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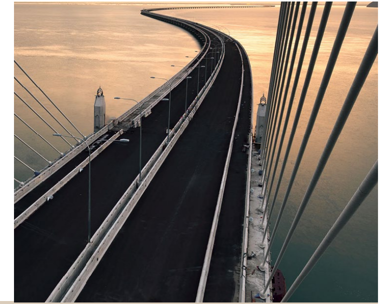

Investment Strategy

Weekly guidance from our Investment Strategy Committee **February 18, 2025**

Asset Allocation Spotlight: The case for international diversification 2

- U.S. equity outperformance over the past 15 years has brought into question the effectiveness of diversifying internationally.
- Despite the historical outperformance in U.S. equities, international assets play an important role in portfolio diversification especially in the event of U.S.-based volatility or downside events.

Equities: Negative equity risk premium a positive? 4

- The equity risk premium has turned negative, which indicates stocks are expensive relative to bonds.
- We see a resilient economy and accelerating earnings growth powering stocks to another year of outperformance versus bonds. But don't forget about fixed income, as the bond yields currently available have not been this attractive for quite some time.

Fixed Income: Be cautious of using TIPS as an inflation hedge 5

- The ongoing threat of new tariffs on imports is causing some investors to consider increasing their exposure to Treasury Inflation-Protected Securities (TIPS) to mitigate inflation concerns.
- Although TIPS can help an investor protect their purchasing power against unexpected changes in inflation, TIPS indices are relatively long duration which increases sensitivity to interest rate movements.

Real Assets: Commodity performance is starting the year off strong 6

- The Bloomberg Commodity Index is up 7.4% year to date, outperforming U.S. Large Cap Equities and U.S. bonds.
- Strong performance has created opportunities for investors to take profits and rebalance between commodity sectors, trimming allocations in relative outperformers and increasing exposure to the favorably rated Energy sector.

Alternatives: Signs of a recovery for Private Equity 7

- As the probability of an economic soft landing increases, the volume of Private Equity investments exited (or sold) rose modestly, offering hope that the Private Equity industry may be in the initial stages of a recovery.
- Despite remaining risks, disciplined investors that can commit new capital to Private Equity strategies may realize longer-term benefits as economic growth remains on a path to accelerate in late 2025.

Current tactical guidance 8

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Asset Allocation Spotlight

Veronica Willis
Global Investment Strategist

The case for international diversification

Over the past 15 years, U.S. equities — particularly large caps — have far outperformed other asset classes, including international equities. 2024 marked another year of U.S. Large Cap Equities leading the way, which has prompted many investors to question the efficacy of international diversification. However, as market conditions evolve, we believe it is prudent to remain globally diversified and not let the previous decade and a half skew long-term expectations for returns. International equities tend to provide diversification benefits by helping mitigate some risks that may be unique to U.S. markets and offering exposure to attractive valuation opportunities.

Diversification works best when different asset classes or regions perform independently under varying conditions. Two of the recent, severe bear markets in equities were associated with global crises — the Global Financial Crisis of 2008-2009 and the COVID-19 pandemic in 2020 — causing equities across both U.S. and international markets to decline simultaneously. These global crises minimized the diversification benefits of international equities in recent years. Additionally, in both of these cases, the U.S. was best positioned to recover, benefiting from aggressive fiscal and monetary policy responses and the strength of its labor market and consumer. As a result, investors who concentrated their portfolios in U.S. equities were rewarded with significant gains during the post-crisis rebounds.

However, there is no guarantee that the next pullback will follow the same pattern. While recent downturns were global in scope, it is entirely possible that the next economic or market disruption could be U.S.-centric. Over the next several quarters, we expect increased volatility over concerns related to rising U.S. debt levels, uncertainty surrounding Federal Reserve policy, or geopolitical tensions with key trading partners. If at any time during our long-term strategic horizon volatility emerges that is more localized in the U.S., international equities could serve as an essential counterbalance, helping in an effort to offset U.S. market declines.

One common expectation from investors is that international markets must outperform U.S. markets to justify their inclusion in a portfolio. However, this overlooks a fundamental benefit of diversification: reducing risk while maintaining competitive returns. Investors who maintain international exposure stand to gain from this risk-mitigation potential.

Our long-term Capital Market Assumptions (CMAs) suggest that Developed Markets ex-U.S. (DM) Equities may not generate returns as high as U.S. equities over the long term. However, because they are not perfectly correlated with U.S. equities, we believe they still play a valuable role in asset allocation construction. When incorporated into a portfolio, DM equities can provide potential for similar or better long-term returns with lower overall expected risk. This is due to the impact of that less-than-perfect correlation between DM equities and the other asset classes included in the allocations.

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Table 1. Historical vs expected return and risk

Asset class	15-year annualized total return (%)	15-year annualized standard deviation (%)	Strategic (long-term) expected return (%)	Strategic (long-term) expected standard deviation (%)
U.S. Large Cap Equities	14.4	14.5	7.8	16.0
U.S. Mid Cap Equities	12.7	16.7	8.3	17.0
U.S. Small Cap Equities	10.8	19.8	8.0	20.0
Developed Market ex-U.S. Equities	6.4	15.7	7.0	17.0
Emerging Market Equities	3.9	17.5	7.8	21.0

Sources: Sources: © Morningstar Direct, All Rights Reserved, and Wells Fargo Investment Institute. Historical data from February 1, 2010, to January 31, 2025. U.S. Large Cap Equities represented by S&P 500 Index, U.S. Mid Cap Equities represented by Russell Midcap Index, U.S. Small Cap Equities represented by Russell 2000 Index, Developed Market ex-U.S. Equities represented by MSCI EAFE Index, Emerging Market Equities represented by MSCI Emerging Market Index. An index is unmanaged and not available for direct investment. Strategic (long-term) return and standard deviation assumptions are based on the Capital Market Assumptions as of July 16, 2024. For illustrative purposes only. CMA forecasts are not promises of actual returns or performance that may be realized. They are based on estimates and assumptions that may not occur. **Forecasts are based on certain assumptions and on views of market and economic conditions which are subject to change.** Strategic expected returns are forward-looking geometric return estimates from Wells Fargo Investment Institute of how asset classes and combinations of classes may respond during various market environments. Geometric return is the compounded annual return that would give the same result as a given series of annual returns based on those same assumptions. The return and risk assumptions are statistical averages that do not represent or predict the experience of any individual investor or any specific time period. Standard deviation is a measure of volatility. It reflects the degree of variability surrounding the outcome of an investment decision; the higher the standard deviation, the greater the risk. **Past performance is no guarantee of future results.**

U.S. large caps significantly outperformed international equities over the past 15 years, and with lower risk, but over the long-term, we do not expect such outsized outperformance. Additionally, history suggests that prolonged periods of outperformance are often followed by a period of weaker performance. Investors who fail to maintain international exposure may find themselves adding these allocations after leadership has already shifted.

