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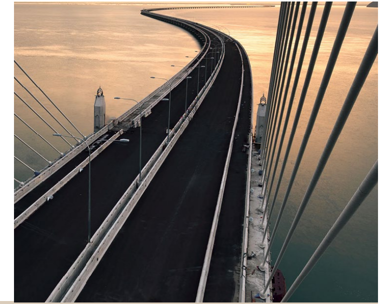

Investment Strategy

Weekly guidance from our Investment Strategy Committee **October 14, 2024**

Alternatives Spotlight: Private Equity — Navigating Private Equity as backdrop improves 2

- Private Equity strategies have shown signs of recovery, and we see upside potential next year as we expect lower interest rates and higher economic growth.
- We believe Private Equity offers the potential for asset appreciation over the long term, and we currently favor secondary strategies along with the Small- and Mid-Cap Buyout and Growth Equity strategies. Thematically, we see opportunities related to artificial intelligence.

Equities: Chinese equities running ahead of reality 4

- Chinese equities have rallied sharply on hopes that newly announced policies will be enough to finally spur a recovery in the troubled property sector and the broader economy.
- While the attempt is noteworthy, we are skeptical that it will lead to a lasting rebound given the depressed levels of sentiment surrounding the consumer and property sectors.

Fixed Income: Emerging-market debt supported by the Fed's pivot........ 5

- Emerging-market (EM) debt, both in U.S. dollars and local currency, has performed well so far in 2024, and we believe this rally has further room to run. Drivers include the Federal Reserve's (Fed's) start of a new interest-rate cutting cycle, a weakening U.S. dollar relative to key EM currencies, and a well-developed downtrend in EM inflation.
- We remain neutral on Emerging Market Fixed Income, but we note that risks now are less compensated by valuations as both yields and spreads have declined from last October's highs.

Real Assets: Expect slower oil-production growth in 2025........ 6

- While oil prices are essentially back to where they started the year, the cost to produce new oil wells has continued to rise.
- We are expecting to see higher oil prices in 2025 as the global economy improves and the cost to produce new oil wells stays high.

Current tactical guidance 7

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Alternatives Spotlight

Chao Ma, PhD, CFA, FRM
Global Portfolio and Investment Strategist

Private Equity — Navigating Private Equity as backdrop improves

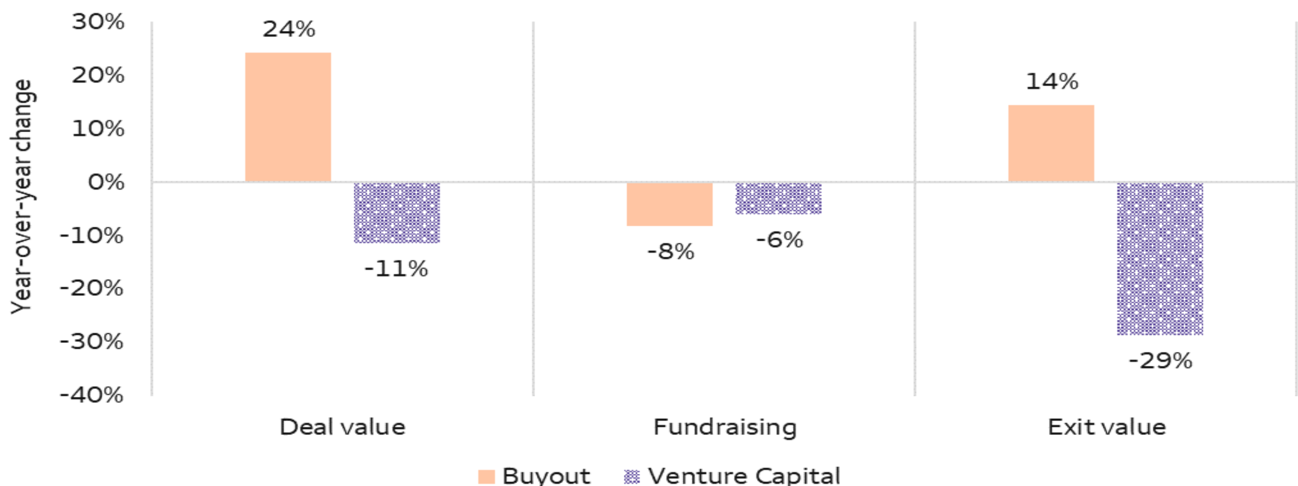
Elevated interest rates, economic weakness, and an uncertain outlook have slowed the private-equity market since 2022. According to Pitchbook, the timeline for fundraising, exits, and dealmaking has extended significantly. The median time for a private-equity fund to raise capital has increased from 11 months in 2022 to 18 months today. Deals also took longer to close as fund managers applied additional scrutiny in due diligence. As a result, private-equity investments exited so far in 2024 reached a record median holding period of seven years. To navigate the challenging landscape, many fund managers have increasingly relied on secondary markets to return capital to investors and have focused on deploying capital to support what they view as the most promising companies to maturity.

