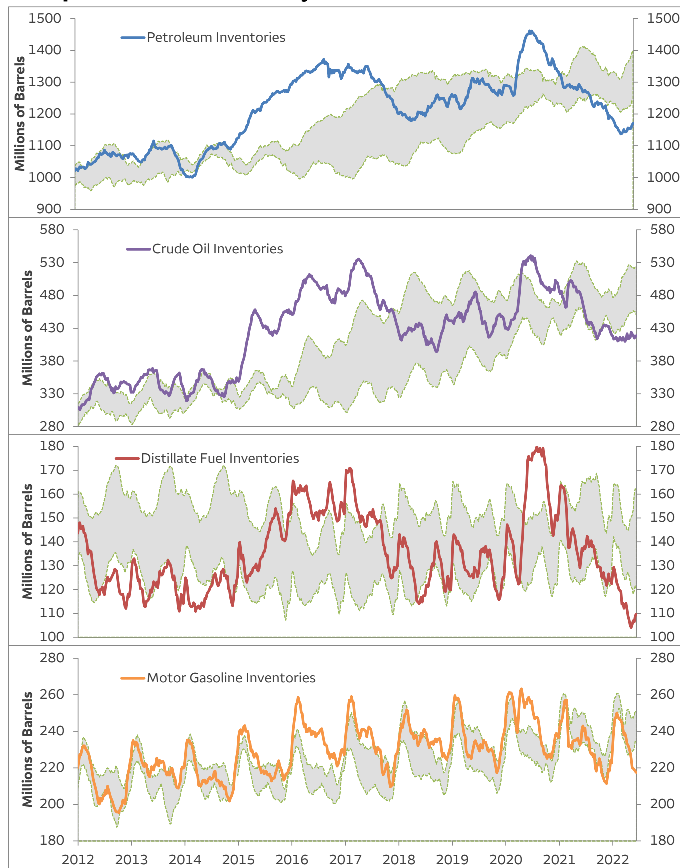
Messy gas tax solutions

Consumers are going through a rough patch with energy inflation, similar to the 1970s. Like in the 1970s, energy prices are grabbing a larger and larger portion of consumers' incomes. Over the last two years, oil prices have essentially tripled, with Brent crude oil, the global oil benchmark price, moving from the high $30s-per-barrel level to $112 per barrel today.

High gasoline prices are never particularly welcome. This is especially the case for politicians during a midterm election year, like 2022. In our view, this is why Washington, D.C. has been floating numerous potential short-term tax-related solutions to high gas prices. Everything from gas rebates, gas tax holidays, to windfall profit taxes on oil companies have been discussed.

While many of these answers can sound enticing, none are likely to help lower gas prices in the long term. In fact, most will likely lead to higher prices. Gas prices are high today mainly because of a lack of global supplies (Chart 1). We believe tax breaks will not drive demand down, but up. And a windfall profits tax on oil producers will likely lead to less oil supply, not more.

U.S. petroleum inventory levels



Sources: Bloomberg, Energy Information Administration (EIA), and Wells Fargo Investment Institute. Weekly data: January 6, 2012 – June 10, 2022. The shaded area represents the 1 standard deviation differences (+ and -) away from the average line.

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Alternatives

James Sweetman
Senior Alternative Investment Strategist

Global macro providing diversification benefits

After the global economy worked through initial complications due to the pandemic, the combination of a subsequent wave of COVID-19 outbreaks in China, fallout from the war in Ukraine, rising interest rates, and inflation have presented new challenges. With these factors as a backdrop, we believe a mild recession will likely occur by year-end and into 2023. Therefore, as we enter the second half of 2022, we maintain our conviction that the greater role of hedge funds is to provide non-correlated returns with lower beta (market sensitivity).

Through most of the first five months of 2022, global markets have experienced the triple threat of depressed equity and bond returns, heightened market volatility, and elevated inflation, making it a difficult start to the year for many investors' portfolios. But our favorable guidance toward non-correlated hedge fund strategies, especially the Global Macro strategy, has proven particularly additive.

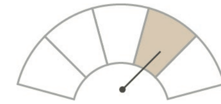
2022 performance through May 2022

2022 year-to-date	Global Equities	Global Bonds	Commodities	Relative Value	Global Macro	Event Driven	Equity Hedge
Jan - May 2022	-12.6%	-11.1%	32.4%	-0.3%	9.4%	-4.5%	-8.1%

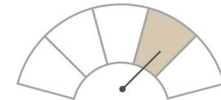
Source: Bloomberg, MSCI, and Hedge Fund Research (HFR). Data as of May 31, 2022. Asset classes are represented by the following indexes: Global Equity (MSCI All Country World Index), Global Bonds (Bloomberg Global Aggregate Credit Total Return Index Value Unhedged USD), Commodities (Bloomberg Commodity Index), Relative Value (HFRI Relative Value Total Index), Global Macro (HFRI Macro Total Index), Event Driven (HFRI Event Driven Total Index), and Equity Hedge (HFRI Equity Hedge Total Index).

This non-correlation benefit has continued into June as both global equity and fixed-income markets experienced continued difficulties, while the Global Macro strategy has benefited from strong technical trends that have them positioned long commodities and the U.S. dollar while short equity and fixed income. The result has been the strongest performance we have seen from the Global Macro strategy since the 2008 global financial crisis, and continues the trend of providing absolute returns and diversification through periods of uncertainty and heightened volatility.

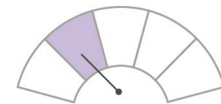
We expect Global Macro to continue to benefit from several drivers, including: higher-than-expected inflation and the impact on commodity prices, divergent global gross domestic product growth, higher interest rates, and heightened volatility.



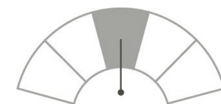
Favorable
Hedge Funds – Relative Value



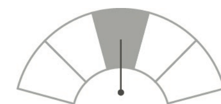
Favorable
Hedge Funds – Macro



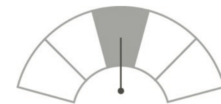
Unfavorable
Hedge Funds – Event Driven



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.

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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.

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. Risks associated with the **Consumer Discretionary** sector include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players; reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. **Consumer Staples** industries can be significantly affected by competitive pricing particularly with respect to the growth of low-cost emerging market production, government regulation, the performance of the overall economy, interest rates, and consumer confidence. 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. Some of the risks associated with investment in the **Health Care** sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market. 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. **Real estate** investments have special risks, including possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market. **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.

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.

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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.

Bloomberg Global Aggregate Credit Total Return Index Value Unhedged USD is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

HFRI Equity Hedge (Total) Index maintains positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios.

HFRI Event-Driven (Total) Index consists of Investment Managers who maintain positions in securities of companies currently or prospectively involved in corporate transactions of a wide variety, including but not limited to: mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. ED exposure contains a combination of sensitivities to equity markets, credit markets and idiosyncratic, company specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

HFRI Macro (Total) Index consists of investment managers who trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed-income, hard currency, and commodity markets.

HFRI Relative Value (Total) Index consists of Investment Managers who maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities Manager employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative or other security types. RVA position may be involved in corporate transactions also, but as opposed to ED exposures, the investment thesis is predicated on realization of a pricing discrepancy between related securities, as opposed to the outcome of the corporate transaction.

Note: HFRI Indices have limitations (some of which are typical of other widely used indices). These limitations include survivorship bias (the returns of the indices may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices 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 indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.

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.

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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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