May 17, 2010

WELLS FARGO ADVISORS

The Week

Gary Thayer, Chief Macro Strategist

Worth noting

- Global equity markets rebounded early last week after European policymakers announced a major aid package designed to prevent the Greek debt problems from spreading to other countries.
- The sharp drop in global equity markets in early May shook investor confidence just when investors were feeling better because of the strong 13 month rally. Investors recognize that Greece still has major budget problems despite the rescue package, and China is trying to dampen economic growth to prevent their economy from overheating.
- The decline in copper prices and the rally in gold prices suggest that investors are turning more concerned about global economic prospects even though policymakers are taking aggressive action to address existing problems.
- We remain long-term positive on U.S. equities but near-term cautious.

Investor complacency turns to concern

In the first half of May, U.S. equity prices pulled back from their April highs. We believe that concerns about rising global risks have replaced the complacency that existed earlier this spring. In this report, we discuss what has changed and why we think investors are more cautious. We close with some near-term guidance on how investors might approach this market.

Back in February, we wrote in this report that many of the global equity markets, including the U.S. markets, were consolidating within broad trading ranges since late last year. We discussed what it might take to push the U.S. market outside that range. In late February, the U.S. equity markets broke out to new highs and continued to rally into April. However, many of the foreign markets did not. This suggests that overseas investors were still worried about the Greek debt problems and the weak Chinese market. But U.S. investors seemed to think that European and Asian problems would not hurt U.S. companies. Unfortunately, these complacent views were misplaced, and the U.S. equity market dropped sharply in early May, falling back to those trading range levels from earlier this year.

Comparing U.S. and foreign market performance often gives a good measure of overvaluation. During the six months ended in late April, the U.S. equity market, as measured by the S&P 500, was one of the best performing markets of 24 international indices that we compared. In other words, the U.S. market was leading the charge, but other markets were not following along. As a result, the U.S. market was overvalued relative to the other international markets. The foreign markets did not follow the U.S. market up. Therefore, the U.S. market was vulnerable to a significant correction.

Another important sign of market vulnerability was investor complacency in late April. The Chicago Board Options Exchange implied volatility index (VIX) dropped in April to its lowest level since mid-2007. This means that the market was not experiencing major daily swings in prices that often accompany sharp declines in prices. Instead, the U.S. equity market was working higher in an orderly fashion, suggesting that investors were not worried about events in other countries and other markets. The sharp drop in prices starting in late April quickly awakened investors' concerns. Now, investors may be wondering if the economy is really working through all its problems, or if investors were just overlooking those problems.

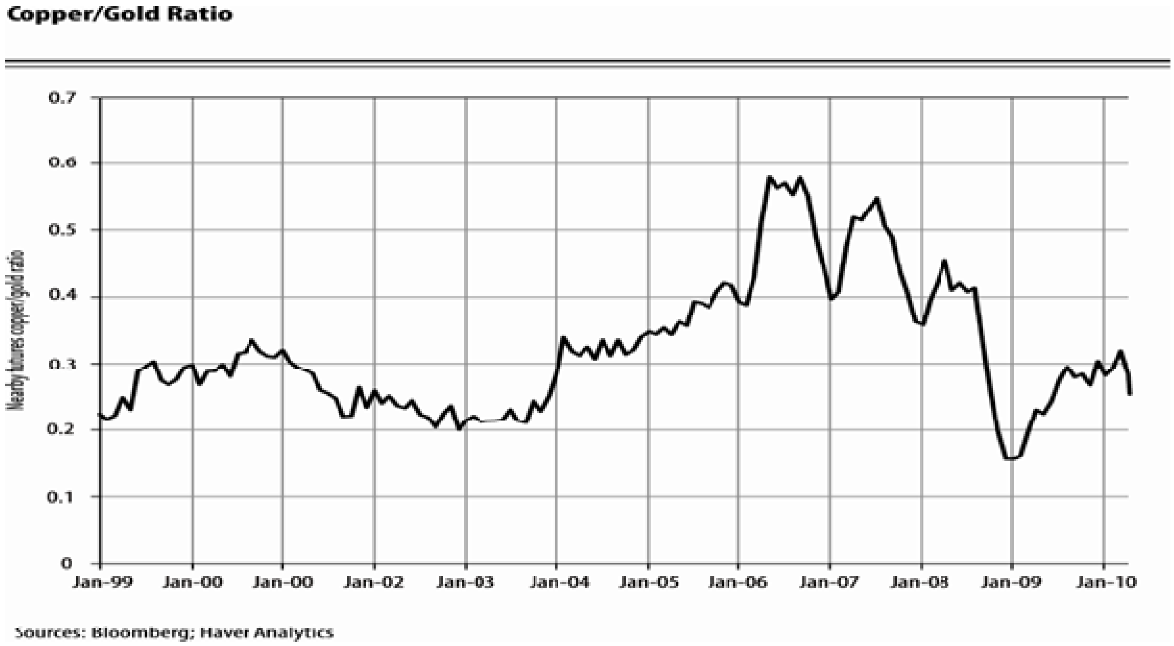
Please see page 3 of this report for Important Information, Risk Factors and Disclaimers