Quality over quantity has been another notable trend as both investors and fund managers placed a premium on confidence. Investors have become more selective and committed primarily to established managers that have demonstrated subject-matter expertise, exceptional strategy specialization, a differentiated sourcing network, and a strong track record. In turn, many fund managers have taken a cautious stance in dealmaking and prioritized high-quality companies that have historically shown a path to success.

Against this backdrop, certain strategies showed more resilience than others:

- Buyouts fared better than Venture Capital. Since the second quarter of this year, Buyout strategies' exits and dealmaking have started to recover from the lows of past two years. As shown in Chart 1, deal and exit values have increased by 24% and 14%, respectively, over the first three quarters of the year relative to the same period last year. Although slightly lower this year, fundraising within the Buyout strategy also continued the momentum of the past three years. Conversely, Venture Capital strategies remained in a downtrend (Chart 1) under the pressure of high rates, price volatility of public technology companies, and geopolitical uncertainties. This downtrend in dealmaking and exits for Venture Capital has further spilled over to assets under management and fund returns (Chart 2) due to markdowns in valuations.

Chart 1. Buyout has shown signs of recovery while Venture Capital has continued its downtrend



Sources: Wells Fargo Investment Institute and Pitchbook. Data as of September 30, 2024. Percent change is calculated by comparing the first three quarters of 2024 with the same period of 2023. Buyout = Burgiss Global Buyout Funds Index. Venture Capital = Burgiss Global Venture Capital Funds Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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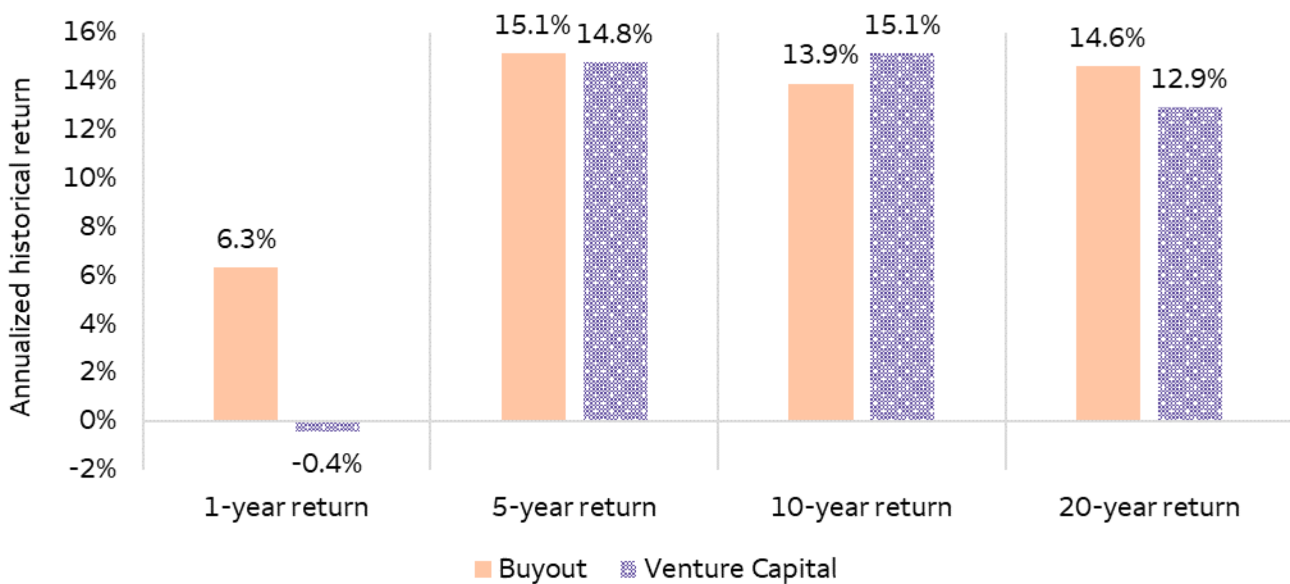
- Small- and Mid-Cap Buyout and Growth Equity deals continued to be pivotal in maintaining the momentum in Private Equity. Small- and Mid-Cap Buyout deals typically require smaller capital outlays, thus making the debt financing more accessible. Further, middle-market companies, often targets of Small- and Mid-Cap Buyouts, can offer more favorable valuations than larger counterparts. Therefore, these smaller deals have provided a pathway for acquirers to strategically deploy capital in the current challenging environment while pursuing growth and consolidation. Similarly, Growth Equity gained traction owing to smaller capital commitments with little debt financing required while focusing on companies with proven a business model. Both strategies showed more resilient returns than other Private Equity strategies in recent periods.

