



The Week

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Finding balance when the global economic stoplight flashes yellow

The current global economic slowdown is likely temporary. Investors are advised to return to our recommended long-term allocations on international bonds, equities and commodities. We suggest this balanced stance entering the second half of 2011, anticipating new opportunities, once the uncertainty about the global economic expansion subsides.

Most international asset classes rallied in April but made abrupt U-turns in May and continued weak in June, once two new speed bumps emerged. Worries about a possible Greek default grabbed headlines, but the back pages of the news meanwhile were reporting a broadening pattern of softening economic data from around the world. Weaker-than-expected Chinese, U.S., European and Brazilian data were the most prominent (but not the only) signs of the moderating global economic pace.

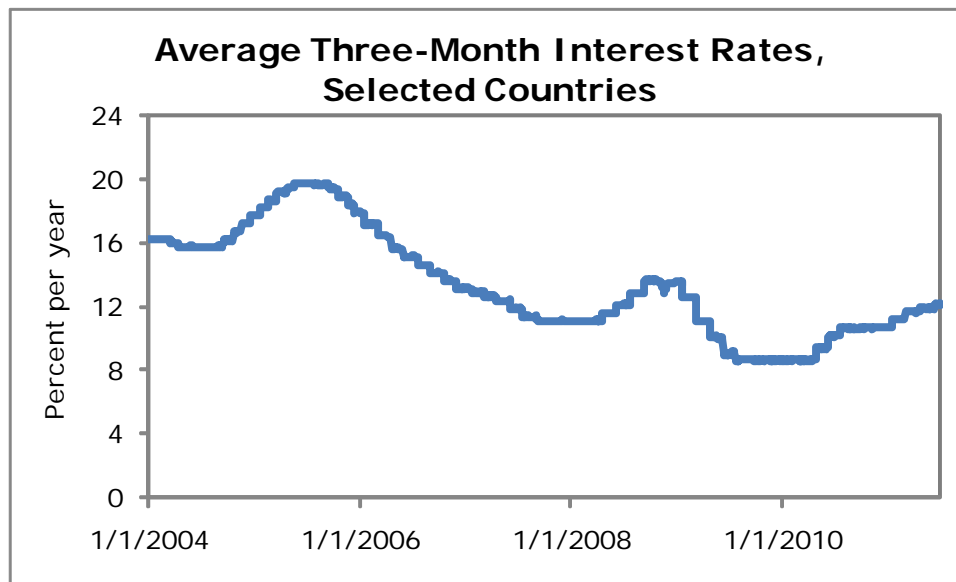
Now that a Greek government default no longer appears imminent, market sentiment has focused on the economic slowdown as the main obstacle to more optimism. The main question is whether the slowdown predicts a new recession and a possible end to the international market rallies that began in 2009. We believe the evidence favors continuing recovery and market rallies, and this report offers advice on positioning while the global economy and markets work through the current uncertainty.

The recent sequence of weaker economic data around the world suggests that the economic expansion is moderating not ushering in a new recession. For comparison, the 2002 – 2008 global economic expansion had two periods of slower but still positive growth (in 2003 and 2005). Each slowdown helped economic activity avoid

overheating and inflation pressures, and international equity markets rebounded following each slowdown.

Recent history suggests that these periods of economic moderation coincide with changes in monetary policy. Immediately after a recession, interest rates tend to be low to stimulate economic activity. But the monetary authorities eventually detect the early signs of inflation and remove the stimulus. At that point, households and businesses must decide whether the economy without stimulus is strong enough for self-sustaining growth.

The global economy appears to have reached this decision point. In the past year, a number of developed and emerging economies have lifted interest rates. The chart below illustrates that an average of short-term interest rates from around the world is rising but remains below the historical average and below the 2008 level that helped curtail economic growth. In the past 30 years, monetary authorities in many countries have come to use rate hikes to pre-empt inflation. The policy probably helps extend the economic expansions but also brings interludes of slower economic growth as central bankers lift rates to “tap on the brakes” of the economy.



Sources: Bloomberg and Wells Fargo Advisors

Data sample: Daily data, Jan. 1, 2004 - June 30, 2011

Countries represented include Brazil, Mexico, Turkey, Poland, Switzerland, Australia, S. Africa, Taiwan, New Zealand, the euro zone, Hungary, Sweden, Indonesia, the Czech Republic, Norway, Canada, Singapore, Japan, Denmark, and the United Kingdom. The rates are three-month deposit or interbank rates.

Other macroeconomic evidence is inconsistent with an incipient recession. First, earnings are robust around the world, particularly in emerging economies. Overall, international earnings growth remains solid, and many national and international benchmark indices appear fairly valued. Second, recessions tend to come after factories run at capacity and skilled labor becomes hard to find – not when significant slack remains in U.S. and European factories and labor markets. These factors all point to a time-out, not an end, to the economic expansion and the market rallies since 2009.

We believe the economic expansion seems robust looking into 2012 and beyond, but short-term

uncertainties about the economic pace may leave market sentiment unsettled. During the coming months, if confidence in the global expansion firms, as we expect, the speed bump should disappear in the rearview mirror. In that case, market sentiment again should see the light change from flashing yellow to green. During this transitional period, investors are advised to return to our recommended long-term allocations on U.S. financial markets as well as on international bonds, equities and commodities. We suggest this balanced stance entering the second half of 2011, anticipating new opportunities, once the uncertainty about the global economic expansion subside.

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