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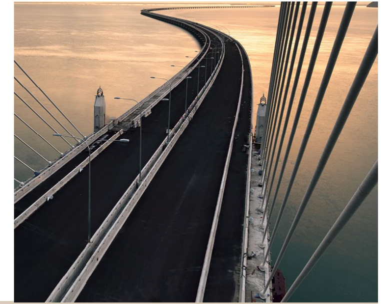

Weekly guidance from our Investment Strategy Committee **January 13, 2025**

Global Economic Spotlight: How exceptional is U.S. exceptionalism? 2

- U.S. exceptionalism — in other words, outperformance by the U.S. economy and asset markets relative to other countries — has been due to inherent strengths at both the company and macroeconomic level.
- Our view is that U.S. exceptionalism will endure due to enduring structural advantages over other major economic centers in Europe and China.

Equities: Health Care tries to break its losing streak in 2025............................ 4

- The Health Care sector has underperformed the S&P 500 Index significantly over the past two years. Several headwinds remain for the sector as we look ahead to 2025.
- On a more positive note, historical and relative valuations for the sector are attractive, and we expect a much more productive merger and acquisition (M&A) environment under the Trump administration. We believe this could help turn the tide for the sector as we move through the year.

Fixed Income: Mixed signals from commercial mortgage loans....................... 5

- Commercial real estate loan delinquencies and charge-offs are at levels not seen since the global financial crisis.
- The performance of commercial real estate loans may be uneven, with certain areas and property types underperforming. This could result in further ratings downgrades for some banks.

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- We believe that President-elect Donald Trump's energy ambitions may have a modestly positive impact on Energy companies, yet the extent and path of change remains highly uncertain.
- We believe that economic forces will remain a more important driver of sector performance and have not adjusted our sub-sector preferences as a result of the new administration.

Alternatives: The middle-market engine continues to roar 7

- Middle-market private equity, also known as small- and mid-cap buyouts, has continued its momentum with transactions growing by 18% in the first three quarters of 2024 over the same period in 2023.
- We remain favorable on this strategy given the breadth of opportunities, resilient fundraising, and accretive performance.

Current tactical guidance 8

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Global Economic Spotlight

Gary Schlossberg
Global Strategist

How exceptional is U.S. exceptionalism?

A bias toward U.S. markets has been one of our more enduring—and successful—portfolio recommendations of the past few years. We explore below some reasons why U.S. economic growth since 2014 has outpaced that of Europe and Japan, and now is converging with China's. Credit some of that strength to more aggressive pandemic-era tax cuts and government spending than elsewhere, which positioned the U.S. economy for a comparatively stronger post-COVID recovery.

Tiered excellence. Strengths at the micro (or company) level and at the economy (or macro) level help explain what's been dubbed U.S. "exceptionalism," or the strong gains by the economy and its asset markets compared to performance abroad.

At the company level, the view among some investors[1] is that U.S. firms have been more innovative, more technology-oriented, and more efficiently run; better at deploying capital; and with a more activist, shareholder-friendly orientation than firms elsewhere in the developed world. Moreover, U.S. firms have operated in a more integrated, efficient market than their European peers. U.S. companies have tended to have less regulation and greater scope for achieving the economies of scale and profit margins needed for a return on invested capital (ROIC), estimated by McKinsey & Co. at four percentage points above the European average.[2] Strengths extend beyond the highly visible tech firms in the U.S. to strong financial and market performance in its non-tech sector. China's dynamic tech sector has been restrained by a quasi-market system with direct and implicit controls that can impair performance compared to the U.S. market.

Even more important are the enduring structural supports for U.S. exceptionalism, contributing to a resilient and flexible economy supported by innovation, immigration, and more proactive economic policies than those abroad.[3] Economic strengths have been fostered by a favorable regulatory environment, ready liquidity in deep and efficient capital markets, and a culture that fosters innovation and entrepreneurship.[4] Financial strengths have been reinforced by the U.S. dollar's enduring role as the key currency in world trade and finance, attracting overseas financing fostering rapid gains in U.S. investment.