Although Private Equity may not be the standout performer currently, we believe the strategy offers the potential for asset appreciation over the long term. As shown in Chart 2, the Private Equity strategy indexes, including both Buyout and Venture Capital, have generated double-digit long-term annualized returns. Further, we think the situation for Private Equity will improve as the Fed has indicated an easing cycle and given our expectation for the economy and public markets to shift to recovery and growth next year.

Within Private Equity, the resilience in secondaries, Small- and Mid-Cap Buyout, and Growth Equity strategies continue to impress us. We also see a multiyear trend developing for artificial-intelligence related investing in private equities, with the potential growth in dealmaking and fundraising outstripping many other areas within Private Equity.

Chart 2. Buyout and Venture Capital strategies have generated double-digit returns over the long term



Sources: Wells Fargo Investment Institute and Burgiss. Data as of June 30, 2024. Returns are based on Burgiss Global Buyout Funds Index and Burgiss Global Venture Capital Funds Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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

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Equities

Sameer Samana, CFA
Senior Global Market Strategist

Chinese equities running ahead of reality

From September 9, 2024 through October 7, 2024, the MSCI China Index rallied close to 40% due to a raft of economic and policy announcements. These announcements have led investors to speculate that a true turn has finally taken place in the Chinese economy, which has been mired in a property crisis that has dampened consumer and business sentiment. Our belief is that this is another false dawn due to the amount of time it will likely take for consumers to rebuild their property-hampered balance sheets, a declining population, continued regulatory uncertainty, high levels of government debt, and a rise in global trade protectionism.

The upcoming elections could also be a negative catalyst as both parties favor a tough stance on China, and higher tariffs and tougher technology-transfer rules might be one of the first initiatives of a new administration. For these reasons, we would encourage investors to take advantage of the recent bounce to trim exposure to China and Emerging Market Equities, where we remain unfavorable. We think investors should instead look to U.S. Large Cap Equities and the Energy, Communication Services, Financials, Industrials, and Materials sectors for potential opportunities amidst any election-related volatility.

The chart below suggests that the MSCI China Index (76.31) remains in an uptrend but is incredibly overbought. On pullbacks, it should find support at the 50-day moving average (58.85), followed by the 200-day moving average (57.05). Resistance on the way up will likely be found at the mid-2022 to early-2023 high (76).

Chinese equities look stretched

Sources: Bloomberg and Wells Fargo Investment Institute. Daily data from October 7, 2021, through October 7, 2024. MXCN = MSCI China Index. SMAVG (50) = 50-day simple moving average. SMAVG (200) = 200-day simple moving average. RSI = relative strength index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Fixed Income

