WELLS FARGO
Investment Institute

Sector Insights

Global Securities Research **January 17, 2025**

Impact of California wildfires on equities

Summary

California's wildfires have caused significant destruction, leading to initial estimated economic damages in the $50-billion range[1] with insured losses of $20 – $30 billion[2]. We expect the Property and Casualty insurance sub-sector and specific companies within the Utilities sector to experience the most acute short- and long-term impact, though it does not currently change our stance on any existing recommendations. We see the potential for longer-term rebuilding opportunities within portions of the Consumer Discretionary, Industrials, and Materials sectors, but do not yet see this event as a material positive catalyst.

Overview

First and foremost, we would like to express our heartfelt sympathies to those impacted by the tragic events unfolding in the Los Angeles area. This round of wildfires has been particularly headline grabbing, and in times such as these, we view it as our job to provide the proper context so that investors can digest what can often be a fast-moving and emotionally charged news cycle. Moving on to the recent events, we would note that the Los Angeles wildfires were sparked by a January 7 Santa Ana wind event and pre-existing dry conditions. The fire has consumed tens of thousands of acres in Los Angeles and surrounding areas, including multimillion-dollar properties.

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1. "Los Angeles wildfire economic loss estimates top $50 billion," CNBC, January 8, 2025.
2. "$30B California Fire Loss Seems Possible," Wells Fargo Securities, January 12, 2025.

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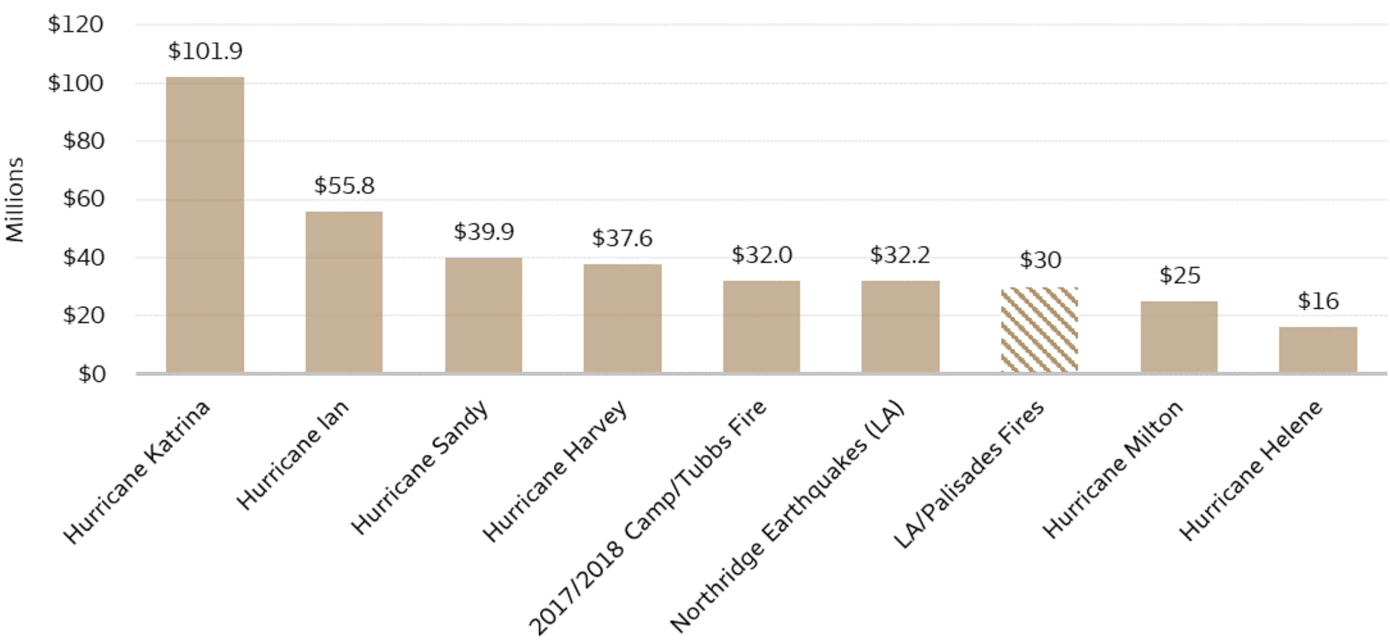
Although the fires are yet to be contained, current estimated insured loss estimates approach roughly $30 billion, making this event one of the costliest natural disasters in recent history. For example, this range of insured losses would put this event nearly on par with some of the most destructive hurricanes the U.S. has witnessed (for example, Hurricanes Harvey and Sandy), as shown in the chart below. The total economic impact, while still highly uncertain, could represent a multiple of this estimate. Initial media reports have primarily focused on the impact to several insurers with homeowners' insurance exposure in the affected areas surrounding Los Angeles County as well as a discrete group of investor-owned utilities with direct exposure to the local market. California Governor Gavin Newsom already proposed emergency funding of $2.5 billion for recovery and cleanup efforts and to reopen schools impacted by the fires. In addition, two executive orders were signed in recent days allowing for expedited rebuilding and debris removals.

