

Investment Strategy

Weekly guidance from our Investment Strategy Committee August 5, 2024

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- Despite the similarities between today’s market and that of the late 1990s, we believe today’s leaders consist of higher-quality companies with strong balance sheets. However, we would also note that macro and geopolitical conditions were more favorable in the U.S. 30 years ago.
- There is also growing concern that the current build-out phase of artificial intelligence could slow down quickly as end-user companies become more cost conscious and start demanding concrete results. Ultimately, we continue to favor U.S. over international stocks and large-cap over small-cap equities.

Equities: Power demand is back — At least for now 4

- After years of very low growth, U.S. power demand is expected to pick up over the next decade.
- Realization of that expected growth would be a nice tailwind for the Utilities sector, but in our view, risks remain.

Fixed Income: Low-coupon bonds may provide attractive total return..... 5

- Bonds with lower coupons will typically see greater price appreciation as yields drop.
- Lower-coupon bonds can be found in high-quality issuers and mortgage-backed securities.

Real Assets: Chinese gold ETF holdings up 92% since 2023..... 6

- Chinese gold exchange-traded funds’ holdings have continued to rise to record highs, indicating strong demand from Chinese investors.
- We suspect that ongoing weakness in China’s economy as well as underperformance among Chinese equities and bonds will continue to push investors toward gold.

Alternatives: Industrial real estate is weathering a deceleration 7

- Industrial real estate is experiencing a notable deceleration due to a combination of overbuilding and weakening demand issues.
- Although we see constructive tailwinds for industrial real estate over the long term, we believe qualified investors should avoid concentration and instead use diversification to navigate the current situation.

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

Asset Allocation Spotlight

Douglas Beath

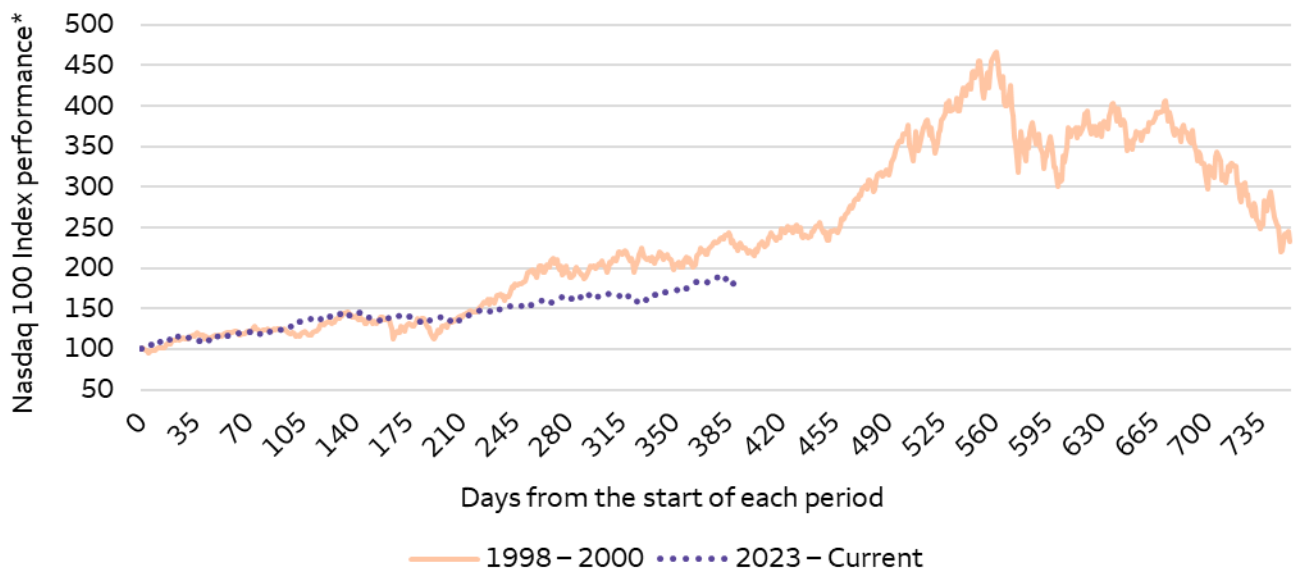
Investment Strategy Analyst

Comparing the dot-com bubble with today’s market

Since the recent bull market commenced in the third quarter of 2022, the focus has been on the massive run-up in technology stocks led by a select group of companies closely tied to artificial intelligence (AI).