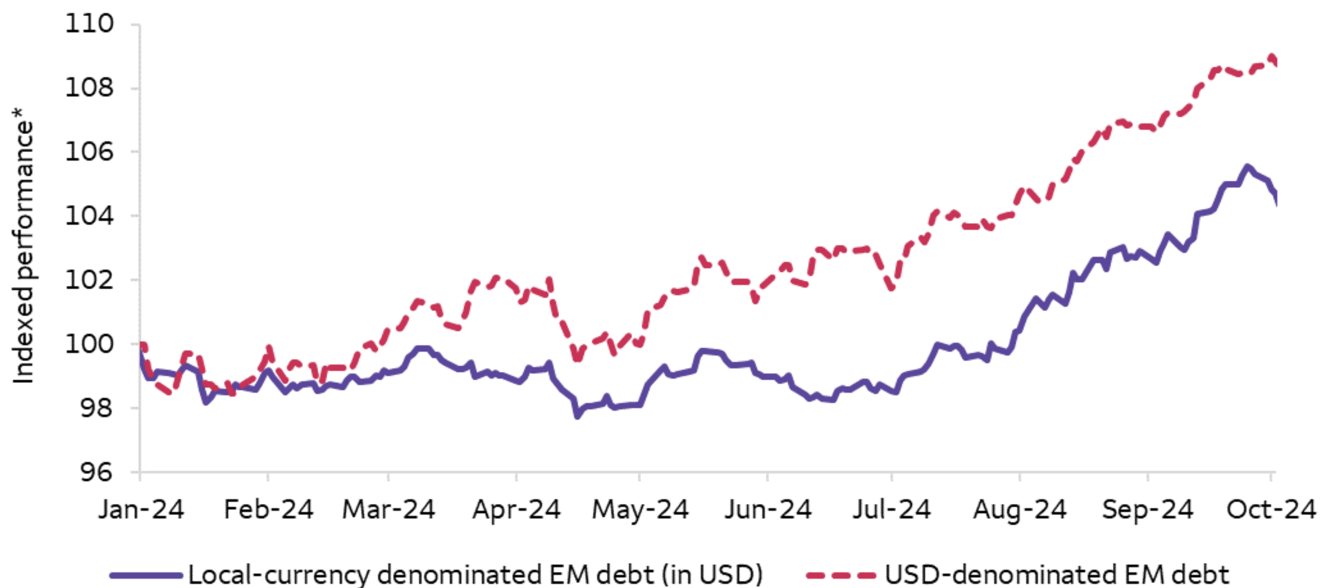
Luis Alvarado
Global Fixed Income Strategist

Emerging-market debt supported by the Fed's pivot

Our expectation for Emerging Market (EM) Fixed Income to perform well in 2024 has been confirmed so far given positive year-to-date returns as of October 7. Local-currency denominated EM government debt has gained 4.03% (in dollar terms) while U.S.-dollar-denominated EM sovereign debt has delivered a total return of 7.2% (see chart below). Granted, most of the gains were accomplished during the third quarter due to the Fed's pivot and start of a new interest-rate cutting cycle along with a weakening U.S. dollar relative to key EM currencies. Also, active Chinese leadership measures to counter the country's economic slowdown have served as a tailwind for EM Fixed Income.

We believe that this rally has more room to run given our base case for a sustained U.S. economic soft landing coupled with further interest-rate cuts from the Fed. However, some gains could be pared back in the near term due to U.S. elections risks or in the event that market expectations for further rate cuts diminish. In addition, valuations may not be as attractive given that EM debt yields have fallen from yearly highs of 9.6% in October 2023 to near 7.6% today, and spreads over U.S. Treasury yields have declined from 384 basis points (100 basis points equals 1%) to near 312 today. However, in our view, the broader U.S. macro story along with the decline in EM inflation and some easing from EM central banks will remain the key drivers.

EM Fixed Income has displayed positive returns year to date



Sources: Bloomberg, JPMorgan, and Wells Fargo Investment Institute. Data as October 7, 2024. *Performance indexed to 100 as of December 31, 2023. USD = U.S. dollar. EM local-currency bond returns are represented by the JPMorgan Government Bond Index-Emerging Markets (Global) Index (GBI-EM). USD-denominated bond returns are represented by the JPMorgan Emerging Markets Bond Index Global (EMBIG). An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Real Assets

