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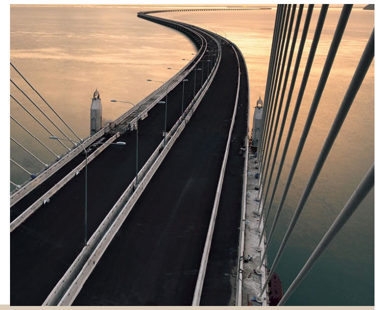
Investment Institute

# Investment Strategy



Weekly guidance from our Investment Strategy Committee — March 17, 2025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- Recent weeks have highlighted the value of diversifying from holding solely U.S. equities.
- We favor diversifying with fixed income and commodities, and with exposure to international asset classes.

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- We believe growth concerns — and the pullback in equity prices — will be transient as the economy proves resilient and earnings growth robust as we expect.
- We tilted more aggressively in portfolios and upgraded U.S. Mid Cap Equities from neutral to favorable as a result.

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- While the upcoming Federal Open Market Committee (FOMC) policy meeting is unlikely to hold any surprises as rates are widely expected to remain unchanged, we will be looking for updates on the pace of the Federal Reserve's (Fed's) balance sheet reduction, given its implications for market volatility.
- Amid economic and policy uncertainty, we see U.S. Intermediate Term Taxable Fixed Income as striking the greater balance between yield generation and price volatility.

## Real Assets: Mixed tariff implications for U.S. steel industry ........ 6

- Domestic steel prices have risen in anticipation of tariffs placed on steel imports, particularly from Canada and Mexico.
- Higher steel prices are a benefit to U.S. producers, but the duration of tariffs and their impact on underlying steel demand drive heightened uncertainty for investors.

## Alternatives: Incorporating hedge funds to navigate volatile markets ...... 7

- The recent market volatility may spotlight the impact of the rising concentration in many equity-centric portfolios as markets are increasingly driven by a few mega-cap technology-oriented companies.
- By adding hedge funds to a portfolio of traditional stocks and bonds, investors may build a more resilient portfolio with the potential to withstand periods of elevated market volatility.

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# Asset Allocation Spotlight

**Jeremy Folsom**
Investment Strategy Analyst

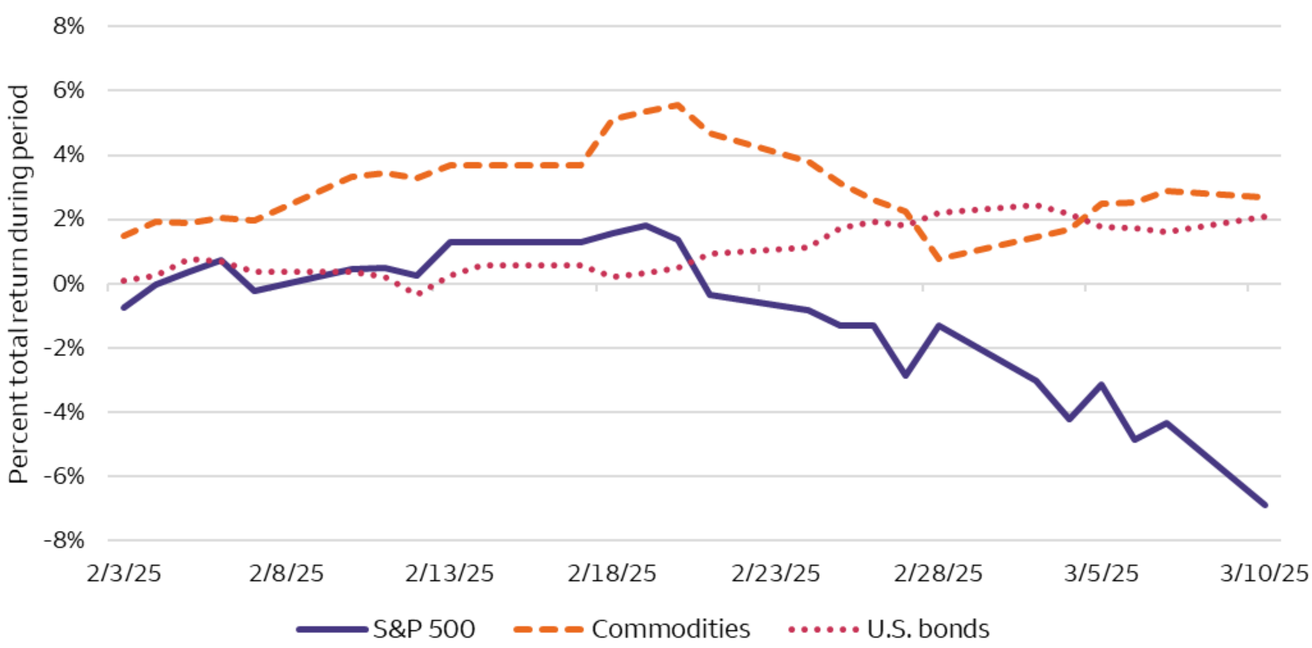
## Recent downturn shows the value of diversification