Our view has been that China's diminished growth prospects are keyed less to inadequate stimulus and more to gathering structural weaknesses beyond a highly visible deterioration in the country's trade environment. First, the country's property slump has reduced household wealth, borrowing capacity, and spending. Second, China's population decline has aggravated the slowdown in consumer spending and restrained the growth of labor supply. Third, the overhang of local-government debt has restrained borrowing to finance what had been an important source of government stimulus. And fourth, past overinvestment has created a headwind to future capital-spending growth by lowering returns and creating excess capacity in much of the manufacturing sector.

1. Bridgewater, "U.S. exceptionalism: drivers of equity out-performance and what's needed for a repeat," September 17, 2024.
2. McKinsey Global Institute, "Investment: Taking the Pulse of European Competitiveness," June 20, 2024.
3. JP Morgan, "The case for U.S. exceptionalism endures, February 22, 2024.
4. MandG Investments, "Unmasking American exceptionalism," October 16, 2024.

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Can exceptionalism endure? Our view is that U.S. exceptionalism will endure despite temporary headwinds to growth created by diminished post-COVID supports to U.S. job gains, consumer spending, and disinflation, along with policy uncertainties, outsized budget deficits, and elevated interest rates reining in still-ample market liquidity. We believe that deeper structural problems in Europe and China, and a threatened spillover to emerging markets, will overshadow U.S. short-term weaknesses in the foreseeable future. Economic risks tied to expected changes in trade and immigration policies are, to a degree, counterbalanced by prospects for growth-enhancing tax cuts and deregulation. Institutional strengths supporting financial-market liquidity, transparency, and efficiency aren't likely to go away soon. Most importantly, the U.S. appears well-positioned to remain on the leading edge of high-tech innovation and absorption based on its access to risk capital and other financing, its entrepreneurial culture, and other strengths supporting productivity-raising investment and economic-growth potential.

Investment implications. Prospects for enduring U.S. exceptionalism, and a well-positioned tech sector critical to driving it, support a continued tilt toward the U.S. market in the foreseeable future. Moreover, we believe U.S. technology likely will remain a tactical (6- to 18-month) market performer and a strategic (15- to 20-year) outperformer, due to its comparative advantage in the global market ongoing digitalization, and the introduction and integration of artificial intelligence and other innovative technologies. The sector's resulting earnings growth favors a longer-term overweight position in Information Technology, Communication Services, and other, more tech-exposed sectors of the market. For now, we believe increases in international exposure are best achieved through U.S. multinationals in Energy, Materials, and Industrials, consistent with our view of enduring U.S. exceptionalism.

