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WELLS FARGO ADVISORS

The Week

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Equities test support

1. The U.S. equity market moved back up to retest the highs last week. This shows that the market has absorbed a fair amount of bad news from Greek sovereign debt problems, to Chinese tightening, to bad winter weather. Now the market is heading into a period of potential seasonal strength in springtime. Nevertheless, at this point, it is still unclear whether the market can sustain a breakout to even higher highs in the near future. In order to answer this question, it is important to look at three things: the near-term economic fundamentals, the likely response to unexpected news and the long-term financial environment.
2. History suggests that after a strong recovery from recession, the equity market often pulls back and consolidates for many months before continuing its advance. If this pattern continues to hold, the equity markets could consolidate in the months ahead.
3. Long-term investors who are risk averse, and are uncomfortable with their equity exposure, may want to lighten up on equities if the market retests the April highs. Alternatively, long-term investors with a greater risk appetite may want to use any market weakness during the next several months to position for a potential resumption of the market advance.
4. The rally in the stock market from the March 2009 low, hit our 2010 target in early April. Therefore, we remain positive but cautious on the U.S. economy and the equity markets.

While talking to several people last week about market pundits, I was reminded of an earlier discussion I had with a friend about scarcity. We live in a world where almost everything is scarce. However, one thing that is not scarce is advice. Everyone has an opinion and is willing to share it. Unfortunately, investors are often confused by conflicting opinions and advice. Nevertheless, it is good to know what other investors are thinking, especially when they change their minds. This can cause markets to reverse direction.

Last week, investor sentiment became extremely negative. Many bearish pundits were very vocal about all the problems around the world. As markets declined during the past month, market opinions became more and more negative. By last week, market opinions seemed almost one-sided. So what makes bearish opinions so convincing at the lows and bullish opinions so convincing at the highs? The answer is market action. A negative opinion looks very accurate when the market is going down, and as the market declines, more pundits turn bearish.

The good news is when market opinion gets very negative and one sided, that means that a lot of the bad news is already be factored into prices. However, when market sentiment is very negative, it is also the time when investors are often convinced to sell. That is why it is important for investors to recognize these extremes in market sentiment and try to avoid selling deeply depressed markets or buying overpriced markets.
So what should an investor to do? First, remember that no one can predict the future. The best anyone can offer is informed guidance from experience or research to back their views. Second, remember that the market often frustrates the majority. In other words, the market seldom does what people expect or want it to do.

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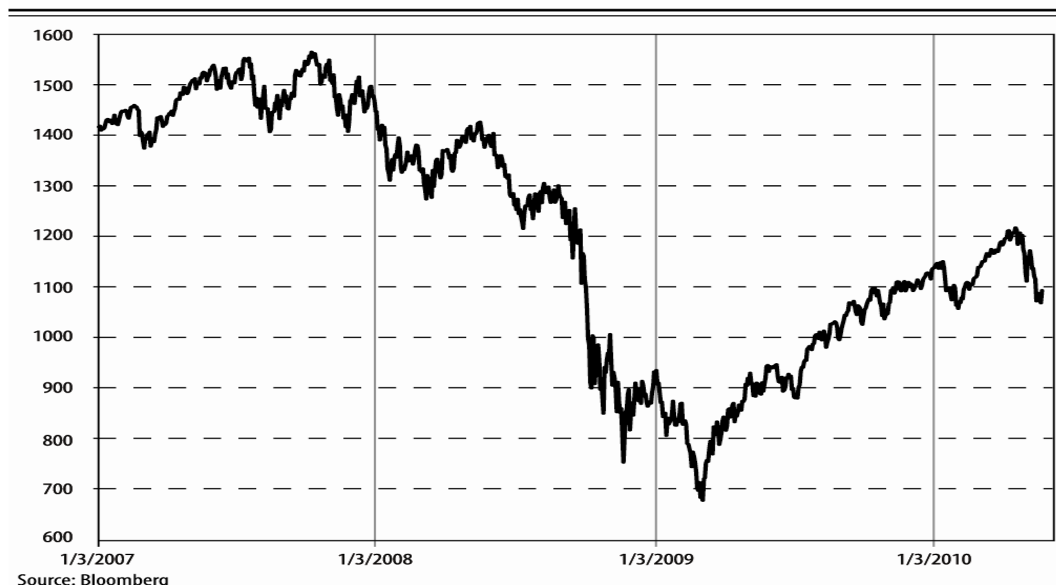
Last week, the U.S. equity market supported right where many analysts expected it to support. Specifically, the S&P 500 dipped slightly below the February correction low of 1044.5, before turning up again. This qualifies as a successful initial test of that earlier support level. Unfortunately, many of the foreign markets have already fallen below these earlier correction lows and then declined further. Therefore, it may be premature to conclude that the U.S. market has completed its downward correction.

History suggests that after the strong 80% advance from the March 2009 low to the April 2010 peak, it would be normal for the market to give back one third or more of those gains in a consolidation that could take several months. By closing above the February low, the S&P has not yet entered a full-blown, multi-month correction.

One indicator that the market is oversold is the negative sentiment. This one-sided sentiment can be a good contrary indicator. When bearish pundits sound most convincing and very few investors say they are bullish, the market is ripe for a change in sentiment that could push prices up instead. Last week's extremely negative sentiment in the stock market suggests that the market is at least temporarily oversold and likely to turn up if sentiment turns positive again.

Thus the market is at a critical juncture. Prices are down at important support. Sentiment is very negative and much bad news is already factored into current market levels. In addition, the market is due for a consolidation when the current correction is complete. If the S&P 500 drops below the 1044 level again, the consolidation is likely to start from a lower level. Alternatively, if support at the February low holds, the market could recover over the summer. It will be important to see how the market trades during this consolidation phase. If the market moves higher with narrow participation and low volume, there is an increasing risk that the recovery will falter. However, if the recovery is broad and volume is good, this would be a positive sign that the upward trend is intact.
Looking ahead, we expect the stock market to consolidate, potentially testing both the April highs and the February lows during the next several months. This would be normal after the sharp rally during the past year. If we are correct, then long-term investors with a time frame of a year or more are likely to get several opportunities to adjust positions depending on their risk appetite. We remain long-term positive, but near term cautious on the economy and the market.



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