Insured property loss, adjusted for inflation



Source: Insurance Business Magazine. Data as of May 17, 2024. Ongoing California wildfires indicated by bar with lines.

We believe that short-term volatility for certain companies in these areas could remain somewhat elevated in the coming days and weeks. Looking longer term, we would note that the risks related to major natural disasters has been rising in recent years, and we have tried to remain abreast of this factor in our sub-sector and individual equity recommendations. We do see this as an appropriate moment for investors to review their exposures to companies that may face particularly acute risks. However, we do not anticipate a materially negative long-term impact to the Property & Casualty Insurance and Electric Utilities sub-sectors given the somewhat limited overall exposure to the region in each case. However, we will continue to monitor events closely at the individual security level.

Within Wells Fargo's third-party manager portfolios, exposures tend to be generally low in any given product type to the insurers and utilities already acknowledged to be most impacted, and we believe that these exposures are being prudently managed and monitored. In terms of active and passive equity products, some minimal exposure resides in infrastructure and concentrated managers, but is mitigated by diversification and active management. We believe listed real assets, non-traded real estate investment trusts, and hedge funds all have de minimis exposure.

We share the next section with the acknowledgment that it can be difficult to look for opportunities that arise as we process the impact of unfortunate events. We do not yet see a material positive catalyst for any sub-sectors or individual equities, although this is subject to change as the secondary impact develops. Looking further out, we believe rebuilding activity could provide modest incremental opportunities for certain sub-sectors and companies across the Consumer

Discretionary, Industrials, and Materials sectors. From a historical standpoint, we would note that reconstruction activity following events with similar loss levels has, in our opinion, not typically resulted in long-lasting investment opportunities. We would caveat this, though, with the reminder that many cyclically oriented areas of the goods economy are currently operating at less than robust levels. There is thus the potential that this event, coupled with additional catalysts, could drive greater-than-anticipated changes over the coming months and quarters.