One potential approach to estimate how long the boom in AI stocks will last is to compare the tech-heavy Nasdaq Index’s current bull-cycle performance with that of the late 1990s. As shown in Chart 1, one could conclude that the dominance of U.S. large-cap growth stocks is still in the early phases with a few more years to go.

Chart 1. Nasdaq 100 Index performance, 1998 – 2000 versus 2023 – present day



Sources: Bloomberg, daily data January 1, 1998 through December 31 2000 and Jan 1, 2023 through July 29, 2024. *Performance indexed to 100 as of the start of each period. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

But, of course, market performance cannot be predicted with the juxtaposition of one historical period with the present-day period. There are both similarities and important differences between the late 1990s tech bubble and the current market euphoria for stocks benefiting from AI. Key examples include:

- **Role of transformative technologies:** The development of the internet 30 years ago and the future potential of AI today to increase efficiencies for businesses.
- **Performance:** Significant outperformance of U.S. large-cap growth stocks, particularly a handful of tech stocks associated with the internet (1995 – 2000) and AI (2023 – present)
- **Valuations:** The cyclically adjusted price/earnings (P/E)¹ multiples on record for the S&P 500 Index, with the dot-com bubble episode exceeded today’s market valuation by a multiple of 44x – 35x (based on trailing-12-months earnings)

1. The cyclically adjusted PE ration (CAPE) uses the trailing 10-year moving average of real earnings on the S&P 500.
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- As of June 2024, the next-twelve-months (NTM) P/E of the 50 largest companies in the S&P 500 Index averaged 24.8x, versus 45.3x in March 2000
- **Concentration:** Based on the top-five and top-ten stocks as a percent of the S&P 500 Index's weight, year-end 1999 registered 17% and 27%, respectively, versus the latest reading of 30% and 39%

Most importantly, today's market leaders consist of higher-quality companies with strong balance sheets compared to the late 1990s. To be sure, the late 1990s and early 2000s offered many blue-chip companies as well, but the period had significantly more loss-making companies — particularly in the IPO market.

Rising skepticism of AI

There is growing concern that the current build-out phase of AI could slow down quickly as end-user companies become more cost conscious and start demanding concrete results. Indeed, some analysts have highlighted the dichotomy between Wall Street estimates for AI-related capital expenditures and the additional revenues that these investments are supposed to help generate.

The recent sell-off of tech stocks sparked by disappointing earnings from two leading technology companies highlights another concern for investors — the elevated bar for mega-cap tech companies and the fact that they must exceed earnings estimates, not just meet expectations.

Contrasting macroeconomic environments

While most investors compare today's stock-market environment with the dot-com bubble in terms of duration, valuation, concentration, and corporate balance sheets, less focus has been placed on the differing macro and geopolitical conditions between the two periods, which we believe were more favorable in the U.S. 30 years ago. Consider the following characteristics of the prior period:

- Real GDP growth averaged around 4%
- Inflation was modest despite above-average growth, with Consumer Price Index (CPI) inflation dropping below 2% from 1997 – 1998.
- Budget deficits were transitioning to surpluses.
- Demographics were more favorable, with peak employment for baby boomers.
- Federal Reserve (Fed) policy was easing in response to the Asian financial crisis of 1997 – 1998.
- Productivity averaged 2.4% over the five years leading up to the first quarter of 2000.
- Geopolitically, the Cold War ended with the opening of China's economy and the North American Free Trade Agreement.

What it means for investors

The current equity market environment has many similarities but is not analogous to the late 1990s dot-com bubble. Valuations are high but less extreme, but more importantly, today's leaders have real businesses with pristine balance sheets that are benefiting from a potentially transformative technology. At the same time, today's late-cycle conditions are less favorable — this leaves stocks susceptible to a pullback, particularly in a highly concentrated market with businesses now demanding more bottom-line results from AI. Ultimately, we continue to favor U.S. over international stocks and large-cap over small-cap equities. Meanwhile, we are keeping a close eye on market volatility for potential opportunities.

