WELLS FARGO
Investment Institute

TIMELY GUIDANCE

Institute Alert

Timely guidance that may affect your investment strategy **October 3, 2022**

Global Investment Strategy Team

☑ **Guidance change**

☑ **Forecast change**

☐ Allocation change

Adjusting targets for new recession and inflation timing

Guidance changes

- We are downgrading our guidance on precious metals from favorable to neutral.

Forecast changes

- Global economy: We are adjusting our forecasts for a U.S. recession and rising unemployment to begin late in 2022, for a deeper contraction in Europe, and for slower but positive growth in emerging markets. These regional changes focus most of the weakness in 2023 and reduce our global growth forecast to close to stall speed. The forecasts also foresee that we expect U.S. inflation to fall faster through 2023 and that we expect much less inflation improvement globally.
- Currencies: Compared to the U.S., the weaker international economic growth outlook and greater dependence on imported energy reinforce U.S. dollar strength in 2022 and stretch the U.S. dollar's advantage into 2023, although with a flatter trajectory in 2023.
- Global equities: We are raising our S&P 500 Index 2022 earnings per share (EPS) target and lowering it for 2023, to align with a later arrival of recession. There are no other equity target changes.
- Global fixed income: We are adjusting our federal funds targets higher in 2022 but lower in 2023, following the latest Federal Reserve (Fed) guidance toward higher, front-loaded rate hikes. Our revised long-term rate forecasts also move higher in 2022, but we are maintaining an outlook for modestly lower rates in 2023.
- Global real assets: We are reducing our 2022 and 2023 gold price targets, based on our revised outlook for extended strength in the U.S. dollar. We are not changing other commodity price targets.

Allocation changes

- No allocation changes.

Table 1. WFII 2022 and 2023 year-end forecasts and market targets

Global economy	New 2023 year-end target	Previous 2023 year-end target	New 2022 year-end target	Previous 2022 year-end target
U.S. GDP growth	**-1.3**	0.9	**1.6**	-0.2
U.S. CPI Inflation, annual average rate	**2.4**	3.5	7.7	7.7
U.S. CPI inflation, December-to-December	**2.2**	3.1	**5.5**	6.3
U.S. unemployment rate	5.2	5.2	**3.8**	4.3
Global GDP growth	**0.9**	1.7	**2.4**	1.9
Global inflation	**4.5**	4.3	**6.7**	6.6
Developed market GDP growth	**-1.3**	0.1	**2.3**	0.8
Developed market inflation	**3.2**	3.4	**7.2**	6.8
Emerging market GDP growth	**2.6**	2.8	**2.4**	2.9
Emerging market inflation	5.5	5.5	6.3	6.3
Eurozone GDP growth	**-3.4**	-2.0	**2.7**	1.1
Eurozone inflation	**4.3**	3.1	**8.0**	7.8

Global equities	New 2023 year-end target	Previous 2023 year-end target	New 2022 year-end target	Previous 2022 year-end target
S&P 500	4300-4500	4300-4500	3800-4000	3800-4000
S&P 500 earnings per share	**205**	220	**215**	200

Global fixed income	New 2023 year-end target	Previous 2023 year-end target	New 2022 year-end target	Previous 2022 year-end target
10-year U.S. Treasury yield	**3.50%-4.00%**	2.75%-3.25%	**3.75%-4.25%**	3.25%-3.75%
30-year U.S. Treasury yield	**3.50%-4.00%**	2.75%-3.25%	**3.75%-4.25%**	3.25%-3.75%
Fed funds rate	**3.50%-3.75%**	4.00%-4.25%	**4.25%-4.50%**	3.50%-3.75%

Global real assets	New 2023 year-end target	Previous 2023 year-end target	New 2022 year-end target	Previous 2022 year-end target
Gold price ($ per troy ounce)	$1900-$2000	$2100-$2200	$1800-$1900	$2000-$2100

Currencies	New 2023 year-end target	Previous 2023 year-end target	New 2022 year-end target	Previous 2022 year-end target
Dollars per euro	$0.94-$1.02	$1.00-$1.08	$0.92-$1.00	$0.97-$1.05
Yen per dollar	¥137-¥147	¥125-¥135	¥140-¥150	¥132-¥142

Source: Wells Fargo Investment Institute, October 3, 2022. GDP = gross domestic product; CPI = Consumer Price Index. **Forecasts, targets and estimates are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.**

Summary

We are adjusting 2022 and 2023 forecasts and targets around two significant policy events in September. First, the Fed's guidance after its September 21 meeting showed not only a higher intended interest rate target (the so-called terminal rate), but that policymakers intend to pull forward as much of the increase into 2022 as possible. Second, Russia closed its Nordstream 1 natural gas pipeline to Europe, forcing economic policymakers into difficult choices around the world.