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Equities

Greg Simpson, CFA
Equity Sector Analyst

Health Care tries to break its losing streak in 2025

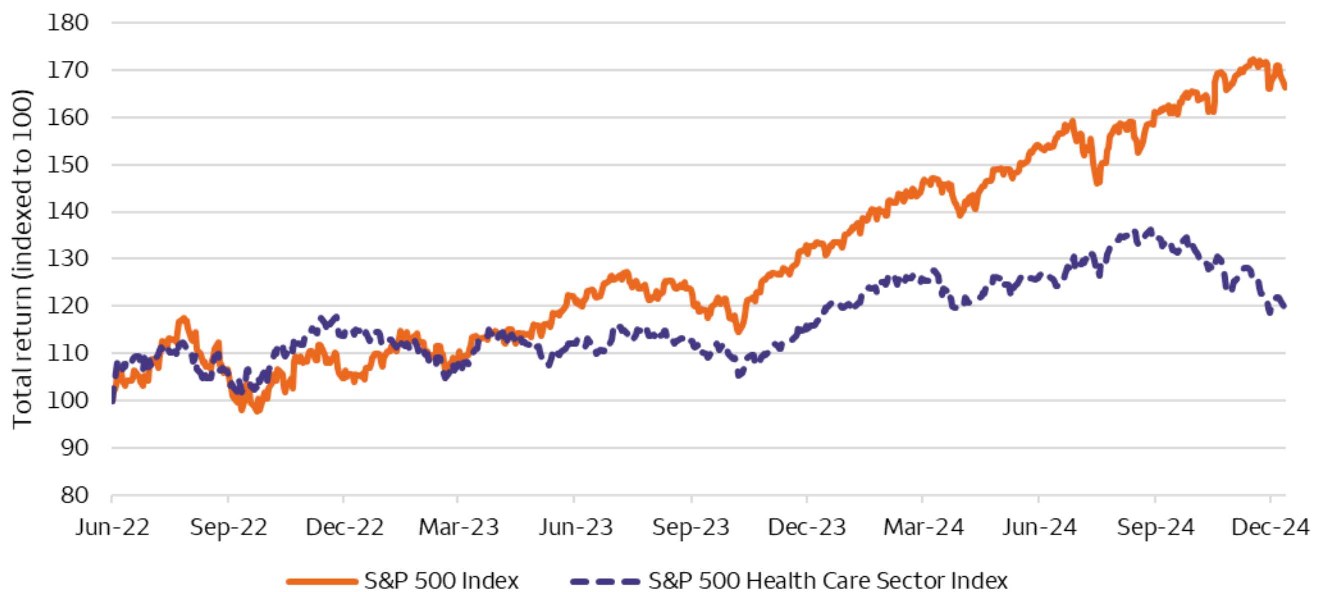
The Health Care sector enters 2025 on the heels of substantial relative underperformance over the past two years. In 2024, the sector gained just 0.9%, far below the 23.3% gain for the S&P 500 Index. Looking ahead, we believe the sector still faces some obvious headwinds as we start the year.

Specifically, we believe the sector is currently dealing with uncertainty related to the potential policies of the Trump administration. We would traditionally view an incoming Republican administration as favorable for the Health Care sector, yet several potential policies discussed by the incoming administration add uncertainty. We believe the nomination of Robert F. Kennedy Jr. as secretary of the Department of Health and Human Services is a near-term headwind and could have meaningful implications for the sector — especially pharmaceutical companies. In addition, the creation of the Department of Government Efficiency could target Medicare and Medicaid for savings, given the percentage of the federal budget represented by health care. Economic weakness and uncertainty in China are also weighing on certain sub-sectors within Health Care. Finally, we believe the growing popularity of GLP-1 drugs for obesity remains a cloud over the sector, reflecting the potential impact on several medical-device markets.

On a more positive note, we believe the sector offers appeal from a historical and relative valuation perspective. In addition, we believe the sector could benefit from a more productive M&A environment under the Trump administration. Despite continued near-term headwinds, we remain constructive on the sector longer term.

Health Care sector's underperforming trend

The chart shows the significant underperformance of the overall Health Care sector relative to the S&P 500 Index over the past two years. The underperformance coincided with the market's focus on artificial intelligence, and the impact on the Health Care sector from the growing popularity of GLP-1 drugs for obesity.



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Sources: FactSet and Wells Fargo Investment Institute. Data as of January 6, 2025. Indexing start date is June 20, 2022, and end date is December 31, 2024. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Fixed Income