The past few years, fixed-income total returns were low or even negative as central banks around the world raised rates to fight inflation and low starting yields provided little cushion to price declines. As yields rise, bond prices fall, making them relatively more attractive to new bond buyers, but a drag on performance for existing bond holders. The higher inflation that led to higher yields also caused equity prices to tumble in 2022. That led to higher correlations between fixed income and equities, which made bonds less valuable for diversification than in the decades prior. Even so, we've continued to favor holding an allocation to bonds in portfolios, seeking to take advantage of the now-attractive yields and to serve as a hedge against a potential economic slowdown.

Recent events have highlighted the value that holding fixed income can have as a counterbalance to equities during periods when markets become concerned about growth and near-term correlations decline. Equity markets have pulled back, and investors now again expect multiple rate cuts from the Fed this year, which has produced a decline in yields and price gains for bond holders.

Commodities, which are generally less sensitive to the factors that affect fixed income and equity markets, may also serve as a diversifier. Chart 1 shows the performance since February 3, 2025 for the major asset groups. Strong commodity and fixed-income performance have boosted performance within diversified portfolios during this recent equity drawdown.

**Chart 1. Commodities and U.S. bonds both have positive total returns since February**



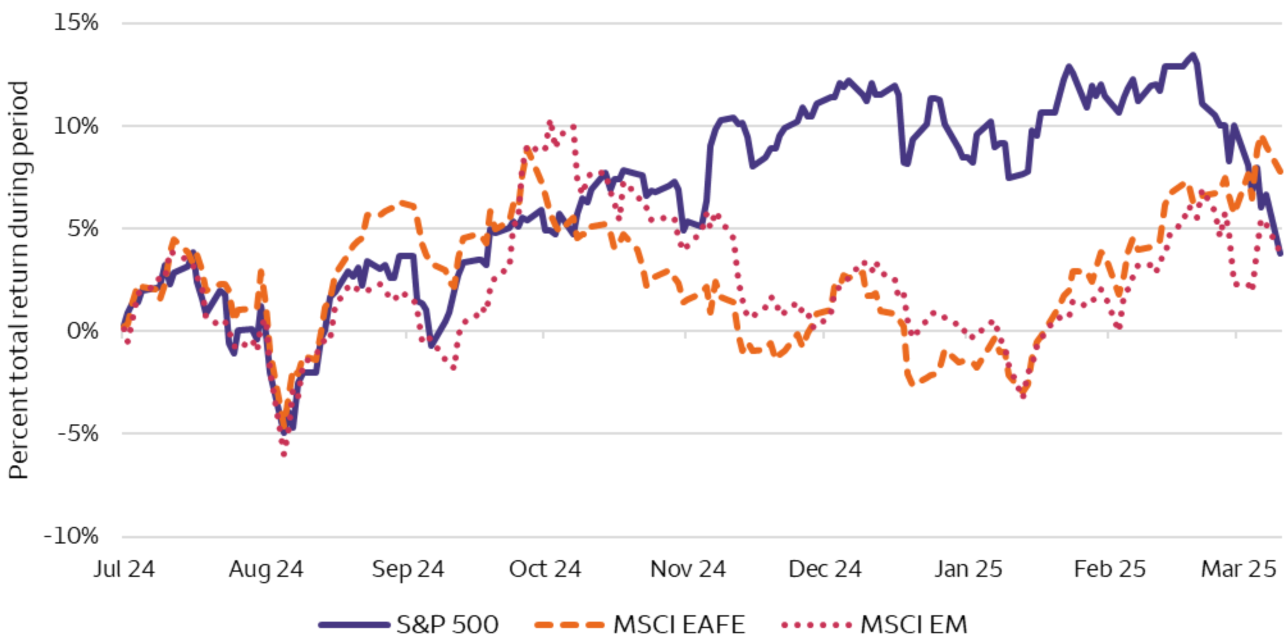

Sources: Bloomberg and Wells Fargo Investment Institute. Daily data from February 3, 2025, through March 10, 2025. Commodities are represented by the Bloomberg Commodity Index. U.S. bonds are represented by the Bloomberg U.S. Aggregate Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