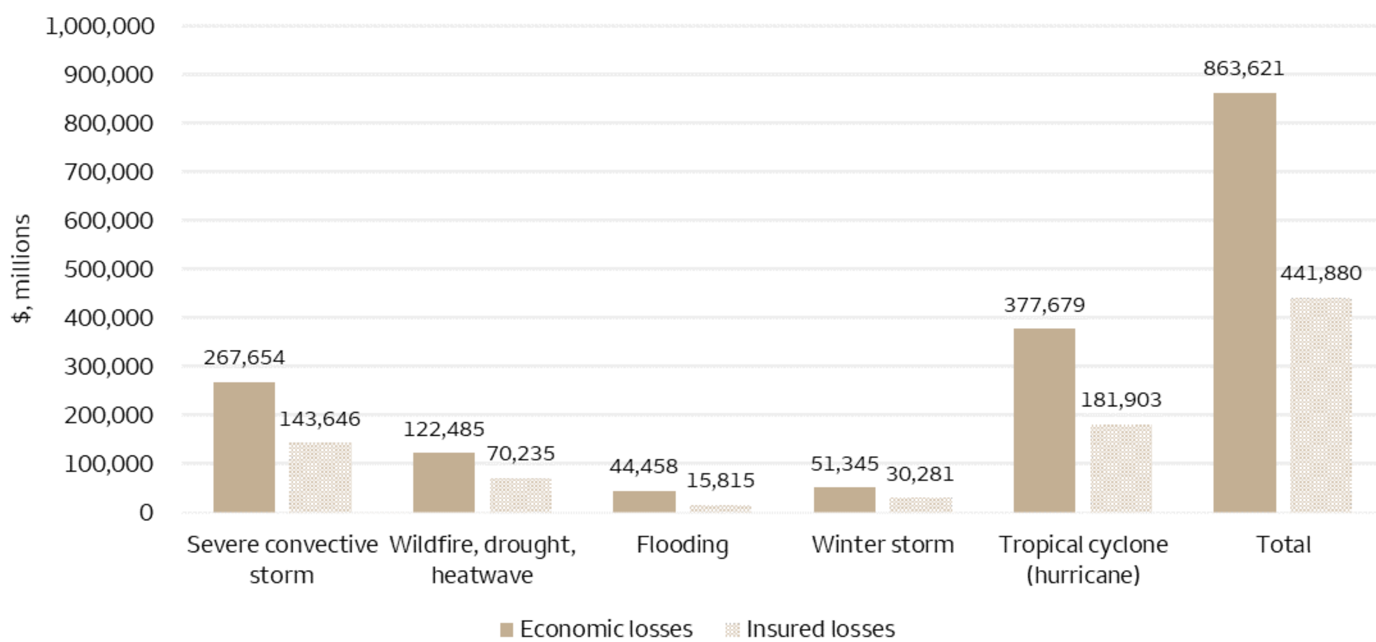
Details from the insurance-industry perspective

Scope of damages

The severity of natural catastrophes has only increased in recent years with floods, hurricanes, and severe thunderstorms driving higher losses. The Los Angeles suburb of Pacific Palisades has a large and dense concentration of multimillion-dollar homes with current average values north of $4 million, and it is located in an area spread over steep canyons, making it difficult for firefighters to access. According to The Department of Forestry and Fire Protection, over 37,000 acres have burned thus far in the Palisades and Eaton Fires with 22% and 55% containment at the time of this report. The primary areas impacted by the wildfires have been residential at this point. With the fires yet to be fully contained, estimated economic damages from this event may exceed $100 billion, as projected by AccuWeather.

Historical context

Natural catastrophe losses in the U.S. (2017 – 2023)



Source: Insurance Information Institute. Data as of January 2024. Represents cumulative losses from 2017 through 2023.

Key insurers affected

In general, we believe losses will be shared among several stakeholders, including the California Fair Access to Insurance Requirements (FAIR) Plan, commercial property insurers, standard homeowners' insurers, and insurers that specialize in high-value excess and surplus. Chubb Ltd's (Chubb's) market share of the state's homeowners' policies was 2.6% as of the end of 2023 according to S&P Global Market Intelligence. It is our belief that Chubb's market share may be even lower now given the disciplined underwriting strategies and relative challenges in the state of underwriting profitable policies.

With that said, the largest insurers have capital strength to absorb losses, and many have already taken steps to reduce their exposure to the state over recent years. Companies have adopted measures like rate adjustments and strengthened reinsurance programs to mitigate exposure. Despite these steps, the growing intensity of wildfires continues to test the resilience of the industry and its ability to balance profitability with coverage accessibility. Recent regulatory changes in the state occurred just prior to the January fires. In the recent past, insurers could not use forward-looking climate-based models to inform their policy pricing. While already expected to put upward pressure on policy rates, it also opened the possibility of insurers returning to the state or expanding their coverage to more homeowners. Additionally, California's Department of Insurance Commissioner Ricardo Lara issued a regulation that would allow insurers to pass along increases in reinsurance costs through their pricing. With such a significant catastrophe occurring so early in the year, it is likely we could see larger-than-anticipated rate-increase requests effective 2026. We continue to view the Property & Casualty Insurance sub-sector as favorable.