David B. Brandmire, CFA
Taxable Analyst

Mixed signals from commercial mortgage loans

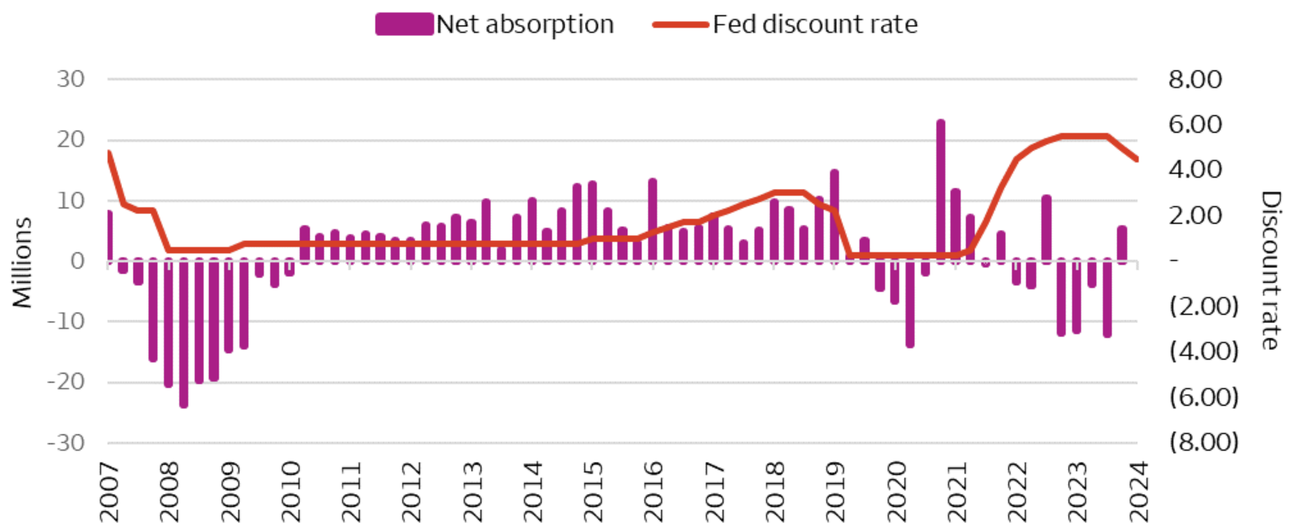
Investors should monitor performance of commercial real estate loans as loan delinquency rates have climbed to levels not seen since the global financial crisis. With banks holding over 50% of the outstanding commercial real estate debt, many investors — especially in community and smaller regional banks — remain concerned about borrowers being able to refinance loans that mature over the next few years. These concerns are driven by the higher interest rate environment, inflation, and higher vacancy rates, which have reduced the net operating income of many commercial properties.

Office vacancy rates have topped 20%, but CBRE (a worldwide commercial real estate services and investment firm) expects prime building vacancy rates to return to the pre-pandemic rate of 8.2% by sometime in 2027.[5] November's office utilization recovery rates were around 62.4%[6] of pre-pandemic levels according to placer.ai. These recovery rates were led by Miami (84.0%) and New York (81.9%), with Chicago (50.7%) and San Francisco (47.9%) lagging.

Net absorption[7] for offices turned positive in the third quarter of 2024. This was only the third quarter that showed a net absorption increase since the Federal Reserve (Fed) hiking cycle started in March 2022.

While we believe some recent data points hint at a recovery for commercial property values, we caution that recovery is expected to be uneven. The rating agencies have taken some actions on banks with higher exposures to commercial real estate loans, and we may see additional downgrades if forecasts are too optimistic, or the recovery is delayed.

U.S. metro office net absorption and Fed discount rate



Sources: Bloomberg, REIS Inc., Federal Reserve, and Wells Fargo Investment Institute. Data as of January 7, 2025.

5. "U.S. Real Estate Market Outlook 2025," CBRE, December 11, 2024.
6. Lila Margalit, "Placer.ai Office Index: November 2024 Recap," Placer.ai Blog, December 11, 2024.
7. Net absorption — leased space that is occupied minus space that was vacated, adjusted for new construction and demolished or converted space.