After years of U.S. equity strength, international markets — particularly in Europe and Japan — offer attractive relative valuations, in our view. For example, the forward price-to-earnings multiples implied by our year-end 2025 earnings targets and price as of January 31 are 22.0x for large caps and 14.0x for DM equities. Should investors search for better valuation opportunities, international equities may experience increased capital flows, providing a potential tailwind for future performance.

So far this year (as of February 10, 2025), DM equities are outperforming U.S. equities, as one of the top performing asset classes. In the emerging market (EM) space, Chinese equities have outperformed U.S. equities over the past 12 months. While these trends may not persist over the next several years, they highlight an important reality: No single market maintains dominance in all time periods.

Our long-term strategic allocations are built with a bias toward U.S. assets given our expectation for higher returns, but the allocations still include exposure to both DM and EM equities for their diversification benefits. We believe that utilizing a globally diversified approach can provide a more stable and resilient investment experience over full market cycles. Maintaining exposure to a variety of assets that do not necessarily move in the same direction or at the same magnitude during a downside event can potentially contribute to greater portfolio stability and higher returns in the long run.

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Equities

"Start where you are. Use what you have. Do what you can." — Arthur Ashe

Austin Pickle, CFA
Investment Strategy Analyst

Negative equity risk premium a positive?

Recently, we have received several questions on the equity risk premium (ERP), which is now negative. What does this mean and what are the implications?

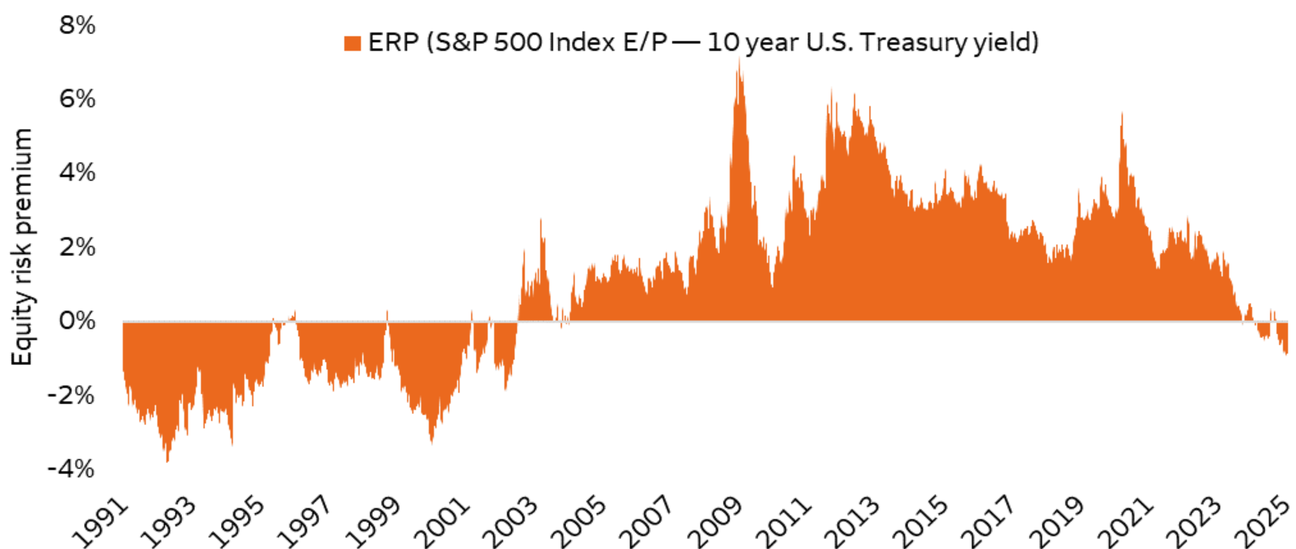
For those unfamiliar, the ERP is an equity earnings yield minus a bond yield. The equity earnings yield is calculated by dividing earnings by price (the inverse of the well-known price-to-earnings ratio). A positive ERP suggests that stocks are cheap relative to bonds and vice versa. With the S&P 500 Index near record highs and bond yields elevated, the ERP has dipped into negative territory (see chart).

Like other valuation measures, the ERP gives little insight into future returns. Take the 1990s as an example. The ERP spent virtually the entire decade in deeply negative territory, yet the S&P 500 Index enjoyed one of the best 10-year return periods in its history. Alternatively, during the so-called lost decade of the early 2000s — when the ERP was largely positive — the S&P 500 Index experienced one of its worst 10-year return periods.

What should investors take away from the current ERP level? In our view, the opportunity cost of holding bonds has come way down. In other words, bonds, after such a long post-global financial crisis period of very low yields, finally offer a reasonable income, in our view.

We see a resilient economy and accelerating earnings growth powering stocks to another year of outperformance versus bonds. Yet, as the ERP reminds us, don't forget about fixed income. We suggest investors move out on the maturity curve to lock in these attractive yields. We are most unfavorable U.S. Short Term, neutral U.S. Long Term, and favorable U.S. Intermediate Term Taxable Fixed Income.