Equities

Joe Buffa

Equity Sector Analyst

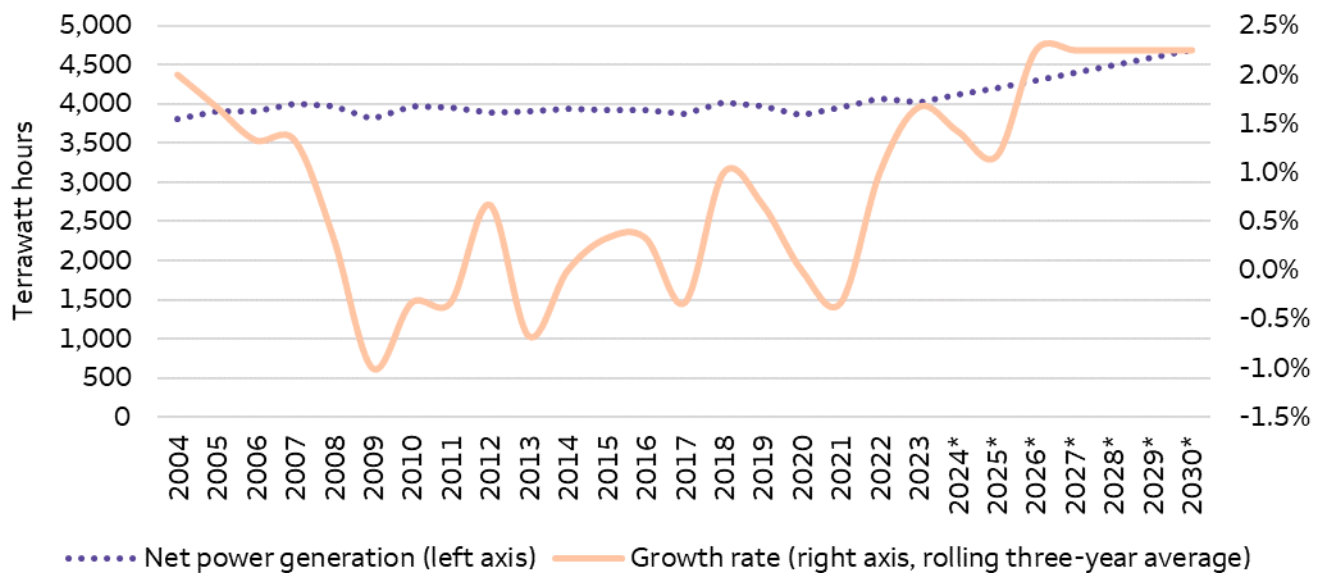
Power demand is back — At least for now

Power generation in the U.S. has been stagnant since the mid-2000s. Over the next decade, however, power-hungry data centers are expected to push demand higher, resulting in a step increase in overall power demand. This is broadly positive for the Utilities sector, and we expect at least some benefits for utilities companies. Our enthusiasm is tempered, however, by the still-uncertain durability of demand, and we continue to see more appealing investment opportunities in other sectors.

The chart below shows U.S. power demand since 2004, which has been flat at about 4,000 terawatt hours. Growth over that time bounced around 0% with an overall compound annual growth rate of less than 0.5%. Industry estimates suggest that annual demand growth through 2030 will increase to the 2.0% – 2.5% range, a sizable jump compared to the prior two decades. Much of this demand is expected to come from power-hungry generative AI data centers. Given current spending by the tech giants building and planning these data centers, we are confident in at least a near-term bump to power demand and utility capital-spending plans. We remain somewhat skeptical, though, of the durability of that demand given the still-uncertain monetization potential of generative AI.

Fortunately, utilities and their regulators have been designing and implementing rate tariffs that protect other customer classes and, indirectly, owners from potentially being stuck with the cost of the infrastructure and power generation being deployed to serve these data centers. So even if generative AI data-center demand peters out in the not-too-distant future, utility owners should still benefit from the near-term buildout to bring the data centers online.

Relatively significant uptick in U.S. power generation and growth expected



Sources: Energy Information Administration and Wells Fargo Investment Institute. Data from January 1, 2004, through July 23, 2024. *Estimated, reflects Wells Fargo Investment Institute estimates as of July 20, 2024. Forecasts and estimates are based on certain assumptions and on our views of market and economic conditions which are subject to change.