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Real Assets

Ian Mikkelsen, CFA
Equity Sector Analyst, Energy

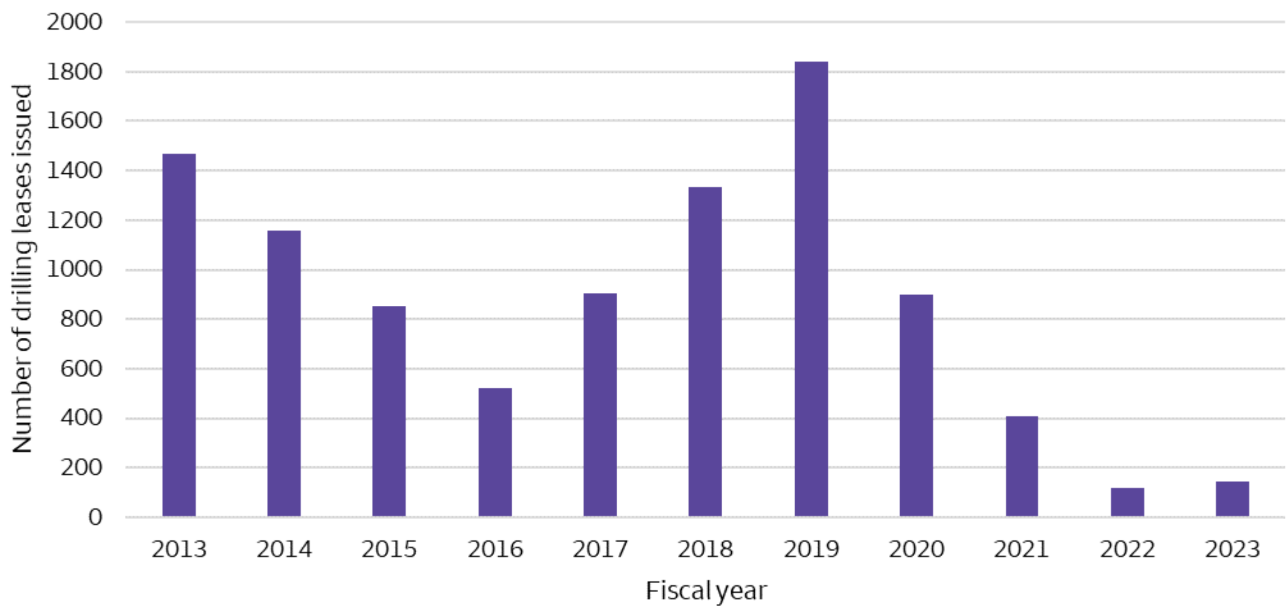
Drill, baby, drill? Unpacking Trump's oil and gas agenda

Trump made a number of promises to voters related to energy during his election campaign under the tagline "drill, baby, drill" — including reducing regulatory barriers, increasing fossil fuel production, and ultimately reducing commodity prices. However, it is important to remember that U.S. energy producers are independent entities with a fiduciary duty to shareholders, and commodity prices are dictated by global markets. Therefore, the decision to increase drilling must be an economic one, not a political one, and we largely expect U.S. producers to maintain capital discipline with limited production growth.

We believe that some deregulation of the oil and gas industry is likely to occur, but the extent of change remains uncertain as the modification process will take time and may compete with other political priorities. Additionally, the Republicans' slim majority in Congress may limit the scope of reform. One area that may be relatively easy to address is the permitting process for drilling on federal land. In 2021, the Biden administration placed greater scrutiny on federal leasing and permitting and increased production royalties, which led to a significant decline in new drilling leases issued (see chart). Streamlining the federal leasing and permitting process would lower the cost of doing business for companies with exposure (roughly 12% of U.S. onshore oil production is on federal land).

Given limited visibility to the scope of change possible under the Trump administration, we are not adjusting our sub-sector preferences within Energy at this time. We continue to recommend Integrated Oil and Midstream Energy companies for investors seeking exposure to the sector.

Number of new federal drilling leases issued per fiscal year



Sources: Bureau of Land Management and Wells Fargo Investment Institute. Data as of October 1, 2023. Fiscal year begins October 1 and ends September 30.