Equity risk premium at multidecade lows



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data: January 1, 1991 – February 07, 2025. E/P is the earnings yield, which is calculated as the trailing-12-month earnings per share divided by the current price. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Fixed Income

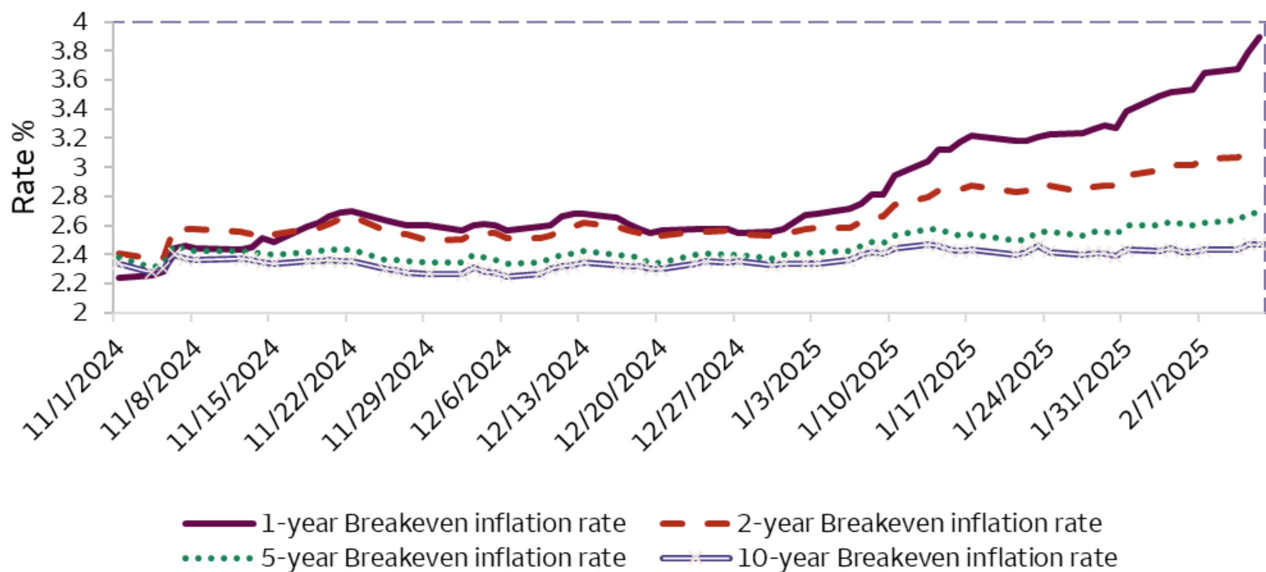
Luis Alvarado
Global Fixed Income Strategist

Be cautious of using TIPS as an inflation hedge

The ongoing threat of new tariffs on imports is causing some investors to consider increasing their exposure to TIPS to mitigate inflation concerns. Although TIPS can help an investor protect their purchasing power against unexpected changes in inflation, the benefit is mostly felt when actual inflation exceeds the market's expected inflation.

Tariffs can create transitory price increases, but, longer-term market expectations[1] for future inflation remain moderate. Breakeven inflation rates (the difference between nominal Treasury yields and TIPS yields) have already increased for the one-year and two-years tenors while five-year and 10-year breakeven inflation rates have not risen significantly, indicating that investors are not pricing in sustained higher inflation.

U.S. breakeven inflation rates



Sources: Bloomberg and Wells Fargo Investment Institute as of February 11, 2025. The breakeven inflation rate represents a measure of expected inflation derived from subtracting Treasury Inflation-Indexed Constant Maturity Securities from Treasury Constant Maturity Securities. The latest value implies what market participants expect inflation to be in the next year, two years, five years, and 10 years, on average.

In addition to changes in inflation expectations, TIPS' market value is mostly impacted by changes in real interest rates. As is the case for any bond — when interest rates increase, the market price of the bond typically decreases, and when interest rates fall, the market price of the bond increases. These interest-rate movements often help to explain how the TIPS' market value sometimes increases even as inflation expectations fall, and it can explain how TIPS' market value can fall when inflation expectations increase.

We currently have a neutral guidance on TIPS and believe they can play a role in providing diversification to a fixed-income portfolio. However, we would be cautious of potential return surprises, as TIPS indices are relatively long duration which increases sensitivity to interest rate movements.

1. 1. 5-year and 10-year U.S. breakeven inflation rates.

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Real Assets

Mason Mendez
Investment Strategy Analyst

Commodity performance is starting the year off strong

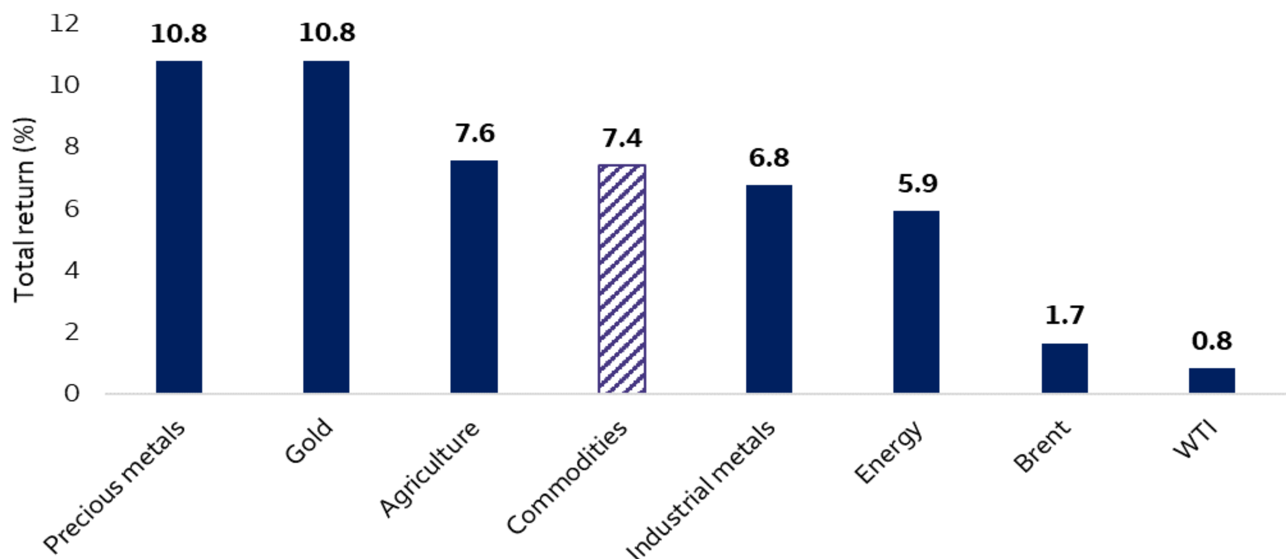
Commodities started the year off strong, with the Bloomberg Commodity Index up 7.4% year to date, outperforming U.S. Large Cap Equities and U.S. bonds as of February 10, 2025. The Precious Metals and Agriculture sectors have been the strongest performers, yet participation in the price rally is high, as all sectors have posted positive year-to-date returns (see chart).