## International diversification

Another important aspect of diversification, in our view, is investing internationally. While U.S. stocks have performed well in recent history, investors who remain concentrated within just a single market may leave their portfolios vulnerable to country-specific risks, such as shifts in political regimes and other idiosyncratic factors. We have encouraged investors to remain invested in developed market (DM) equities, given the attractive valuations, and emerging market (EM) equities, for potential growth. We believe that both can help to provide diversification to portfolios.

Looking back since July 2024, Chart 2 shows how both DM and EM (as measured by the MSCI EAFE Index and the MSCI EM Index, respectively) equities have outperformed the S&P 500 Index. While we still prefer larger allocations to U.S. equity markets, this volatile period highlights the potential value of international diversification in helping to mitigate downside risk. We believe that markets will recover and that moderating the drawdown can both help reduce the amount of time for portfolios to regain value and encourage investors to remain calm and stick to their selected allocations.

**Chart 2. International equities have outperformed since July 2024, though emerging markets only just so**




Sources: Bloomberg and Wells Fargo Investment Institute. Daily data from July 1, 2024, through March 10, 2025. Developed markets are represented by the MSCI EAFE Index . Emerging markets are represented by the MSCI Emerging Markets Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Bringing both asset-class and international diversification together, our strategic allocations have performed relatively well so far this year despite the U.S. equity selloff. The strategic Moderate Growth & Income Liquid [1]allocation has gained 0.4% year-to-date (as of March 10), driven by strong international equity and commodities performance relative to U.S. equities. While periods of market volatility can be stressful for investors, they are also a great reminder of the value that proper allocation selection and diversification can serve.

1. Please see end of report for the allocation composition of Moderate Growth & Income Liquid Allocation.

# Equities

*"How very little can be done under the spirit of fear." — Florence Nightingale*

**Austin Pickle, CFA**
Investment Strategy Analyst

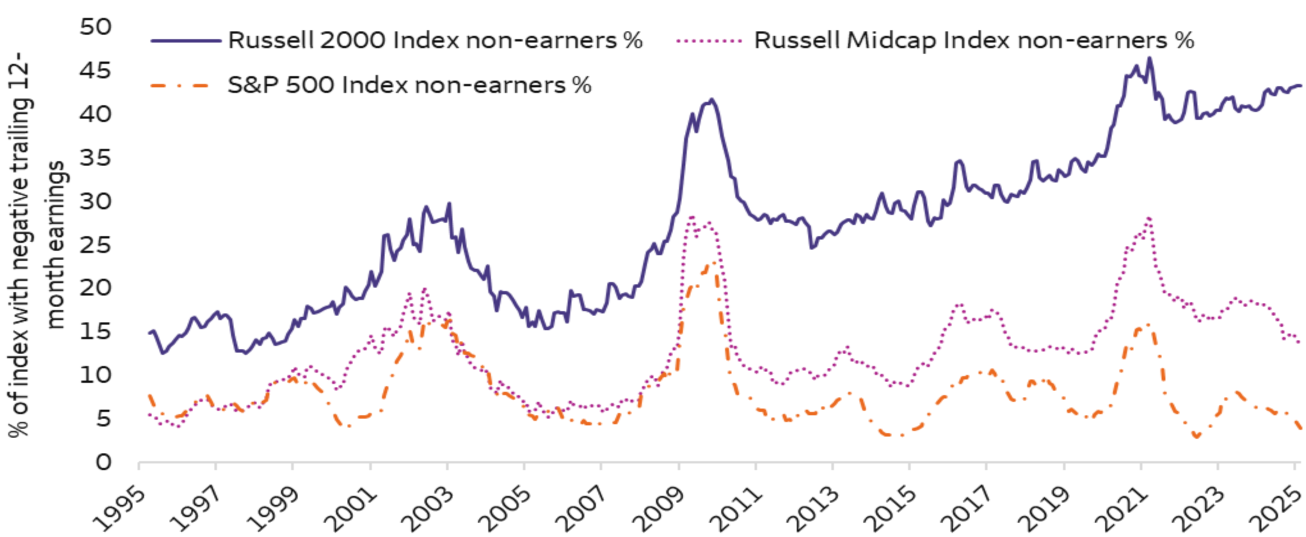
## Volatility — and opportunity — have arrived

We discussed in the January 27, 2025 edition of the Investment Strategy report[2] the inevitability of market volatility and urged investors to be prepared to take advantage of opportunities it can offer. Well, volatility has now arrived, and on March 11, 2025, we capitalized on the opportunity by publishing several guidance changes. We summarize the equity update and rational below.