Fixed Income

David Brandmire, CFA

Taxable Analyst

Low-coupon bonds may provide attractive total return

As inflation cools and the Fed considers moving its policy rate lower, we expect lower-coupon fixed income securities to outperform higher coupon securities. Bonds with lower coupon rates will typically see greater price appreciation as yields drop. These lower coupon bonds can typically be found in high-quality issuers and highly rated mortgage-backed securities. High coupon bonds typically price higher than lower coupon bonds if they have similar risks (in terms of quality, redemption, and liquidity).

We illustrate examples of five-year and ten-year corporate bond price changes in the tables below. The illustration reflects how price changes from May to July impacted returns. Based on market expectations for the end of the year, we expect additional returns from bond price improvements of 40 to 50 basis points (100 basis points equals 1%).

Five-year corporate bonds — Estimated price impact of changes in yields

	May	July	Dec	Price return May – July	Price return July – Dec	Price return May – Dec
5-year corporate bond yield	5.51%	5.17%	4.92%	-	-	-
3.00% coupon, 7/23/2029	\$88.82	\$90.51	\$92.17	1.91%	1.83%	3.77%
4.00% coupon, 7/23/2029	\$93.27	\$94.89	\$96.26	1.74%	1.44%	3.20%

Ten-year corporate bonds — Estimated price impact of changes in yields

	May	July	Dec	Price return May – July	Price return July – Dec	Price return May – Dec
10-year corporate bond yield	5.80%	5.54%	5.29%	-	-	-
4.00% coupon, 7/23/2034	\$86.27	\$88.25	\$90.35	2.29%	2.39%	4.73%
6.00% coupon, 7/23/2034	\$101.52	\$103.52	\$105.32	1.97%	1.74%	3.74%

Sources: Bloomberg and Wells Fargo Investment Institute. Data as of July 23, 2024.

We have favorable guidance on U.S. Taxable Investment Grade Fixed Income and Residential Mortgage-Backed Securities. Regardless of the number and timing of rate cuts, we believe investors can take advantage of price appreciation by including low-coupon bonds in a diversified portfolio.

Real Assets

Mason Mendez

Investment Strategy Analyst

John LaForge

Head of Real Asset Strategy

Chinese gold ETF holdings up 92% since 2023

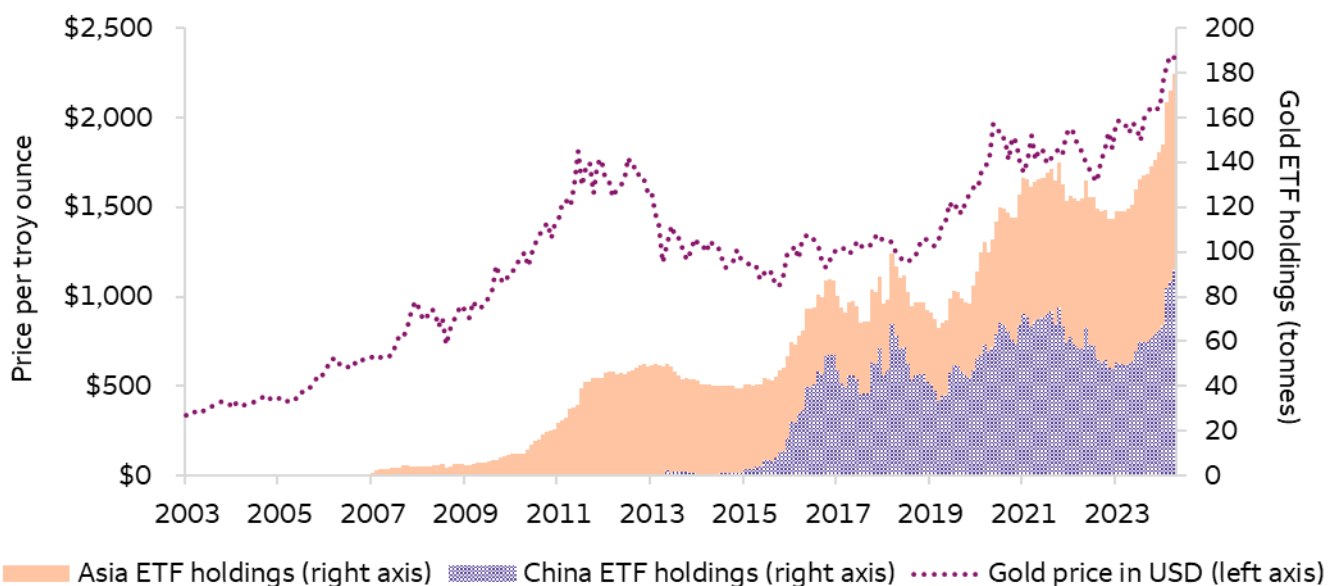
Gold prices have rallied 15% year to date through July 29, driven by strong purchasing activity from emerging-market central banks and heightened geopolitical tensions. However, a lesser-discussed driver of the recent rally has been Chinese investors, who are turning toward perceived safe-haven assets amid economic weakness stemming from a faltering property sector.