Looking ahead over the tactical horizon, we remain favorable on Commodities and expect modest performance to be driven by an improving macro environment and stronger global demand growth. In addition, we believe that Commodities could act as an effective portfolio diversifier and hedge against ongoing geopolitical risks stemming from sanctions and tariffs. Precious-metal prices have been especially sensitive to these growing trade risks, as gold prices climbed to new highs of $2,908 per troy ounce on February 10, surpassing our year-end target of $2,800 – $2,900 per troy ounce.

While we welcome such strong performance, we believe that the risk to return of further upside appears less attractive at current prices. Our 2025 year-end target for the Bloomberg Commodity Index is 250 – 270, which leaves only a 2% return to the midpoint from current prices (January 10, 2025).

We do, however, see opportunities to rebalance within the sectors. One such opportunity would be to take profits from the relative outperformers (Precious Metals and Agriculture) and rotate into the favorably rated Energy sector. Crude oil and energy prices have softened over recent weeks, but we suspect that performance will improve throughout the year amid an improving macro environment. Therefore, we view current weakness in energy prices as an attractive opportunity to gain exposure and benefit from a brighter demand outlook in 2025.

Year-to-date commodity returns in 2025



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data is from December 31, 2024 – February 10, 2025. Commodities are represented by the Bloomberg Commodity Total Return Index. Brent= Brent Crude Oil. WTI = West Texas Intermediate. 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

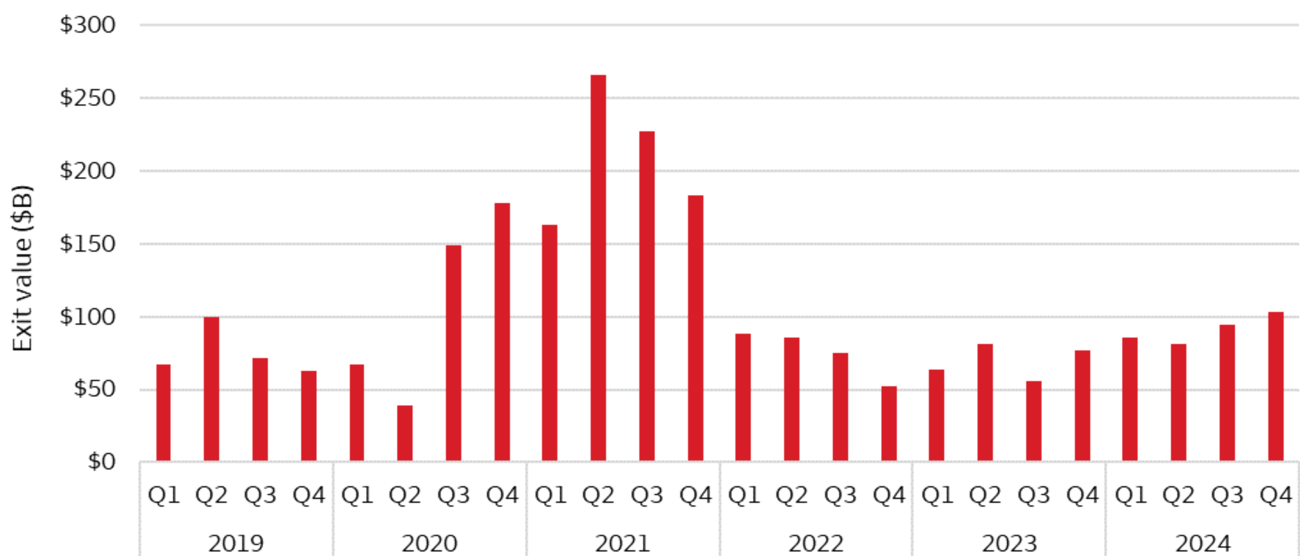
Signs of a recovery for Private Equity

The exit environment witnessed a notable increase in volumes during the second half of 2024 (see chart). Though levels remain well below the frothy 2021 market, the modest increase in exit-investment values provides hope that the Private Equity downturn may be nearing its end, and the initial stages of a rebound may be underway. Declining valuations over the past few years have led to a significant gap between what sellers believe their investments are worth and what buyers are willing to pay. However, the increased optimism that the economy may achieve the rare soft landing as well as the continued upward trend in public-market prices is likely contributing to rising activity levels in private markets.

Though the modest pickup is encouraging, the positive trends may be partially offset by the growing realization that interest rates may not fall as far (or as fast) as many investors expected. While lower rates may be needed before exit volumes accelerate from current levels, corporate leader's growing confidence that the economy is on the right track may be enough to keep the trend moving upwards through early 2025. Moreover, the inventory of Private Equity-owned companies continues to grow and now stands at over 11,800 firms at the end of 2024 (up nearly 3,000 firms since 2018).[2] Based on the current pace of exits, it would take approximately eight years to exit all investments held. The greater supply of mature investments that may be nearing an exit may force sellers to make concessions on pricing even as the economy recovers.

Despite the remaining risks, we believe disciplined investors that can commit new capital to Private Equity strategies may realize the longer-term benefits as we expect economic growth to accelerate in late 2025.

The value of Private Equity investments exited (or sold) rose modestly in recent quarters



Sources: Pitchbook and Wells Fargo Investment Institute. Data as of December 31, 2024.

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

2. Pitchbook 2024 Annual US PE Breakdown report.

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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, February 18, 2025.

*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

Asset allocation and diversification are investment methods used to help manage risk. They do not guarantee investment returns or eliminate risk of loss including in a declining market.
Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. **Treasury Inflation-Protected Securities (TIPS)** are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond to fluctuate more than other fixed income securities. TIPS have special tax consequences, generating phantom income on the "inflation compensation" component of the principal. A holder of TIPS may be required to report this income annually although no income related to "inflation compensation" is received until maturity. 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.

Investing in gold, silver or other precious metals involves special risk considerations such as severe price fluctuations and adverse economic and regulatory developments affecting the sector or industry.

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.

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.

MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000 Index.

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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Market Commentary

Weekly perspective on current market sentiment **February 20, 2025**

Scott Wren
Senior Global Market Strategist

Last week's S&P 500 Index: +1.5%

Fixed income opportunities

Key takeaways

- Our regular readers know that over the last 10 years or more, fixed-income yields have been historically low.
- We favor moving money out of short-term instruments and into higher-yielding investment-grade fixed income further out on the maturity spectrum.