These developments filter through several channels into our 2022 and 2023 economic estimates and market targets. Interest rates are already catching up to the Fed's guidance. Liquidity has been sufficient but now should evaporate rapidly, undercut spending, and cause inflation to cool sooner and more noticeably.[1] We maintain our view for a U.S. recession between autumn 2022 and mid-2023, but the worst of the U.S. recession now looks likeliest around the turn of 2022 and into winter 2023.

The sharp global economic slowdown should funnel increasingly scarce international liquidity into the U.S. dollar, which appears stronger for longer, although at the expense of the price of gold. For the second half of 2023, financial markets should see lower short-term interest rates but a larger yield premium for long-term rates, a higher S&P 500 Index, and corporate earnings acceleration into 2024.

Updating economic forecasts

The Fed's decision to pull forward rate hikes coincides with its program to double the pace of its balance sheet reduction. As policy hits the brakes harder, the economy's remaining pillars — liquidity and the labor market — should come under more immediate and forceful stress.

Until now, ample liquidity has supported spending. The full effect of Fed rate hikes typically takes 6 to 12 months, and the economy is well into that incubation period, but rising bond yields are reducing the waiting time. Yields have surged in recent weeks, and credit markets are pricing in greater risk for lower-rated borrowers. Spreads between non-investment-grade bonds and U.S. Treasuries of the same maturities have widened, especially for the lowest-rated private credits (CCC and below), and by more than spreads of higher-rated BB debt since mid-August.

Today's strong labor market is unlikely to prevent a recession. As payrolls grow, firms can shorten the workweek and temper pay raises. These trends add pressure to household budgets, while Fed policy is making credit more expensive and less available. In sum, today's strong jobs market is eroding more slowly than the economy, but just enough to be the last support pillar to fall as the recession arrives.

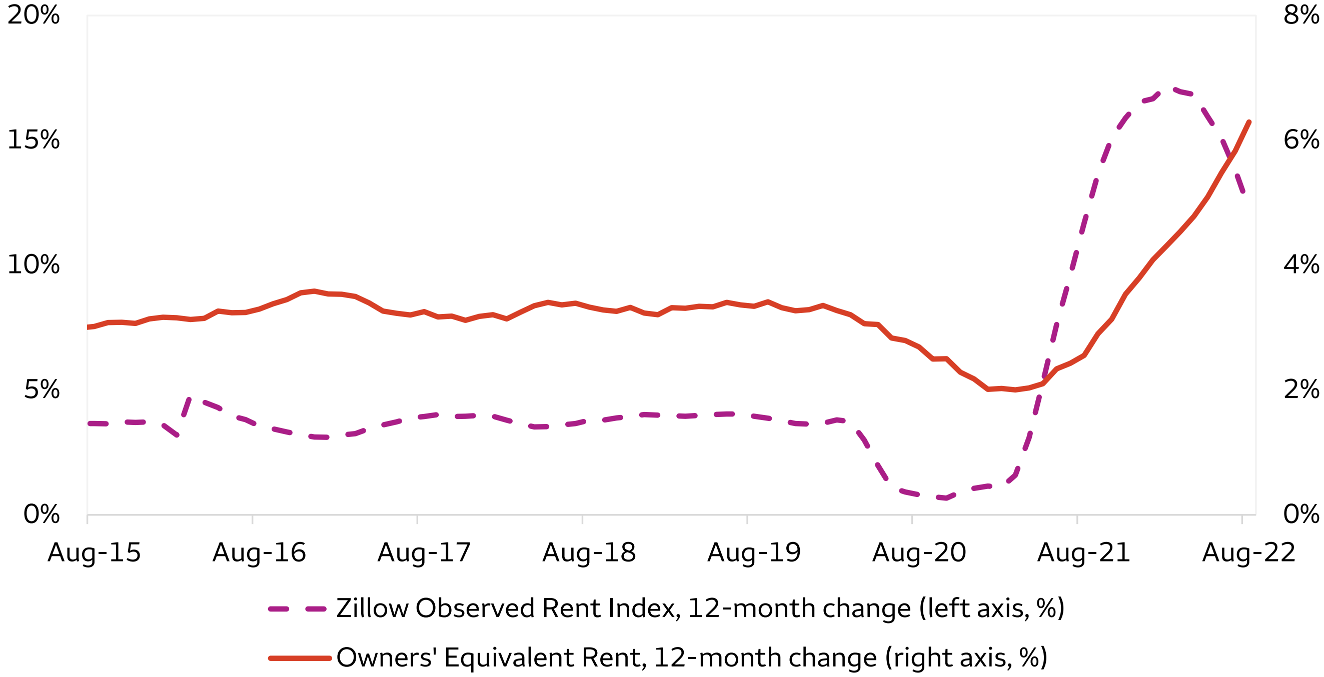
Timing is everything, so the saying goes. If the pressure on credit markets and the economy comes sooner, then we also should expect to see inflation's persistence crack sooner, rather than more gradually, over the next 12 months. For the moment, inflation still finds support from price gains in services, food, and rents. But all are vulnerable to slowing spending power, especially rents.