Impact by sector

Utilities

Joe Buffa — Equity Sector Analyst

There are three major investor-owned utilities in California. Historically, California law and regulation have not been favorable to utilities regarding wildfire liability given the state's use of inverse condemnation. Under inverse condemnation, a utility in the state can be held liable for property damage caused by the utility's equipment, regardless of negligence. The most recent example of inverse condemnation in action comes from the 2017 – 2018 Northern California wildfires that ultimately sent a local investor-owned utility into bankruptcy. Following those fires, California lawmakers took steps to address utility liability arising from these natural disasters. While the state did not eliminate the strict liability of inverse condemnation, it did provide guidance for utility regulators to determine prudency and set up a wildfire insurance fund for the state's utilities. Positively, these actions lowered the financial risk for the state's utilities regarding wildfires, but that risk was not (and cannot be) eliminated.

The current wildfires are largely in Los Angeles' municipal utility's territory, but an investor-owned utility's transmission lines are also present in the area. Shares of publicly-traded utilities that operate in the state have reacted negatively to the developments and we do believe these stocks could continue to experience near-term volatility. If the California Public Utilities Commission finds any impacted utility was prudent in its management of its system, the company would be repaid for eligible claims from the California Wildfire Fund.

Financials

Laurie Harlan Cheek and Alex Sagal — Equity Sector Analysts

Banks and other financial institutions face multiple challenges when natural disasters, such as the wildfires in California, occur. Infrastructure damage and physical destruction to branches and ATMs limit customers' access to banking services. Looking past temporary branch closures, government agencies have encouraged financial institutions to work constructively with borrowers in communities affected by the wildfires. Prudent efforts to adjust or alter terms on existing loans in affected areas are supported by the agencies. Under Fannie Mae's guidelines for single-family mortgages impacted by a disaster, homeowners may request mortgage assistance by contacting their mortgage provider. Homeowners are often eligible to reduce or suspend their mortgage payments for up to 12 months by entering a forbearance plan with their mortgage servicer.

The financial impact of natural disasters on banks has been studied by some, with varied findings. In a Federal Reserve Bank of New York publication titled "How Bad Are Weather Disasters for Banks?", natural disasters were found to be generally insignificant or to have only a small effect on bank performance and stability. A different study, titled, "Natural disasters and bank stability: Evidence from the U.S. financial system," published in the Journal of Environmental Economics and Management, showed that weather-related natural disasters in the U.S. significantly weakened the financial stability of banks with business activities in the affected regions.

Banks live and thrive on liquidity and confidence — each informs the other and strengthens or weakens the other. Confidence levels in community and regional banks that have material exposure to the Los Angeles market may take a hit, with potentially higher probabilities of defaults and non-performing assets in mind. However, we believe a backstop of insurance payments and financial-aid programs will help snuff out most concerns. We also expect both large and small financial institutions to be integral in supporting the short- and long-term recovery efforts of this natural disaster. In the immediate aftermath of the disaster, we expect banks to quickly mobilize cash reserves and distribute aid. In the intermediate term, we expect loan demand to be elevated in the affected areas due to reconstruction efforts, benefiting some banks.

Real Estate

John Sheehan, CFA — Equity Sector Analyst

There have not been any announcements of significant property damages by equity real estate investment trusts (REITs). Importantly, virtually all REITs maintain comprehensive property insurance including business interruption coverage, which should help mitigate economic losses. REIT sub-sectors could witness increased demand. We believe the Los Angeles wildfires will likely result in increased demand for rental housing from both displaced residents and workers brought to Los Angeles to assist with the reconstruction process. For apartment and single-family REITs, we expect occupancy rates of Los Angeles area properties to spike over the next few quarters. Over the intermediate term, we believe industrial warehouse properties could see higher demand as construction materials and equipment is brought to the Los Angeles area. Self-storage companies may witness a similar increase in demand related to material and equipment storage during the reconstruction process.