We believe growth concerns — and the pullback in equity prices — will be transient as the economy proves resilient and earnings growth robust as we expect. Amid this positive outlook, we tilted more aggressively in portfolios and upgraded U.S. Mid Cap Equities from neutral to favorable as a result. U.S. Mid Cap Equities generally offer higher quality than smaller companies and are only a modest step lower in quality versus their larger peers. The group leans more cyclically than U.S. Large Cap Equities, meaning it can be more sensitive to an acceleration in economic growth. We remain neutral on U.S. Small Cap Equities due to some benchmark characteristics that leave us more cautious, namely excessive leverage, a poor earnings track record, and an elevated portion of Russell 2000 Index components with no profits (see chart). U.S. Large Cap Equities continues to be rated favorable as we view it as the highest-quality equity asset class, with strong balance sheets, durable pricing power, and resilient growth potential.

Overall, we believe the latest pullback in equity prices presents investors an opportunity to broaden equity exposure and to favor equities over fixed income. In equities, we retain our preference for U.S. over international and favor U.S. Large Cap and U.S. Mid Cap Equities over U.S. Small Cap Equities (neutral).

**The Russell 2000 Index (our small-cap benchmark) has a non-earner problem**




Sources: Bloomberg and Wells Fargo Investment Institute. Data as of January 31, 1995 – February 28, 2025. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

2. Please see our Investment Strategy report titled "Death, taxes, and... volatility," January 27, 2025.

# Fixed Income

**Brian Rehling, CFA**
Head of Global Fixed Income Strategy

**Amanda Martinez**
Intern, Global Fixed Income team

## What to watch as Fed meeting approaches

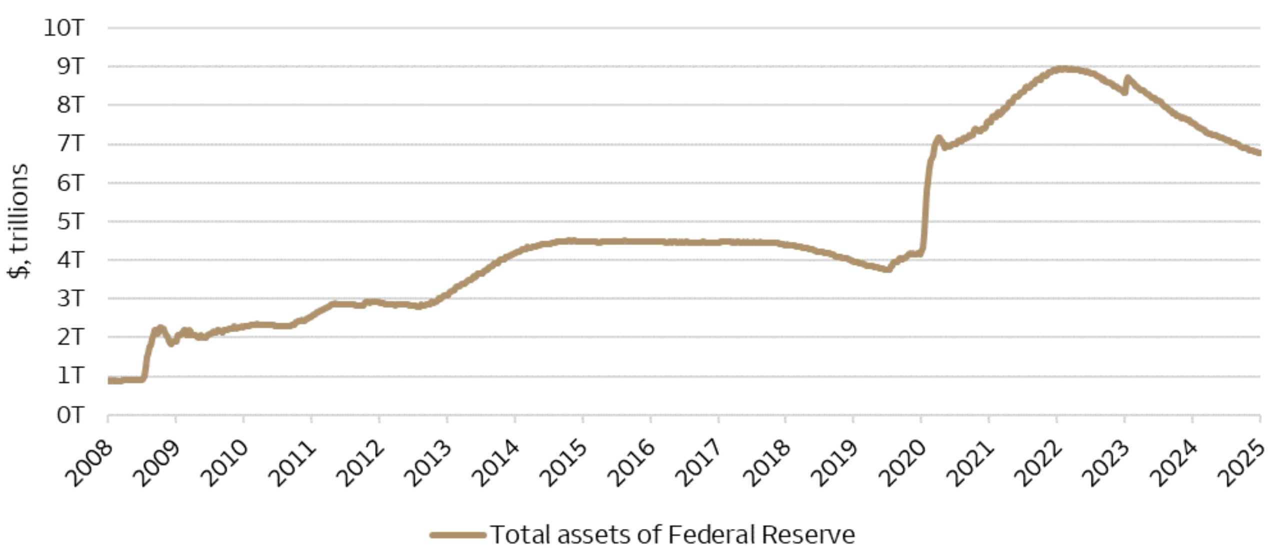
The Fed has been drawing down its balance sheet (known as quantitative tightening) since mid-2022 with the aim of normalizing monetary policy. However, minutes from January's FOMC meeting revealed that the Fed is considering slowing or pausing the pace of quantitative tightening given "the potential for significant swings in reserves over coming months related to debt ceiling dynamics."