Chart 1 shows that a market-based measure of 12-month rental inflation has cooled by roughly five percentage points in August from its peak rate in February. The chart also shows that historically this measure turned before the U.S. Department of Labor's gauge of rental inflation, which comes from a monthly survey of households that is slower to report.[2] The slowdown in rent inflation is especially important, because housing costs represent approximately 25% of expenditure in the consumer price index.

Our inflation forecast adjustments (Table 1) now foresee inflation slowing more quickly into end-2022 and for 2023. For additional perspective on how quickly inflation's trajectory is changing, Table 1 adds December-to-December forecasts that show CPI inflation very near the Fed's 2% target by year-end 2023.

1. Liquidity refers to cash available for households and businesses, and the ability of financial market participants to buy and sell at close to prevailing market prices.
2. The monthly Labor Department survey asks consumers who own a primary residence how much they would pay to rent instead of own their home. This factor is roughly 25% of the CPI.

Chart 1. Rent increases are starting to slow, and shelter costs should follow



Sources: Bloomberg, Zillow, U.S. Dept. of Labor and Wells Fargo Investment Institute. Monthly data, August 2015-August 2022. Notes: Owners' equivalent rent is the Labor Department's estimate of what it would cost a property owner to rent a similar premise.

Global economy to stall in 2023; U.S. dollar stronger for longer: In China, COVID restrictions and stress in the property sector are risks to the global economy, but we anticipate modestly positive China economic growth through 2023. Nevertheless, China is unlikely to lift the global economy, which leaves global growth vulnerable to Europe's suddenly acute energy shortage, and to the tightening liquidity conditions that currency-related inflation creates.

These international factors flow through our forecasts in three ways:

1. **Higher for longer U.S. dollar:** Tighter-for-longer dollar liquidity and the relatively deeper eurozone recession imply more upward pressure on the dollar than in our July forecasts.
2. **A 2023 global recession:** Our growth downgrades for the U.S., eurozone, and China (and elsewhere) imply a global economic stall at just above 0.5% in 2023, a fraction of its long-term 3.4% average.
3. **But the U.S. economy should enjoy some insulation from Europe's deeper recession:** Swings in U.S. exports to Europe are small compared to U.S. domestic spending. Moreover, weakening import demand during U.S. economic slowdowns further mutes any deterioration in exports.

Anticipating a stronger-for-longer dollar

The proposed target changes would raise and flatten the implied U.S. Dollar Index (DXY) trajectory over the coming 15 months. Most of the pre-existing factors in the dollar's favor — rate differentials, greater economic resilience, and perceived "safe-haven" demand — are still in play. The European energy crisis should be a persistent negative for both the euro and the pound sterling (which faces additional policy headwinds), as well as tightening liquidity conditions globally.