Opportunities and patience are two topics we have been focused on over the past couple of years and covered often in reports and other various communications. You have to take what the market gives you. In other words, for example, when looking at the equity market and the forward outlook is positive but investors get spooked by fears about potential inflation, global geopolitical tensions, or any number of other concerns that lead to a pullback, longer-term investors need to have a plan to put funds to work and take advantage of lower stock prices.

The same can be said about the fixed-income market. Many, if not most, of our regular readers know that over the past 10 years or more, fixed-income yields have been historically low. Opportunities to lock in attractive longer-term yields have been few and far between. In fact, since the beginning of 2009, the average yield on the 10-year Treasury note through January of this year was just 2.55%. It wasn't all that long ago (mid-2022) when the 10-year Treasury note yield finally rose above 3% after an extended period of more modest rates. The yield stands just above 4.5% at the time of this writing, still low by historical standards. Note that from January 1961 through January of this year, the average yield on the 10-year Treasury note was 5.8% according to Bloomberg data.

We have conviction around our year-end target range of 4.50% – 5.00% for the U.S. 10-year Treasury note, and on that basis, we see attractive fixed-income opportunities for investors. We favor moving money out of short-term instruments, such as money market funds, into higher-yielding investment-grade fixed income further out on the maturity spectrum. We believe that intermediate maturities (three to seven years) offer attractive yields and less sensitivity to rising interest rates should economic growth or inflation increase more than we currently expect.

For investors who want to lock in yields today for a longer period, and who can look past the potential price volatility as economic growth and inflation fluctuate, we would bring longer-term fixed-income allocations up to neutral or in line with their strategic target level.

And finally, we favor investment-grade corporate bonds over other types, including high-yield, Treasury, and agency securities, and we prefer to stick to high-quality issuers.

We believe investors have a number of potential opportunities to put funds to work in fixed income now and favor a review of portfolio positioning to see if any adjustments need to be considered.

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Definitions

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

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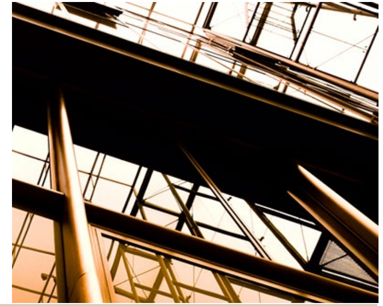
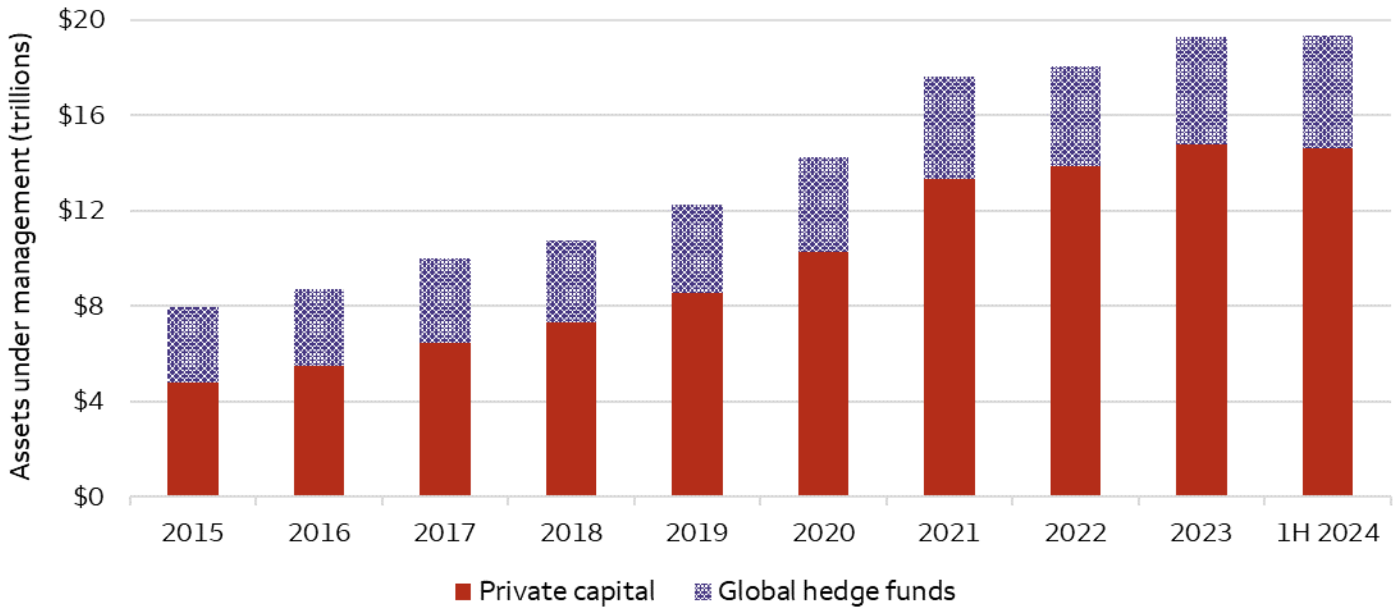
Chart of the Week



Weekly analysis of key themes in markets — February 19, 2025

An era of growth in alternative investments



Source: Preqin. Data as of June 30, 2024. 1H = first half.

Alternative investments increasingly seen as core component of well-diversified portfolio

As the chart above shows, there has been significant growth in alternative investments' assets under management in recent years. The combined total in 2015 registered near $8 trillion and steadily rose to over $19 trillion through June 2024. We see this growth as largely a result of two factors — greater accessibility and growing awareness.

First, the world of alternative investments — historically the realm of institutional or ultra-high net worth investors — is more accessible to the average investor. The other key factor is growing awareness of some of their potential benefits in building long-term wealth, preserving capital in challenging markets, and generating income.

What it may mean for investors

While many investors have yet to incorporate alternative strategies in their portfolios, this asset group is increasingly thought of as a core component of any well-diversified portfolio. For more detail on which strategy types may align with various investment objectives, please see our February 3 *Investment Strategy* report.

Mark Steffen, CFA, CAIA, *Global Alternative Investment Strategist* — Excerpted from Investment Strategy report (February 3)

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

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.

