

# The Week

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## Risk aversion diminishes, but market volatility is likely to persist

The U.S. stock market advanced further last week as investor sentiment improved and risk aversion decreased. As a result, some market indexes are now near the highs of early last year. The U.S. equity market has come a long way in the past three and a half months, thanks to good news on the U.S. economy and less bad news on the European debt crisis. However, the stock market is vulnerable to a pullback because profit-taking is likely to follow the big gains since the early October lows.

Five months ago, it was hard for many investors to imagine that the stock market would be where it is today. Investor sentiment was very low in August after a confluence of negative events, including the U.S. debt downgrade and the escalating European debt crisis, which caused investors to worry that the U.S. economy was going into a double-dip recession. Fortunately, those worst fears did not materialize. Instead, the U.S. economy has proven

to be more resilient than many expected last summer.

Looking back, the remarkable reversal in the stock market in October was an important sign that investor sentiment was starting to improve. In November, the stock market pulled back and successfully retested the early October lows, then moved higher again. In December, the stock

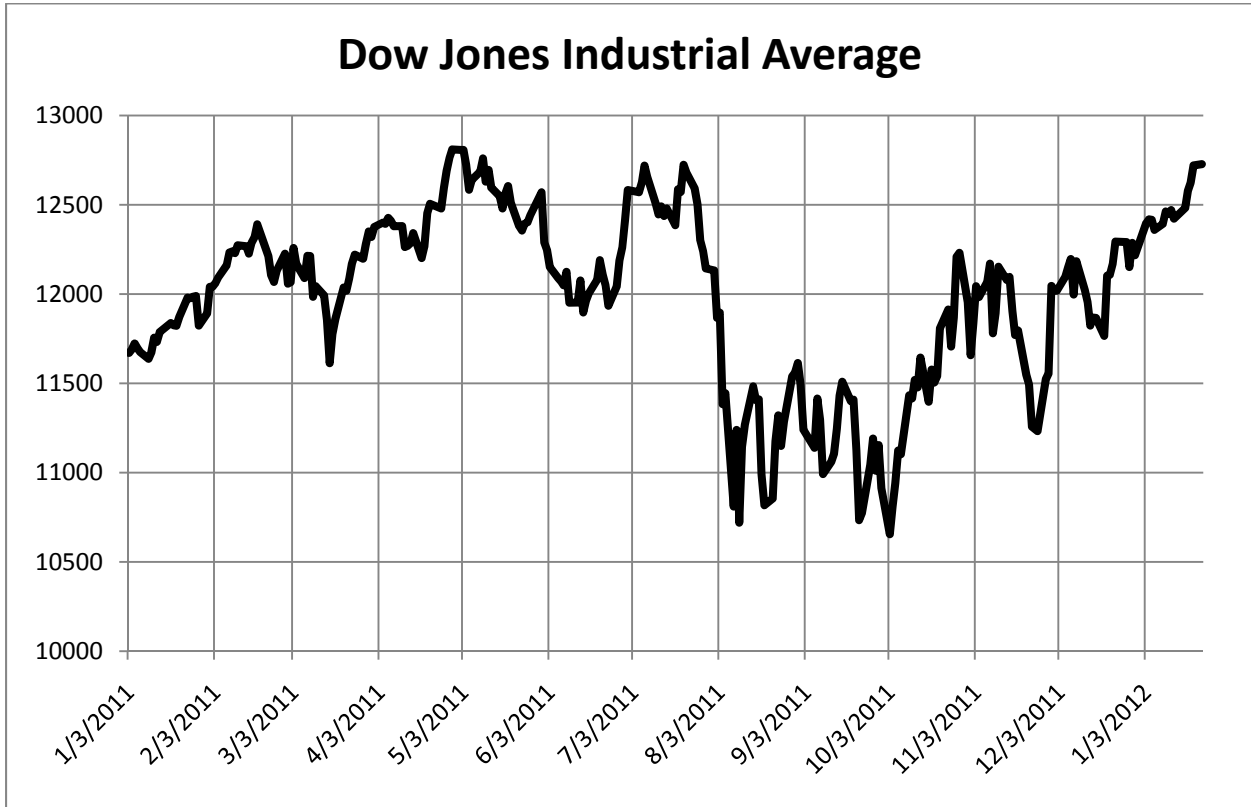


Figure 1: Source, Bloomberg, Wells Fargo Advisors; Past performance is not a guarantee of future results.

market broke above its downtrend in another sign that investors were looking at events more favorably. Finally, during the first few weeks of January, the character of the stock market started to improve with the economically-sensitive sectors outperforming the defensive sectors. This market action indicates that investor sentiment was slowly improving during the past few months and investors were more willing to take risk again. During the transition from negative sentiment to positive sentiment, the stock market can be very volatile as we have seen recently. Equally important, volatility is likely to persist because the economic news is still mixed.

It is encouraging to see the markets respond favorably to recent economic news. The gains in the stock market, despite continuing negative news out of Europe and to a lesser extent Asia, means that investors may be thinking that something good will follow all the recent bad news. So what are some other signs to look for over the next few months that would demonstrate that investors are turning more positive and less risk averse?

First, we look for stocks to perform better than bonds this year. Last year, U.S. government bonds outperformed stocks as investors sought perceived safety. The increased demand for government bonds in 2011 pushed bond prices higher, putting a risk-aversion premium in bond prices. If we are correct and investors are more willing to take risk this year, then this premium in the government bond market is likely to decrease. The erosion of the risk-aversion premium in the government bond market could depress U.S. government bond prices and increase bond yields in the months ahead.

Second, if we are correct and investors are more willing to take on more risk this year, then the U.S.

government yield curve could widen in 2012 as long-term interest rates increase relative to short-term interest rates. Last year's preference for perceived safety over risk also caused the U.S. government security-yield curve to narrow as long-term interest rates declined relative to short-term interest rates.

If the demand for perceived safe-haven investments diminishes this year and investors are willing to take more risk, then we believe investors should use pull backs in the stock market as buying opportunities. Last year, when investors were increasingly risk averse, investors sold stocks on rallies. This year, if investors are more willing to take risk, investors are more likely to buy stocks on weakness.

Finally, President Obama will deliver his State of the Union address this week, and the Federal Reserve will hold its first policymaking committee meeting of the New Year. Investors will be watching for signs that policymakers are committed to boosting economic growth this year.

In summary, the U.S. economy is more resilient than a lot of investors expected this past summer when many people feared that the economy was going back into recession. Recent market action suggests that investors are more willing to take risk again because U.S. economic news has been relatively good, and the news out of Europe has not been quite as bad as it was several months ago. The stock market is vulnerable to profit-taking after the big price gains over the past three and a half months. The U.S. economy still faces many problems. Global economic growth has slowed down and the European debt problems are not yet resolved. However, we believe the stock market has further upside potential if investors are more willing to take risk this year after weathering many problems this past year.

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