We believe that while we could see the dollar's very fast ascent lose momentum, our stronger U.S. outlook does not argue for any material depreciation of the dollar, and it is not the time for trying to pick the top. Our revised euro and yen exchange rate target ranges appear in Table 1.

Federal funds rate

We have contended for most of the year that the Fed is serious about reducing inflation to its 2.0% target. Over the past month, the Fed has reiterated this resolve and indicated after its September meeting that policy will continue with aggressive rate hikes — with an expectation to take the federal funds rate to its terminal rate of 4.50%-4.75% by early next year.

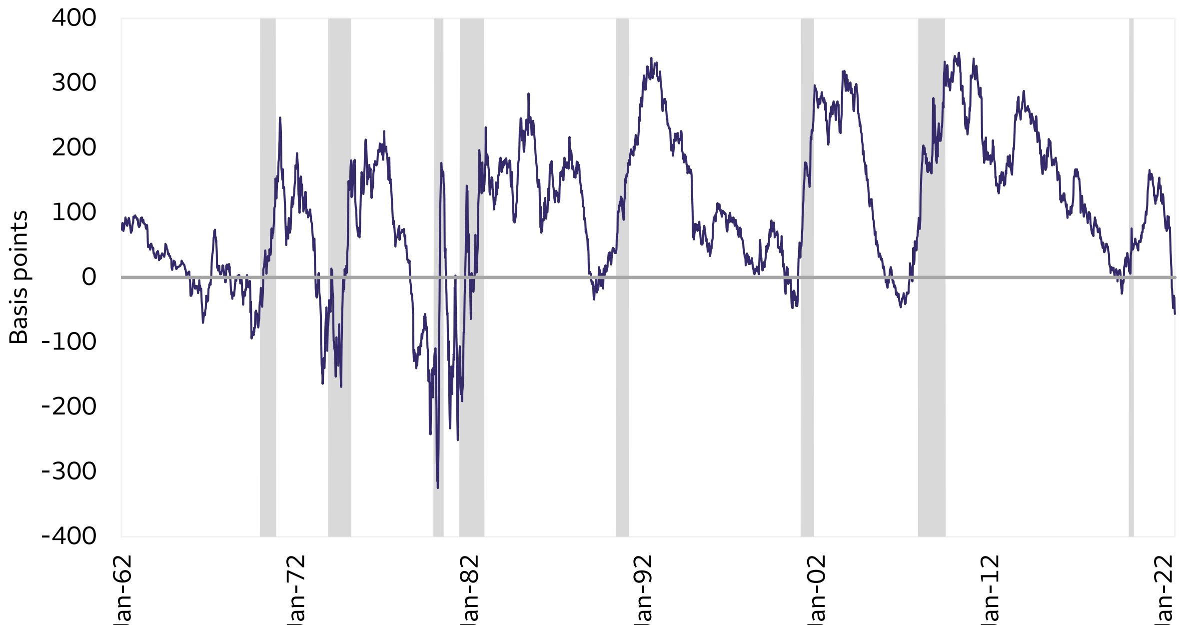
While we have maintained aggressive federal funds rate targets throughout the current tightening cycle, rate hikes continue to get pulled forward. As a result, we are increasing our year-end 2022 federal funds rate target to 4.25% - 4.50%. We are expecting an additional rate hike early next year before the Fed pauses. We expect inflation to come down relatively fast in 2023 and anticipate that the Fed will switch to easing in the second half of 2023. As the economy falters and inflation approaches the Fed's target, we look for an aggressive rate-cutting cycle to bring the federal funds rate down to a more neutral level promptly in 2023. Our new year-end 2023 federal funds rate target of 3.50%-3.75% implies 100 basis points (1% percentage point) of easing from the terminal federal funds rate. Easing will be necessary to help pull the economy out of recession, and we look for the Fed to pivot meaningfully once it is evident that it has won the war on inflation.