To see how sentiment has changed, it is important to look at other markets, not just the equity markets. One good indicator of investor concerns is the ratio of copper prices to gold prices. When the global economy starts to cool off, or when traders begin to worry that the economy is cooling off, the demand for copper decreases and copper prices often turn down. That has happened during the past month. At the same time, investor demand for gold appears to have increased, especially in Europe, because of the actions by the European Central Bank and European finance ministers to support the euro and contain the Greek debt problems. Consequently, gold prices, measured in dollars, rallied to new record highs. With copper prices declining and gold prices rising, the copper/gold ratio has turned down, signaling that there is an increasing concern that the global economic recovery may be weakening. At this point, the copper/gold ratio is not signaling a recession as it did in late 2007 and 2008. However, the decline in the copper/gold ratio indicates that global investors are not convinced that the economic problems and equity market turmoil are behind us.

The currency markets are also signaling some skepticism about the European aid package and China’s efforts to control inflation. In particular, neither the Asian currencies nor the euro have been able to rally significantly after a succession of policy measures. This failure to rebound, along with the rally in the price of gold, indicates that there is further near-term downside risk in the global equity markets.

We remain positive, but cautious, on the U.S. economy and the U.S. equity market this year. As previously indicated in recent reports, the U.S. equity market has already hit our equity strategy team’s year-end target of 1175-1200 for the S&P 500. We continue to believe that the equity market is likely to have only modest gains this year, after the strong 80% rally from March 2009 to April 2010. In addition, we continue to look for increased volatility. Recent market action is consistent with these views. From this point, we do not expect the U.S. equity market to rally significantly higher in the near term, but do expect the rally to continue in 2011, provided policymakers do not make mistakes that derail the economic recovery.

So what should an investor do? On a short-term basis, we are carefully watching the recovery in the equity markets since the dramatic selloff in early May. If the recovery in the equity market is narrow and on low volume, the stock market is vulnerable to further weakness and a possible retest of the early May lows. Short-term tactical traders may want to consider lightening up on equity exposure, if the S&P 500 fails to mount a broad and strong rally above its April highs near 1225-1250 on the S&P 500. Alternatively, if the S&P 500 fails to rally back to the April highs and drops below the early May lows instead, the market is likely to test the February correction lows. If the market does not hold there, it would be an important sign that the equity market is most likely in a longer and deeper correction that could last through the summer and fall.



Important Information, Risk Factors and Disclaimers:

- Past performance is not a guarantee of future results.
- An index is not managed and is unavailable for direct investment.
- Investing in foreign securities presents certain unique risks not associated with domestic investments, such as currency fluctuation and political and economic changes. This may result in greater price volatility.
- Buying commodity based investments allow for a source of diversification for those sophisticated persons who wish to add commodities to their portfolios and who are prepared to assume the risks inherent in these markets. Any investment represents a transaction in a non-income –producing commodity and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.
- Buying gold, silver, platinum or palladium allows for a source of diversification for those sophisticated persons who wish to add precious metals to their portfolios and who are prepared to assume the risks inherent in the bullion market. Any bullion or coin purchase represents a transaction in a non-income-producing commodity and is highly speculative. Therefore, precious metals should not represent a significant portion of an individual's portfolio.
- There is no assurance that the target price will be attained.
- Correlation refers to a statistical measure of how two securities move in relation to each other.