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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Policy, politics & portfolios

What federal budget, regulatory, and trade decisions could mean for investors **February 20, 2025**

Trump economic policy 2.0 2

- The Trump administration has initiated its trade and immigration policies in a targeted fashion. Looking ahead, we expect neither set of policies to move in a straight line.
- Although tariffs and immigration controls pose inflation risk, the negative economic impact will depend on the scope and timing of implementation as well as factors that offset the negative effects.

Tax cuts and deregulation 4

- We see deregulation and tax cuts as economic positives with a high probability that the 2017 Tax Cut and Jobs Act (TCJA) provisions will be extended in 2025.
- Additional tax cut proposals may be considered in 2026.
- Deregulation, especially in the financial and energy sectors, should boost economic growth but with a lag as corporations require time to allocate capital in response to potential future benefits.

The big picture 6

- We believe inherent economic strengths, along with support from deregulation and looming tax cuts, will outweigh the threat to growth and inflation from tariffs and immigration policy, leading to another year of above-average U.S. economic growth.
- As a less predictable policy environment creates volatility across capital markets, we favor looking for buying opportunities outlined in our 2025 Outlook report, which anticipated new rounds of tariffs as policy.

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Trump economic policy 2.0

Michael Taylor, CFA
Investment Strategy Analyst

Promises made, promises kept

Two focal points of President Trump's economic policy are trade and immigration. Although his proposed steel and aluminum tariffs look like long-term measures to reshore production to the U.S., his other tariff rhetoric has appeared targeted and transactional — to secure concessions from trade partners that range from purchasing more U.S. energy to stemming illegal border crossings and fentanyl inflows to the U.S. Even tariffs on China have been measured.

Deportations of undocumented immigrants also have started in a targeted way, focusing first on those apprehended for breaking laws. We anticipate tariff-driven trade policies to continue and immigration policy to encompass larger-scale deportations, but, so far, both tactics have had limited capital-market impact.

Going forward, we expect that neither set of policies will move in a straight line, and we foresee two implications for investors. First, we expect significant noise — news reports of grandiose plans that then give way to more incremental steps. Second, we anticipate that incrementalism will get another impulse as the administration weighs policy goals against the economic costs that tariffs and deportations create, particularly on inflation.

Tariffs and foreign trade

We prefer to focus on the destination rather than the twists and turns that dominate newscasts. First, Trump views China's trade policies as a barrier for U.S. economic growth. Chinese subsidies give local firms an advantage over competitor U.S. firms,[1] and China's antimonopoly laws could be used to undercut successful U.S. firms operating in China, for example.[2] Closer to home, Trump has demanded that Mexico and Canada halt illegal immigration and flows of fentanyl to the U.S. More tariff threats are likely for Europe, China and other countries, but the administration may present these threats as incentives to buy more U.S. products. Tariffs are a means of leverage to negotiate an array of goals involving countries that sell more to the U.S. than they buy.

The timeline and scope of the administration's foreign-trade policy remain unclear, but the early signals are that Trump is prepared to negotiate, in many cases. If tariffs follow through for a prolonged period, the economic implications would be damaging. Fortunately, there are offsetting factors that should discourage aggressive tariff increases. Mitigating factors include the U.S. dollar's strength against other currencies and the potential for other countries' suppliers to bear at least part of the tariff. U.S. firms also might reduce their profits somewhat to cover part of the levy. U.S. consumers ultimately may shoulder part of the burden through higher prices, the more aggressive the levies are and the longer they stay in place. Even so, it is worth remembering that reversing inflation and promoting economic growth also are important goals for the administration. Moreover, Trump's reliance on the International Economic Emergency Powers Act may prompt blowback from the courts or Congress.

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1. The Wall Street Journal, "G-7 Nations Criticize Chinese Subsidies, High-Tech Exports," June 14, 2024, and Voice of America, "China Spends Billions of Dollars to Subsidize Favored Companies," May 24, 2022.
2 .The Wall Street Journal, "China Retaliates Against U.S., Intensifying Trade War," February 4, 2025.

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Immigration reform

Border security is a signature issue for Trump and is gathering support among Democratic lawmakers. Undocumented workers in the U.S. exceed 9 million[3] as legal and undocumented immigrants have offset slowing labor-force growth. An 11.7 million person rise in foreign-born workers topped a loss of 8 million native-born workers in 2024.[4] Democrats generally favor legal paths for residence, though some now lean toward comprehensive immigration reform. The Laken Riley Act may be an indication of more bipartisan collaboration. Voters also expect Trump to fix an antiquated immigration system.

Using Trump's first-term record of 1.2 million deportations,[5] we developed three scenarios for weighing the potential breadth and magnitude of immigration reform. Under a *mild scenario,* convicted criminals would be deported. A *moderate scenario* would add undocumented foreign nationals based on federal deportation capacity (roughly 1 million per year) to lawbreakers. A less-likely *heavy scenario* would expand extraditions to maximum capacity (exceeding 3 million annually).

Just as with tariff policy, large-scale deportations carry economic costs. Reducing foreign-born laborers through deportations could disrupt sectors with sizable undocumented immigrant workforces — construction (13.7%), agriculture (12.7%), hospitality (7.1%), and general services (6.5%).[6] Many of these sectors have unfilled job openings, which would be exacerbated by shrinking the labor pool,[7] aggravating wage and price inflation.[8] And, again here, legal roadblocks to pursue an aggressive immigration policy include immigration-court backlogs, lack of Immigration and Customs Enforcement (ICE) agents, blue-state resistance, lack of cooperation from other countries, and legal challenges.[9] Although we see few legal hurdles to deporting convicts, extraditing undocumented immigrants who entered the U.S. within the past four years will likely pose legal challenges.

What it means for investors

Based on the flurry of President Trump's executive actions, we expect immigration and trade initiatives to precede tax and regulatory changes. Although tariffs and immigration restrictions pose inflation risk, the economic impact will depend on the scope and timing of implementation. In our view, any growth impediments should be offset by tax-cut extensions and deregulation coupled with U.S. economic resilience.

China's trade surplus reached a record $992 billion in 2024 as Chinese companies hastened to export goods ahead of a revised U.S. trade policy.

Source: Bloomberg, January 13, 2025

68% of Americans believe the Trump administration will control illegal immigration, an 8-point increase over 2016.