Long-term rate targets

As the Fed aggressively tightens and pulls forward rate hikes, we anticipate higher long-term rates in the near term. A federal funds terminal rate of 4.50%-4.75% is likely to push long-term rates up to test the 4.00% level. Long-term inflation expectations anchored near 2.50% should support peak yields around this level. As a result, we are increasing our year-end 2022 10-year and 30-year U.S. Treasury yield targets to 3.75%-4.25%.

Looking into 2023, our expectation for economic recovery and Fed interest-rate cuts should reverse the inversion and allow short-term rates to drop by relatively more than long-term rates. (Yield curve inversion refers to short-term rates above long-term rates.) Yield curve inversions typically end by the time the Fed lowers rates and the recession eventually ends (Chart 2). We expect a similar dynamic in the recovery as well. As a result, we see long-term rates falling slightly and place our new year-end 10-year and 30-year U.S. Treasury yield targets at 3.50%-4.00%.

Chart 2. Yield curve inversions typically ended by the time the recession ended and the Fed cut rates



Sources: Bloomberg, Federal Reserve, Wells Fargo Investment Institute. Weekly data, January 5, 1962-September 19, 2022. Data are the 10-year constant maturity U.S. Treasury 10-yield bond yield, minus the 1-year constant maturity U.S. Treasury 1-year yield, expressed in basis points (100 basis points = 1%). Shaded areas represent economic recessions.

Adjusting 2022 and 2023 S&P 500 EPS targets

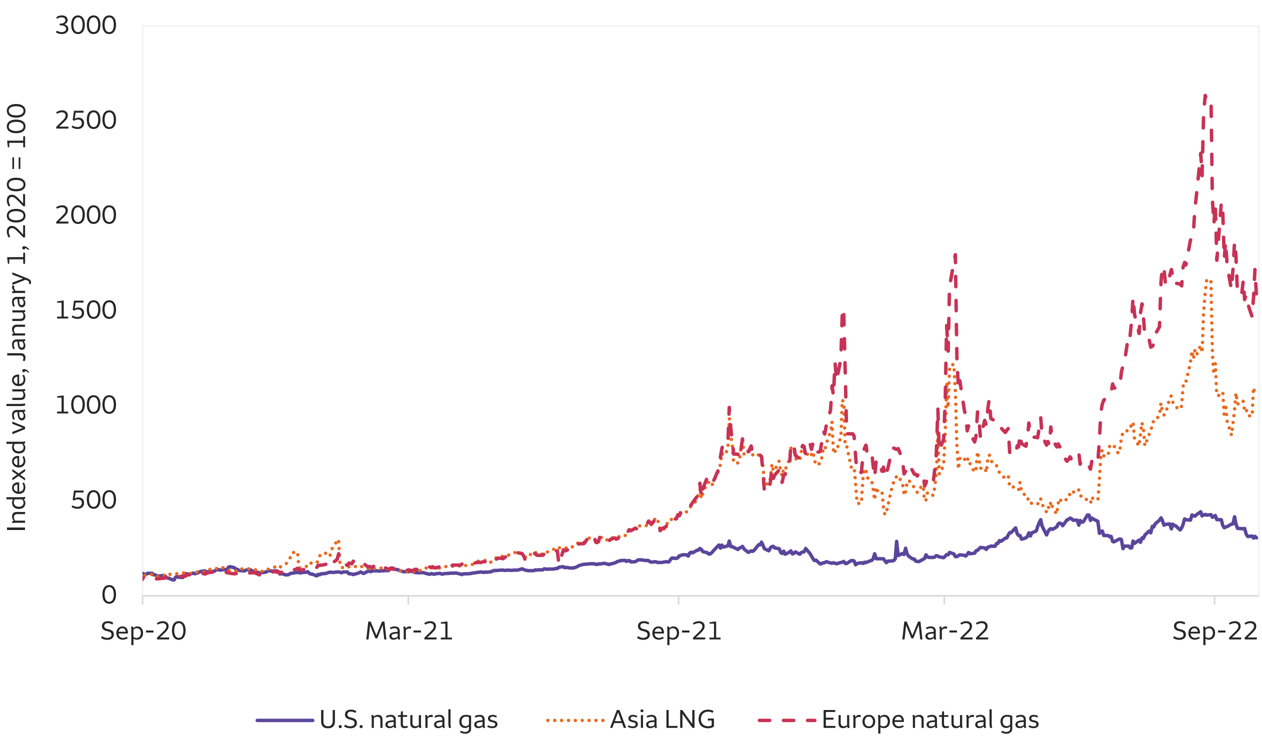
Consistent with our economic forecast changes, we are raising our S&P 500 Index 2022 EPS target and lowering our 2023 EPS target. As the worst of the recession comes in the winter, instead of the autumn, 2022 earnings are modestly higher than in our previous outlook. The earnings contraction should push into early next year, instead. We emphasize that this earnings target adjustment changes the *timing* rather than our *overall outlook*. As before, we still expect earnings to peak in 2022 — as the economy weakens, revenue growth stalls, and input costs remain elevated — and to trough in 2023 as the economy begins to recover later in the year.