Mason Mendez
Investment Strategy Analyst

John LaForge
Head of Real Asset Strategy

Expect slower oil-production growth in 2025

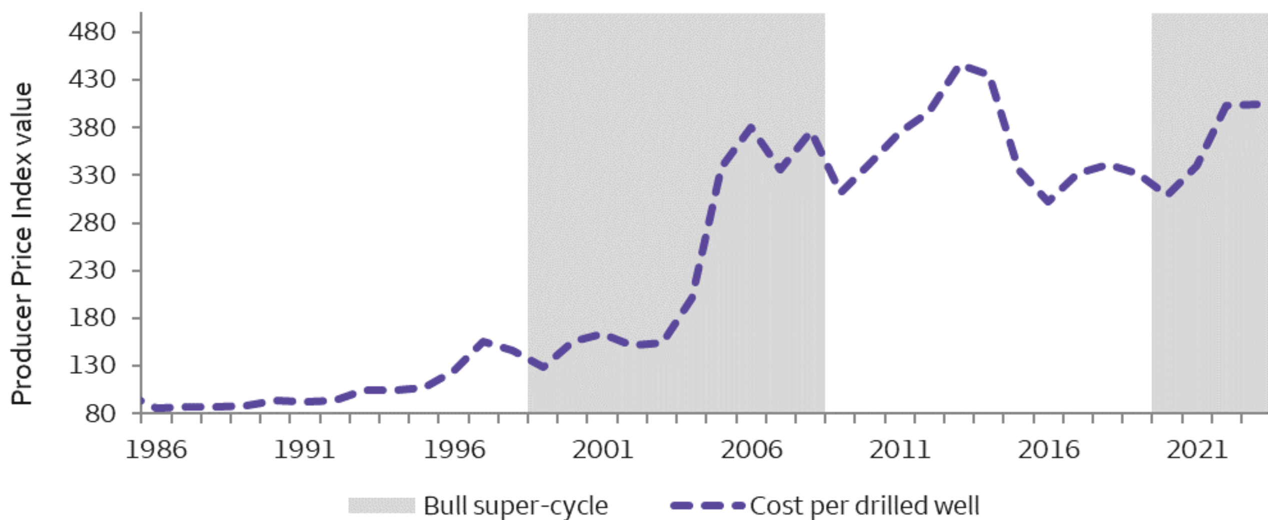
2024 has been a pretty volatile year for oil prices. The price of Brent, as an example, has been as high as $91 per barrel (April) and as low as $69 per barrel (September). A $22 spread between the high and low is quite large, even for oil, which is known to be volatile. We find it interesting, though, that oil prices today are roughly where they were at the start of the year despite the extra volatility. As one investor put it to us, "Oil has put a lot of hard work into going nowhere."

The reason oil prices have essentially gone nowhere, we believe, is that investors have been torn between concerns over a slowing global economy and slowing global oil-supply growth. We suspect that the winner of this tug of war will emerge soon, and we believe it will be slowing global oil-supply growth, which would result in higher prices in 2025.

On the global economic front, it has become clear to us that global central banks have embarked on a new monetary easing cycle, which should eventually boost economic growth. While the number and magnitude of future interest-rate cuts can be deliberated at length, our perspective is that a new global liquidity cycle has started. Commodities, especially economically sensitive ones like oil, have classically performed well when global liquidity has been rising.

On the global supply-growth side, we do not see supply growth rising anytime soon. In fact, supply growth seems more likely to fall in 2025, not rise. Most oil-producing countries continue to struggle to produce more oil each year. And those that do, like the U.S., face persistently rising costs (see chart below). According to a recent study by the Dallas Federal Reserve, the average breakeven cost to drill a new well is now roughly $65, up 6% from 2023. With the price of West Texas Intermediate at $72 today, barely above breakeven costs, the incentive to increase drilling is not evident. The bottom line is that we are expecting to see higher oil prices in 2025 as the global economy picks up while global oil supply growth remains hampered by high costs.

Cost per drilled well in the U.S.



Sources: Bureau of Labor Statistics and Wells Fargo Investment Institute. Annual data is from 1986 – 2023. Bull super-cycles spanned from 1999 – 2008 and 2020 – Current. Note: If you look at commodity prices over the very long term (hundreds of years), it becomes evident that they tend to move in overall bull and bear cycles, some lasting decades. These are super-cycles. **Past performance is no guarantee of future results.**

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Tactical guidance*

Cash Alternatives and Fixed Income

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

Equities

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

Real Assets

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
		Private Real Estate	Commodities	

Alternative Investments**

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
		Hedge Funds—Event Driven Hedge Funds—Equity Hedge Private Equity Private Debt	Hedge Funds—Relative Value Hedge Funds—Macro	

Source: Wells Fargo Investment Institute, October 14, 2024.

*Tactical horizon is 6-18 months

**Alternative investments are not appropriate for all investors. They are speculative and involve a high degree of risk that is appropriate only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. Please see end of report for important definitions and disclosures.

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Risk considerations

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.

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

Burgiss Global Buyout Funds Index includes over 2600 closed-end private buyout funds, totaling close to $3,700 billion assets.

Burgiss Global Venture Capital Funds Index includes over 3500 closed-end private buyout funds, totaling close to $1,100 billion assets.

JPMorgan Emerging Markets Bond Index Global (EMBIG) covers 27 emerging market countries. Included in the EMBIG are U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

JPMorgan Government Bond Index-Emerging Markets (Global) Index (GBI-EM) is a comprehensive global local emerging markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure.

MSCI China Index captures large and mid-cap representation across China H shares, B shares, Red Chips and P Chips. With 140 constituents, the index covers about 85% of the China equity universe.

An index is unmanaged and not available for direct investment.

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