Source: Gallup, January 2, 2025

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3. Pew Research Center, "What We Know About Unauthorized Immigrants Living in the U.S.," July 22, 2024.
4. U.S. Labor Department.
5. The Wall Street Journal, November 11, 2024.
6. American Immigration Council, 2024.
7. Ned Davis, May, 2024.
8. See Wells Fargo Investment Institute Alert 2.3.25 for detailed investment implications.
9. The Wall Street Journal, January 1, 2025.

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Tax cuts and deregulation

Douglas Beath
Global Investment Strategist

Tax policy

The 2017 TCJA is set to expire at the end of this year, which will trigger a tax increase for 62% of filers according to the Tax Foundation. Beyond the extension of the TCJA, President Trump has proposed a further reduction in the corporate-tax rate from 21% to 15% for companies that make their products in the U.S. Additional tax-cut proposals floated by Trump during the election campaign include increasing the deduction limit on state and local taxes along with tax exemptions on Social Security benefits and overtime pay and tips and restoring full expensing of equipment and research and development (R&D) investment.

For most of the TCJA provisions up for extension, an extension would simply leave existing policies in place and on the surface would not be economically stimulative.[10] However, a 2024 National Federation of Independent Business (NFIB) survey suggests that small-business confidence would plunge if the TCJA is not extended. Thus, the elimination of an "uncertainty factor" regarding the TCJA would likely be a benefit to the economy.

Extending all expiring individual and estate-tax cuts within the TCJA, along with business-tax changes that congressional leaders favor, would reduce projected government revenue by $4 trillion over a decade, according to the congressional Joint Committee on Taxation. That would come atop $20 trillion in new deficits projected under current laws. The aforementioned additional tax-cut proposals should provide further stimulus that would benefit the U.S. economy over the long-term but are estimated to cost $3 trillion. President Trump expects that tariff revenue will offset lost revenue from additional tax-cut proposals, and, indeed, the Tax Foundation estimates that an aggressive scenario imposing hefty tariffs on China along with lesser-but-universal tariffs on all imports would increase federal-tax revenues by $3.8 trillion over 10 years.

Although we expect the TCJA extension in 2025, any additional proposed tax changes seem more probable in 2026. Congress must raise the debt ceiling to fund the TCJA with negotiations possibly running into the "X date" when the U.S. Treasury projects it will run out of cash sometime between June and August of this year. The legislative process could also be encumbered by slim majorities and intraparty differences.

Deregulation

Two key areas for deregulation include the financial and energy sectors.

Financials

In the aftermath of the global financial crisis, financial companies have experienced a surge of regulations, and bank executives are optimistic that Trump will reduce capital cushions and consumer protections and ease scrutiny of consolidation in the industry.

Small banks will be key as they have significant power to push regulatory relief. However, Republicans hold thin majorities in both the Senate and the House and are unlikely to find any Democratic support for dramatic changes.

These deregulation efforts will likely spur bank lending and boost the economy. We also expect mergers and acquisitions (M&A) to increase in the coming years with many regional banks selling at all-time highs and banks looking to achieve greater scale.

10. However, we note that the original TCJA that allowed for expensing R&D expenses already has converted to a more gradual amortization. Restoring the original provision to expense these costs should help stimulate more business capital spending.

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Conversely, a temporary 10% cap on credit-card interest rates, which Trump proposed during his campaign, is a potential tail risk for banks, in our view. Deregulation initiatives are also more vulnerable to legal challenges — which can mean additional delays following last year's reversal of the so-called "Chevron deference" Supreme Court ruling, undercutting agencies' ability to unilaterally mandate regulatory changes. Finally, there are logistical lags in the corporate response to deregulations passed by Congress in allocating capital; spending it on plant, equipment, and R&D; and in fully integrating the added investment in production, so investor returns may need time to reflect the positive benefits of deregulation.

Energy

During President Trump's first full week in office, he declared a "national energy emergency" and signed a series of executive orders that encourages more oil and gas production but that disincentivizes electric vehicles. Still, while crude oil prices remain range bound, we expect restrained oil and gas production growth. Secondly, if a new 10% tariff on Canadian oil imports comes out of suspension and into force, we would expect refiners to see their profit margins narrow and gasoline prices rise. Other potential sources of demand that could boost prices and returns would be a policy to refill the Strategic Petroleum Reserve, which is 300 million barrels short of its potential, or expanding sanctions on Russian and Iranian oil sales. The bottom line is that it is not yet clear if recent executive orders or potential future policies from the U.S. will impact energy prices going forward.

What it means for investors

Although the initial relative outperformance of U.S. small-cap stocks postelection has faded, the equal-weighted S&P 500 Index is outpacing the market-cap weighted version year-to-date and U.S. large-cap value stocks are outperforming growth, indicating to us that the U.S. equity market is broadening in anticipation of expanding growth.

The significant outperformance of the Financial sector versus the S&P 500 — both since election day and year-to-date — combined with the KBW Bank Index (this index covers large national and regional banks) handily exceeding both, suggest that investors believe potential deregulation polices from the new administration will have a positive impact — particularly in the M&A space.

In the meantime, master limited partnerships (MLPs) have performed in line with bank stocks since the election (+14% to date according to the Alerian MLP Index and KBW Bank Index). This is an indication that MLPs potentially stand to benefit from deregulation of the domestic energy industry based on increasing natural-gas supply and demand and higher export volumes — particularly as Europe seeks to diversify its energy sources away from Russia while Trump is demanding the European Union buy more energy from the U.S. to avoid tariffs. However, the natural-gas sector will face time-consuming logistical issues as it takes several years to build storage and liquefaction facilities before extrapolating additional supply.

We continue to have most favorable and favorable ratings on the Energy and Financials sectors, respectively.

Although tax cuts and deregulation will likely happen in 2025 and early 2026, markets have already started to respond:

- **NFIB Small Business Optimism Index has soared.**
- **Equal-weighted S&P 500 Index is outperforming the market-cap weighted version and U.S. large-cap value stocks are outpacing growth, indicating to us that the U.S. equity market is broadening in anticipation of expanding growth.**
- **Financial and Energy stocks have outperformed, particularly small banks and the midstream energy sector.**

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The big picture

Jennifer Timmerman
Investment Strategy Analyst

Placing President Trump's policy pillars into our outlook

While some policy aspects have already been unveiled in the opening weeks of the new administration, many details remain uncharted or subject to reversal. The good news is that we view President Trump's four policy pillars as only one set of factors in our overall outlook, overshadowed by other drivers of economic and investment performance in the coming year.