S&P 500 Index earnings have been resilient to date. Earnings for the first two quarters of 2022 handily beat expectations, and we expect Q3 earnings to continue that trend, albeit at a slowing pace. For the full year 2022, we now expect S&P 500 Index EPS of $215 (Table 1), showing modest growth over 2021 EPS of $210. Given our view that the earnings contraction will largely take place in 2023, we lower our 2023 EPS estimate to $205.

Reducing our gold target; maintaining other commodity targets

Gold becoming more sensitive to U.S. dollar strength – taking targets and rating lower: Europe's energy troubles over the coming winter, and beyond, have elevated natural gas prices by multiples worldwide (Chart 3) but much less so in the U.S. This difference should work to the advantage of the U.S. dollar. We suspect that the dollar will keep this advantage, while elevated energy costs in Europe should continue to pressure European consumers, economies, and the euro into 2023. Against this backdrop, we are reducing our gold targets by $200 per ounce in 2022 and 2023, as shown in Table 1. We are also downgrading the Precious Metals sector to neutral from favorable.

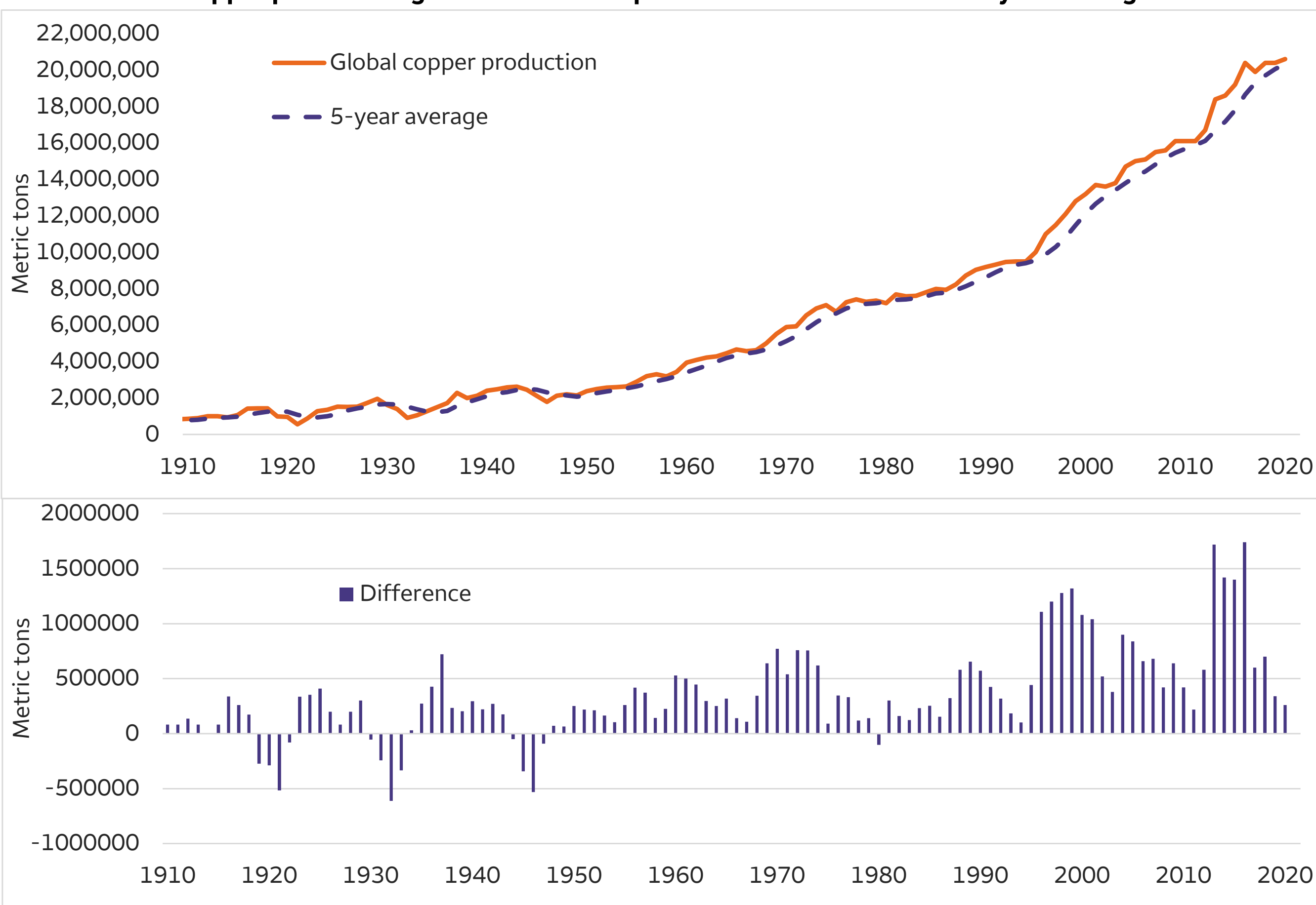
Chart 3. Natural gas prices have spiked higher in Europe and Asia than in the U.S.