The Fed's approach to quantitative tightening in coming months could carry significance for markets. In the event that the debt ceiling is raised, Treasury issuance would likely increase, driving yields higher and returns lower. By pausing quantitative tightening, the Fed would potentially limit market volatility by limiting the amount of Treasury supply that the market would need to absorb.

The chart below provides perspective on the size of the Fed's balance sheet and the magnitude of drawdowns thus far. Since June 1, 2022, when the Fed began the process of quantitative tightening, its balance sheet has come down by $2.2 trillion. While its assets still exceed pre-coronavirus levels by a wide margin and it remains to be seen how much quantitative tightening would bring the Fed's balance sheet to a normalized level, we believe that in the Fed's view we are getting close to what it would consider a normalized balance sheet.

We would view a decision to slow or pause quantitative tightening favorably given its implications in the context of debt-ceiling debates. Economic and policy uncertainty does, however, hold asymmetric risks for longer-term bonds, which mathematically see the largest price impact from a change in yields. Ultimately, we see U.S. Intermediate Term Taxable Fixed Income (five- to seven-year maturities) as striking the greater balance between yield generation and price volatility.

**The Fed's balance sheet has come down significantly since its peak**




Source: Federal Reserve. Data from March 5, 2008, through March 5, 2025.

# Real Assets

**Ian Mikkelsen, CFA**
Equity Sector Analyst

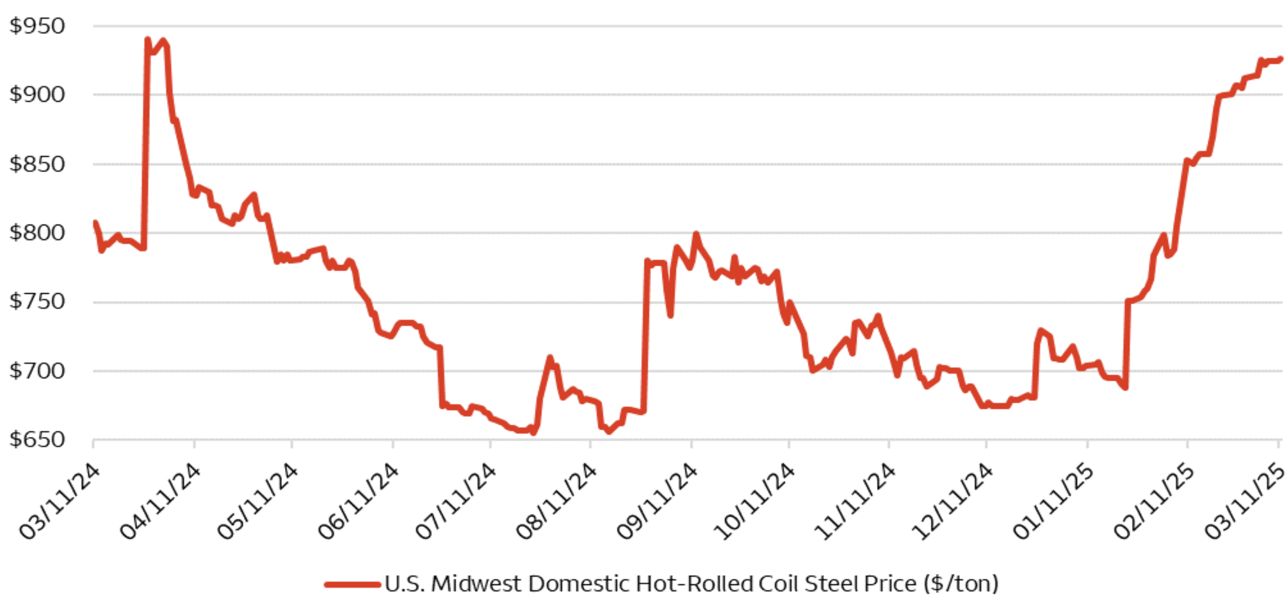
## Mixed tariff implications for U.S. steel industry

President Trump placed blanket 25% tariffs on all steel and aluminum imports on March 12, 2025. Imports from Canada and Mexico are currently exempt from an additional 25% tariff under the United States-Mexico-Canada Agreement (USMCA) but could face a total tariff of 50% if the exemption expires on April 2, 2025, as planned. Canada and Mexico provide 23% and 16% of all U.S. steel imports, respectively.