A wave of policy changes set on a firm economic foundation

Our view is that the flurry of policy changes — some positive for capital markets, others negative, and all carrying at least some uncertainty about timing and degree — are set against a solid U.S. economic backdrop. In 2025, we expect above-average economic growth and slightly higher year-end inflation to support equities and other risk assets. Our view is that the economy will be propelled by ample liquidity[11] and supported by still-respectable job growth, wage gains outpacing inflation, and increases in upper-income household wealth tied to the recent rally in stocks and other financial assets. In our base case, these economic strengths, along with growth-supportive deregulation and looming tax cuts, will outweigh the threat to growth and inflation from tariffs and immigration restrictions.

Stocks should tolerate modestly higher inflation

We believe the stock market can tolerate modestly higher inflation due to a resilient consumer and because of companies' discipline around cost controls. Our outlook for solid economic growth and firmer inflation in 2025 leaves us with a year-end target range of 4.50% – 5.00% for the 10-year U.S. Treasury yield — only slightly above recent levels. We think long-term interest rates in this range can limit the pressure on housing and other credit-sensitive sectors of the economy. In our view, modestly higher longer-term interest rates will be insufficient to impede further equity-market gains, supported by our expectation for earnings growth as the primary driver of stock prices, and allow the S&P 500 Index to accommodate current valuations. Further, we believe continued economic strength will foster widening stock-market breadth to include more cyclical (or economically sensitive) sectors as growth becomes more balanced between resilient services and lagging manufacturing due to tax cuts, reshoring, and consumer spending.

Weighing the impact of all policy pillars

We believe that threats to economic growth from tariff increases and the effect of tighter immigration controls on labor supply will be overshadowed by deregulation and tax policy for at least two reasons. First, as we discussed above, we expect tariffs to target the main trading partners of the U.S. along with deportations that focus on undocumented immigrants who are incarcerated. Universal tariffs are possible, but the Trump administration likely wants to avoid their high costs to the U.S. economy in slower growth and higher inflation. Second, our view is that tax cuts and deregulation initiatives can boost investment and raise business and labor productivity by improving the return on capital. On balance, we believe these factors support a positive

11. By this we mean cash available for investing and spending.

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environment for equities and provide fixed-income investors opportunities to lock in higher long-term yields than have been available in years.

Putting policies into perspective

To reiterate a key point, noisy headlines will no doubt be the norm rather than the exception this year and we prefer to look through policy twists and turns to economic policy's final destination. Supportive economic measures, on balance, combined with the economy's strong underlying growth, inflation, and interest-rate fundamentals will ultimately drive market performance. But we do expect the ride to be bumpy as new tariffs and immigration controls are announced and enacted — a noticeably different backdrop for investors after the subdued volatility of the recent past.

Investment implications

Our portfolio guidance looks through initial policy announcements from the new administration and continues to focus on expected policy supports and more fundamental drivers of growth, inflation, and interest rates because of the economy's ongoing strengths:

- We favor U.S. over international assets and, within that, higher-quality and more-liquid U.S. large cap stocks. Large caps' underlying strengths should outweigh potential currency losses on multinationals' overseas earnings tied to U.S. dollar strength. Our preference is that portfolios hold full allocations to small- and mid-cap equities.

- We prefer to position for a rotation into more economically sensitive equity sectors. Our favored sectors include Energy, Financials, Industrials, and Communication Services.

- In fixed income, we favor reallocating from cash and money market funds into intermediate (three to seven years) and longer maturities to lock in rising yields.

- Tariffs on Canada, Mexico, and China may lift the prices of industrial metals, such as copper, aluminum, and zinc. We still favor commodities, both for potential return and as hedges for investors most sensitive to rising inflation.

We believe strong underlying fundamentals will ultimately drive market performance as investors look through a changing policy landscape in focusing on the economy's strengths.

We think more cyclical equity sectors will be able to participate in the stock rally as economic growth becomes more balanced between resilient services and lagging manufacturing due to tax cuts, reshoring, and consumer spending.

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Risk considerations

Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. There is no guarantee that value stocks will increase in value or that their intrinsic values will eventually be recognized by the overall market. The value type of investing tends to shift in and out of favor.

The prices of small and mid-cap company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse 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.

Investments in fixed-income securities are subject to interest-rate, credit/default, liquidity, inflation, and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high-yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. If sold prior to maturity, fixed-income securities are subject to market risk. All fixed-income investments may be worth less than their original cost upon redemption or maturity.

U.S. government securities are backed by the full faith and credit of the federal government as to payment of principal and interest. Unlike U.S. government securities, agency securities carry the implicit guarantee of the U.S. government but are not direct obligations. Payment of principal and interest is solely the obligation of the issuer. If sold prior to maturity, both types of debt securities are subject to market 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.

Investment in Master Limited Partnerships (MLPs) involves certain risks which differ from an investment in the securities of a corporation. MLPs may be sensitive to price changes in oil, natural gas, etc., regulatory risk, and rising interest rates. A change in the current tax law regarding MLPs could result in the MLP being treated as a corporation for federal income tax purposes which would reduce the amount of cash flows distributed by the MLP. Other risks include the volatility associated with the use of leverage; volatility of the commodities markets; market risks; supply and demand; natural and man-made catastrophes; competition; liquidity; market price discount from Net Asset Value and other material risks.

Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Investments in commodities may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies which may expose investors to additional risks.

Definitions

Alerian MLP Index is a composite of the 50 most prominent energy Master Limited Partnerships (MLPs) that provides investors with an unbiased, comprehensive benchmark for this emerging asset class. The index, which is calculated using a float-adjusted, capitalization-weighted methodology, is disseminated real-time on a price-return basis and on a total-return basis.

KBW Bank Index serves as the benchmark for the banking sector and consists of the stocks of 24 banking companies.

NFIB Small Business Optimism Index is the small business optimism index is compiled from a survey that is conducted each month by the National Federation of Independent Business (NFIB) of its members. The index is a composite of ten seasonally adjusted components based on questions on the following: plans to increase employment, plans to make capital outlays, plans to increase inventories, expect economy to improve, expect real sales higher, current inventory, current job opening, expected credit conditions, now a good time to expand, and earnings trend.

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.

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

An index is unmanaged and not available for direct investment.

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