Sources: Bloomberg, Wells Fargo Investment Institute. Daily data, January 1, 2020 – September 29, 2022. Each line represents a regional natural gas price indexed to January 1, 2020 = 100. The U.S. natural gas price is represented by the generic first futures price. Asia LNG is represented by the LNG Marker swap futures price for Japan and South Korea. The Europe natural gas price is the Netherlands TTF natural gas one-month forward price.

The commodity bull super-cycle since March 2020 keeps us favorable on commodities: Bull super-cycles are multi-year periods, often lasting a decade or longer, of commodity scarcity. It often takes years of capital investment and rising commodity prices to slow a bull super-cycle. Even though commodity prices have tempered their gains from earlier in the year, inventories remain low for many industrial, energy, and agricultural commodities. Chart 4 highlights the example of copper, where global supply growth, relative to a five-year average, has slowed to levels last seen in the 1970s. These types of underlying supply issues should limit near-term price downside and support price gains that follow economic recovery in mid-2023. More to the point, Russia's economic disengagement with the West is likely to aggravate the inventory shortages of fertilizer, metals, and energy well into the future. We are maintaining our 2022 and 2023 target levels for the Bloomberg Commodity Index and for crude oil.

Chart 4. Global copper production growth at slowest pace since 1970s relative to 5-year average



Source: Bloomberg, United States Geological Survey, Wells Fargo Investment Institute. Annual data is from 12/31/1900 - 12/31/2020.

Risks considerations

Forecasts, targets and estimates are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.

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. **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. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate. 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. Investing in **gold,** silver or other precious metals involves special risk considerations such as severe price fluctuations and adverse economic and regulatory developments affecting the sector or industry. **Currency** risk is the risk that foreign currencies will decline in value relative to that of the U.S. dollar. Exchange rate movement between the U.S. dollar and foreign currencies may cause the value of a portfolio's investments to decline.

Definitions

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

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.

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

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. Dollar Index measures the value of the U.S. dollar relative to majority of its most significant trading partners. This index is similar to other trade-weighted indexes, which also use the exchange rates from the same major currencies.

Zillow Observed Rent Index is a weighted average of rents, in dollars, of the typical observed market rate rent across a given region. ZORI is a repeat-rent index that is weighted to the rental housing stock to ensure representativeness across the entire market, not just those homes currently listed for-rent. The index is dollar-denominated by computing the mean of listed rents that fall into the 40th to 60th percentile range for all homes and apartments in a given region, which is once again weighted to reflect the rental housing stock.

An index is unmanaged and not available for direct investment.

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