U.S. steel prices have climbed higher in recent weeks in anticipation of these tariffs. However, we believe that investors are taking a cautious approach toward positioning in U.S. steel companies. The fluid nature of tariff announcements, reciprocal tariffs against the U.S., and related negotiations with trading partners introduces a high degree of uncertainty around the duration of tariffs and their impact. We also note that the U.S. is a net exporter of certain steel products which could be at risk from reciprocal tariffs.

Demand for steel has been relatively soft in recent months due to high interest rates and general macroeconomic uncertainty. The U.S. steel industry has been operating at a capacity utilization rate of around 74%, and there is some concern that higher steel prices could further erode demand.[3] We expect volatility to remain elevated in the near term but remain constructive on high-quality U.S. steel companies from a value perspective. In our view, higher steel prices driven by tariffs could provide a bridge for near-term earnings growth before underlying steel demand growth is eventually driven by lower interest rates or macroeconomic improvement.

**U.S. Midwest domestic hot-rolled coil steel price (dollars per ton)**




Sources: FactSet and Wells Fargo Investment Institute. Data as of March 11, 2025. The U.S. Midwest Domestic Hot-Rolled Coil Steel Price Index is a widely used benchmark for U.S. steel prices. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

3. Source: American Iron and Steel Institute.

# Alternatives

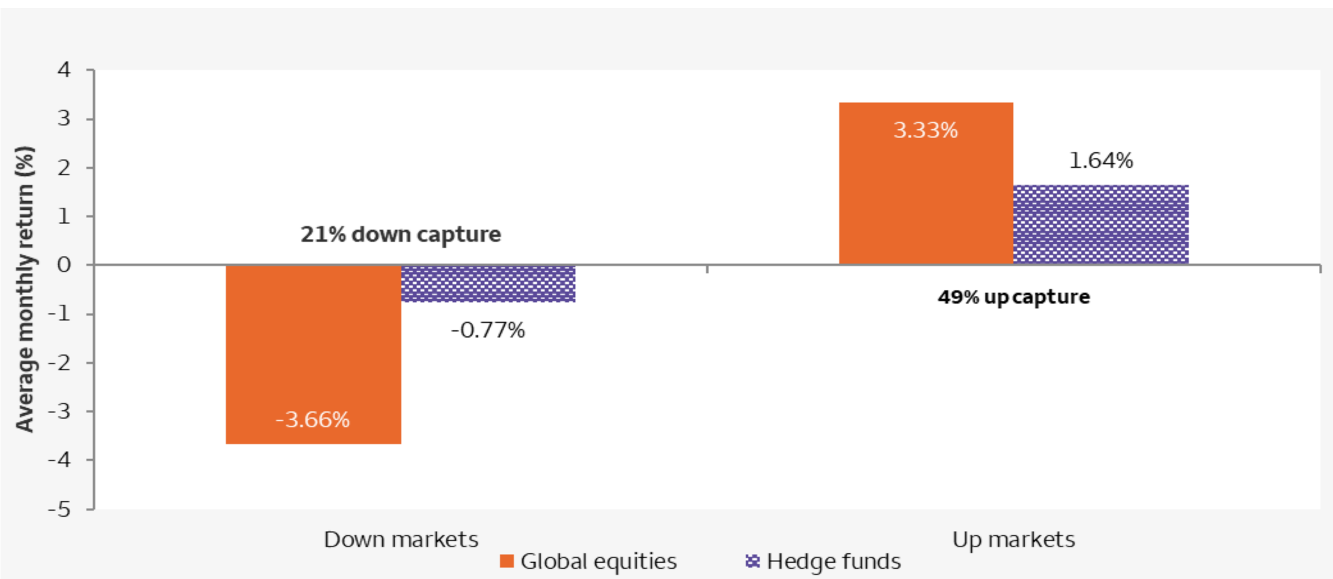
**Mark Steffen, CFA, CAIA**
Global Alternative Investment Strategist

## Incorporating hedge funds to navigate volatile markets

The recent equity market volatility may have alerted investors to the growing concentration in their portfolios, which may be a cause for concern for any risk-averse investor. As the S&P 500 Index has grown increasingly driven by the seven stocks (the Magnificent Seven[4]) that accounted for over 35% of the index at the end of 2024, the pullback in the growth-oriented sectors has exposed a lack of diversification in many equity-centric portfolios, particularly those implementing passive, index-based strategies.