Industrials

Larry Pfeffer, CFA — Equity Sector Analyst

We do not currently anticipate a material short- or long-term positive or negative impact at the sector level from the tragic events unfolding in the Los Angeles area. We do believe that reconstruction activity could provide a modest positive lift over the medium term for companies in the Construction Machinery & Heavy Transportation, Trading Companies & Distributors, and Building Products sub-sectors. That said, we do not view this as a material catalyst to change our opinion on these sub-sectors or individual equities therein.

Separately, we would note that natural disasters have on certain occasions, acting in concert with other forces, contributed to inflationary forces in certain portions of the industrial supply chain, most notably the Cargo Ground Transportation sub-sector. The Los Angeles market tends to be a heavy source of outbound freight as it contains the largest port complex in the country. We would anticipate a moderate amount of short-term disruption to the broader logistics network surrounding the port complex, even as the facilities themselves are not directly impacted. Key factors to consider include displacement of port employees, closed or constrained road networks, and reliable access to power. In addition, the region is likely to experience a spike in inbound demand over the coming quarters as reconstruction efforts move forward. This could in turn effect the balance of freight lanes across the country, contributing incrementally to freight inflation. More broadly, we believe excess capacity remains in this industry and that consumer demand for goods, while growing modestly, is currently not anticipated to place material pressure on the system. In summary, we do believe these events could contribute to a somewhat more rapid rebalancing of supply and demand in favor of freight carriers than we had previously anticipated. We will closely monitor leading indicators in the coming weeks, but for the time being, we remain less favorable on Cargo Ground Transportation relative to the rest of the Industrials sector.

Consumer Discretionary

Brian Postol — Equity Sector Analyst

We believe the Los Angeles wildfires have minimal impact in the retail industry. The Los Angeles and Long Beach port is not close to the impacted area. Disruption, if any, should be immaterial to the flow of goods through the rest of country and stores. Target Corporation (Target) is the retailer with the largest exposure to the Los Angeles metropolitan area, however, not all Target stores in Los Angeles will be impacted — and it is likely to be just a few. Retailers and landlords will have insurance coverage to cover any losses of buildings, inventory, etc.

We estimate that the two leading home-improvement retailers each have roughly 1% of their store base in the Los Angeles area. We would not expect all stores to be affected, but we would expect rebuilding efforts in the region to provide a slight benefit to same-store sales over the medium term. We view the dynamics as somewhat similar to those of a major hurricane. Historically, it has taken roughly six to nine months for this impact to occur as insurance adjustors need to evaluate damage and distribute payments and homeowners then need to secure the services of contractors. We remain favorable on the Home Improvement Retail sub-sector due to the underlying strengths of these businesses and our ongoing expectation for the maintenance and repair of an aging housing stock. We do not expect this event to be a material positive catalyst for the group.

Materials

Ian Mikkelsen, CFA — Equity Sector Analyst

Companies within the Materials sector (particularly within the Specialty Chemicals and Construction Materials sub-sectors) that have exposure to construction and restoration may see increased product demand in the intermediate term once rebuilding efforts accelerate. We would expect the bulk of this demand impact to occur within a 6 – 18 month lag following the cessation of the wildfires.

Additional resources

For more information on the fixed-income implications of the wildfires, please see the following two reports from the Global Securities Research's fixed-income analysts.

- Municipal Sector Insights — Potential impacts of the Southern California wildfires
- Municipal Issuer Insights — Wildfires lead to Los Angeles Water and Power downgrade

Appendix — Prices for companies discussed

Company	Symbol	Price
Chubb Limited	CB	$273.53
Target Corporation	TGT	$133.25

Source: FactSet. Prices as of January 16, 2025.

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The **Diversified Stock Income Plan (DSIP) List** focuses on companies that we believe will provide consistent annual dividend growth over a long-term investment horizon. Our objective is to provide a broad list of high-quality, industry-leading companies from which an investor can assemble a well-diversified portfolio. Through consistent dividend growth, our goal is to help investors stay ahead of the wealth-eroding effects of inflation.

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