As shown in the chart below, Asian gold exchange-traded funds' (ETFs') holdings have grown 56% since January 2023, which has corresponded with a 23% return on gold over the same period. In China specifically, the growth has been even more impressive, with gold ETFs' holdings increasing 92% since January 2023.

In our view, such impressive growth of Chinese gold ETFs' holdings highlights the growing demand for gold and other perceived safe-haven assets. We suspect that Chinese investors are turning to gold as economic struggles from the country's faltering property sector have strained the consumer and hindered potential investment opportunities. Year to date, gold has outperformed both Chinese equities (Shanghai Composite Index) and Chinese bonds (Bloomberg China Aggregate Bond Index). We believe gold has benefited from this weakness found elsewhere in China's financial markets, ultimately making it a more attractive investment.

The bottom line is that we expect Chinese investors to continue driving growth in gold demand as they look for protection against economic weakness along with returns that are lacking elsewhere in their financial markets. We therefore remain favorable on Precious Metals and believe prices will continue to rise through 2025 to our year-end target of \$2,400 – \$2,500 per troy ounce.

Growth in Chinese and Asian gold ETFs' holdings has corresponded with rise in prices



Sources: World Gold Council and Wells Fargo Investment Institute. Monthly data is from January 2003 – June 2024. USD = U.S. dollars. **Past performance is no guarantee of future results.**

Alternatives

Chao Ma, PhD, CFA, FRM

Global Portfolio and Investment Strategist

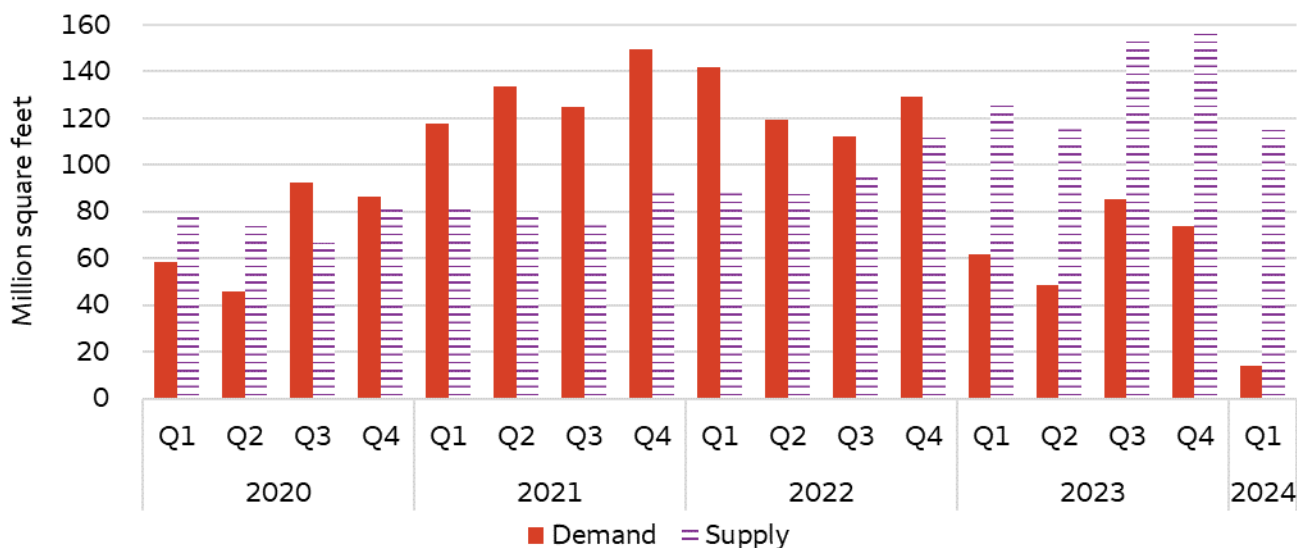
Industrial real estate is weathering a deceleration