We believe that Hedge Fund strategies may be able to help smooth over bumps in the road as they have generally participated in upward-trending markets yet have limited their exposure in declining markets. As shown in the chart, while hedge funds have captured 49% of the performance in positive markets, they have limited their participation in downward-trending markets to a mere 21% of the index returns. While there are many types of Hedge Fund strategies, the larger toolbox afforded to these strategies offers greater flexibility to express views on stocks, markets, and the economy. One example of this flexibility is the use of short sales, a practice whereby a manager sells a borrowed stock and attempts to purchase the stock back at a lower price in the future to repay the loan, thereby profiting on the decline of the stock price. Short positions can act as a hedge in declining markets and may limit the overall volatility (or risk), acting as a sort of shock absorber in volatile markets. By combining Hedge Funds with a portfolio of traditional stocks and bonds, we believe investors can potentially weather challenging market environments and maintain the discipline to remain invested during periods of market turmoil.

**Hedge funds can help reduce downside participation while still participating on the upside**




Sources: Morningstar Direct and Wells Fargo Investment Institute. Data from January 1, 1990, to February 28, 2025. Data as of February 28, 2025. Global equities = MSCI World Index. Hedge funds = HFRI Fund Weighted Composite Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** Please see disclosures for additional information.

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.

4. The Magnificent Seven stocks include Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

# Tactical guidance*

### Cash Alternatives and Fixed Income

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

### Equities

| Most Unfavorable | Unfavorable | Neutral | Favorable | Most Favorable |
|---|---|---|---|---|
| | Emerging Market Equities | Developed Market Ex-U.S. Equities<br>U.S. Small Cap Equities | U.S. Large Cap Equities<br>U.S. Mid 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<br>Hedge Funds—Relative Value<br>Private Equity<br>Private Debt | Hedge Funds—Event Driven<br>Hedge Funds—Macro | |

Source: Wells Fargo Investment Institute, March 17, 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.

### 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. **Growth stocks** may be more volatile than other stocks and there is no guarantee growth will be realized. **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.

Short selling involves the risk of potentially unlimited increase in the market value of the security sold short, which could result in potentially unlimited loss for the fund. In addition, taking short positions in securities is a form of leverage which may cause a portfolio to be more volatile.

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

Moderate Growth and Income Liquid: 2% Bloomberg U.S. Treasury Bills (1–3 Month) Index, 30% Bloomberg U.S. Aggregate Bond Index, 6% Bloomberg U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index, 27%, S&P 500 Index, 10% Russell Midcap Index, 3% Russell 2000 Index, 8% MSCI EAFE Index, 5% MSCI Emerging Markets Index, 4% Bloomberg Commodity Index.

Bloomberg 1-3 Month U.S. Treasury Bill Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. In addition, the securities must be denominated in U.S. dollars and must be fixed rate and non-convertible.

Bloomberg Commodity Index is comprised of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity.

Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Bloomberg U.S. Corporate High Yield Index covers the universe of fixed-rate, noninvestment-grade debt.

HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager funds that report to HFR Database. Index returns do not represent investment returns or the results of actual trading. Index returns reflect general market results, assume the reinvestment of dividends and other distributions, and do not reflect deduction for expenses or taxes applicable to an actual investment. Unlike most asset class indexes, HFR Index returns reflect deduction for fees and expenses. Because the HFR indexes are calculated based on information that is voluntarily provided actual returns may be higher or lower than those reported. The HFRI indexes are based on information self-reported by hedge fund managers that decide, on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indexes may not be complete or accurate representations of the hedge fund universe and may be biased in several ways.

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

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.

MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets including the United States.

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

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.

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.

U.S. Midwest Domestic Hot-Rolled Coil Steel Price Index is made up of spot transactions from the prior week and reflects real spot business. It does not include bids, offers and opinions, or transactions based on contracts.

Note: HFRI Indices have limitations (some of which are typical of other widely used indices). These limitations include survivorship bias (the returns of the indices may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information self-reported by hedge fund managers that decide on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.

An index is unmanaged and not available for direct investment.

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