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Alternatives

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

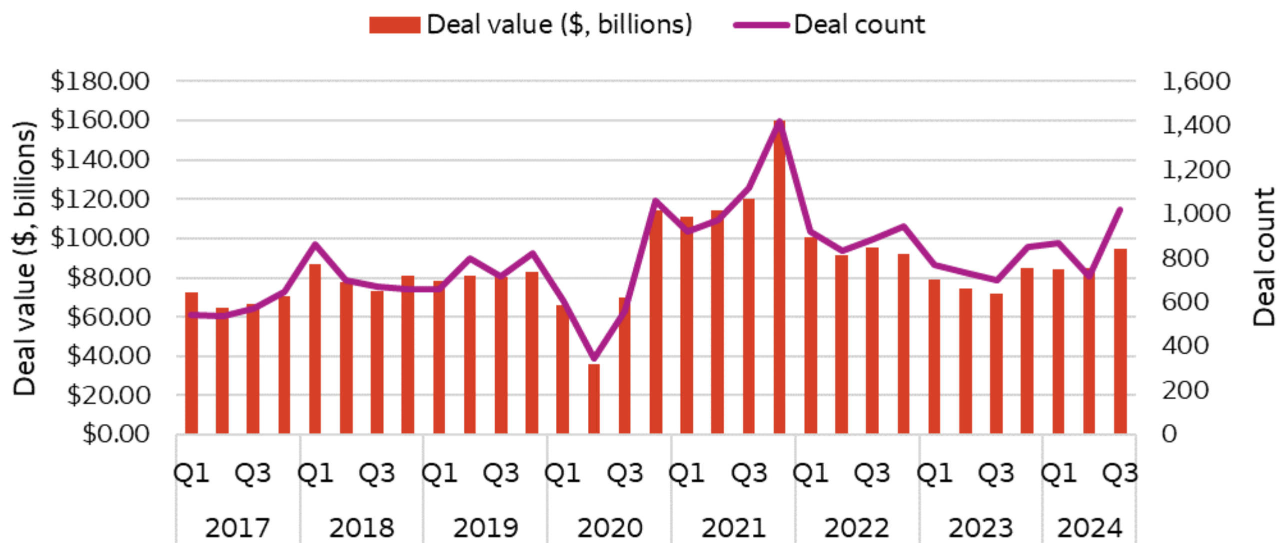
The middle-market engine continues to roar

Private-equity transactions in the middle market[8] continued to accelerate in the third quarter of 2024. As the chart shows, both deal value and count have grown by 18% in the first three quarters over the same period in 2023. This momentum in middle-market private equity is remarkable, especially given that other competing strategies (such as large buyouts) have started to recover as leveraged loan issuance experienced a resurgence in 2024.

We believe the breadth of opportunities in the middle market is an important driver of its resilience. According to the National Center for the Middle Market, there are nearly 200,000 middle-market companies in the U.S. representing one-third of the nation's gross domestic product. As a result, private-equity funds have continued to capitalize on this broad opportunity set. Based on data aggregated by Pitchbook, middle-market fund managers sought to create value through growing existing portfolio companies with bolt-on deals, strategically purchasing non-core assets from other corporations, and acquiring family-owned businesses as founders looked for retirement opportunities or strategic shifts.

The constructive environment and investor sentiment for middle-market investing is also reflected in fundraising and performance. According to Pitchbook, middle-market private equity, also known as small- and mid-cap buyouts, raised over $30 billion a quarter in 2024, a level in line with the past three years. Based on Preqin data, small- and mid-cap buyout strategies also generated more favorable returns than large buyout funds over the past year, three years, and 10 years, ending in the second quarter of 2024. We maintain our favorable view on Small- and Mid-Cap Buyout given the strategy's resilience, robust opportunity set, and lower valuations.

Middle-market private equity transactions continued to increase in 2024



Sources: Pitchbook and Wells Fargo Investment Institute. Data as of second-quarter 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.

8. Middle market is commonly defined as companies generating revenues between $10 million and $1 billion.

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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, January 13, 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

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.

Commercial Mortgage Backed Securities (CMBS) are a type of mortgage-backed security backed by commercial mortgages rather than residential real estate. CMBS tend to be more complex and volatile than residential mortgage-backed securities due to the unique nature of the underlying property assets.

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.

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 Health Care Index comprises those companies included in the S&P 500 that are classified as members of the GICS® health care sector.

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