After two years of remarkable rent growth, industrial real estate experienced a notable deceleration in operating fundamentals starting in 2023. This slowdown has continued so far this year as tenants, including both traditional and e-commerce retailers, prioritized cost management amid an uncertain macroeconomic environment and weakening consumer spending. On top of this, supply-chain disruptions during the coronavirus pandemic have also left many retailers with excess warehouse capacity, further reducing their appetite for new leases. Coincidentally, industrial real estate’s strong performance in recent years spurred a record-high level of new developments, as shown in the chart below. These three factors have contributed to weakening pricing power for landlords and a rising property-vacancy rate. As a result, we believe market fundamentals for industrial real estate will continue to soften over the coming quarters until new-supply completion falls off.

Over the longer term, though, we continue to see structural tailwinds for industrial real estate. The group may continue to benefit from the growth of e-commerce as e-commerce businesses typically require more warehouse space relative to traditional brick-and-mortar stores. Further, according to Green Street, over \$400 billion in business investments have been announced so far in support of U.S. onshoring efforts across the semiconductor, electric-vehicle, and clean-energy industries. We believe these investments have the potential to drive higher demand for industrial real estate over the coming decade.

Given the significant price growth in recent years, industrial real estate has become expensive relative to many other areas. This, coupled with the current overbuilding issue, leads us to believe that long-term, qualified investors should develop a diversified private real estate portfolio rather than holding a concentrated position in industrial real estate. Within industrial real estate, we believe that regions with supply barriers, either due to limited land availability or high regulatory hurdles, are likely to be more resilient in navigating the current situation.

Industrial real estate supply overwhelmed demand in recent quarters



Sources: Green Street and Wells Fargo Investment Institute. Data from January 1, 2020 through March 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.

Tactical guidance*

Cash Alternatives and Fixed Income

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

Equities

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
U.S. Small Cap Equities	Emerging Market Equities	U.S. Mid Cap Equities Developed Market Ex-U.S. 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, August 5, 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.

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. In addition to the risks associated with investment in debt securities, investments in **mortgage-backed securities** will be subject to prepayment, extension and call risks. Changes in prepayments may significantly affect yield, average life and expected 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. Investments in **gold** and gold-related investments tend to be more volatile than investments in traditional equity or debt securities. Such investments increase their vulnerability to international economic, monetary and political developments. **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. 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.

Concentration within certain sectors or industries within the economy may present more risks than if a portfolio were broadly diversified over numerous sectors of the economy. This will increase the fund's vulnerability to any single economic, political or regulatory development affecting the sector and may result in greater price volatility.

Exchange Traded Funds seek investment results that, before expenses, generally correspond to the price and yield of a particular index. There is no assurance that the price and yield performance of the index can be fully matched. Exchange Traded Funds are subject to risks similar to those of stocks. Investment returns may fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost.

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

An index is unmanaged and not available for direct investment.

Bloomberg China Aggregate Bond Index tracks the performance of the CNY-denominated fixed income market. It contains fixed rate Treasury, government-related (including policy banks), and corporate securities that are traded in the China Interbank Bond Market

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

NASDAQ 100 Index consists of the 100 biggest companies listed on the NASDAQ Composite Index. The list is updated quarterly and companies on this Index are typically representative of technology-related industries, such as computer hardware and software products, telecommunications, biotechnology and retail/wholesale trade.

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.

Shanghai Stock Exchange Composite Index is a capitalization-weighted index. The index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange.

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