



The Week

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Favorable Winds

The U.S. recovery is slowing down as negative headwinds dampen economic activity. Nevertheless, we continue to believe that U.S. economy is likely to expand modestly because other favorable tailwinds are supporting growth.

Flying out of St. Louis can be very convenient because of its central location within the country. However, flying times to the same destination can vary, depending on headwinds, tailwinds and crosswinds. Investors, like passengers on an airplane, need to watch such outside influences in order to better understand how long it will take the economy to progress through the economic cycle.

Many investors are well aware of current headwinds, because the media spend a lot of time focused on the negative side of things. High unemployment and cautious consumer spending are significant headwinds, hampering economic growth. The good news is there are some favorable tailwinds, particularly strong economic growth overseas and stable energy prices, supporting U.S. economic activity.

Last week, in this report, we showed that the U.S. economy often slows down at this point in the economic cycle. This means that the recent slowdown is normal, although weaker than average compared to the previous 10 economic cycles. If the economy faced too many headwinds and no tailwinds, the risk of a double-dip recession would be high. Fortunately, there are some favorable conditions, supporting economic growth through the current slowdown.

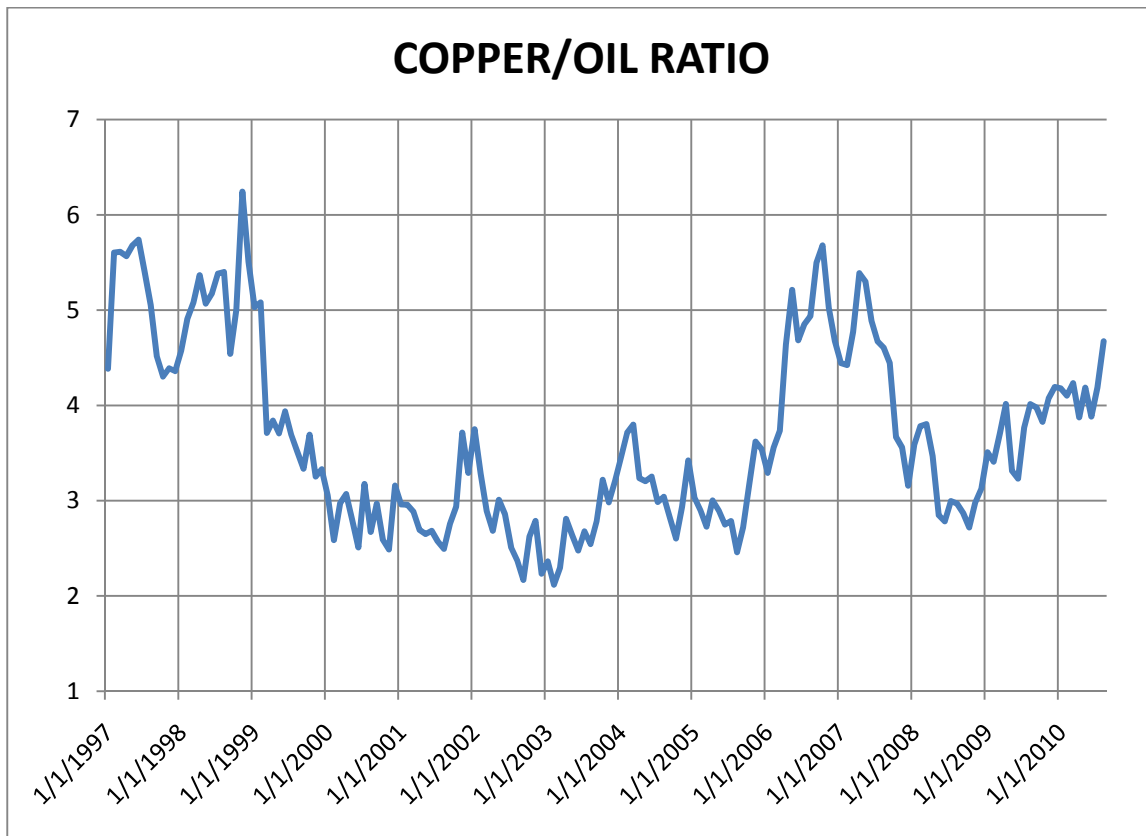
The commodity markets often tell us a lot about the prevailing winds affecting the economy. In particular, copper and oil prices frequently reflect important developments that hurt or boost economic activity. One good indicator of economic prospects is the ratio of copper prices to crude oil prices. The accompanying chart shows that this ratio has increased recently and is now at its highest level since 2007. This is a very encouraging sign that the U.S. economic recovery is likely to continue rather than falter.

A quick look at the graph shows that the ratio of copper to oil prices was declining in late 2007 and early 2008, when the U.S. economy was falling into recession. This was because slower global economic growth dampened copper prices at the same time that rising inflation expectations pushed crude oil prices up to \$147 per barrel. These two negative headwinds, along with the declining housing market, eventually pushed the economy into recession.

Copper prices are increasing this year as the global economy recovers from recession. The United States benefits from a global recovery because of an increased demand for American products. In previous economic cycles, the United States was often leading the recovery, pulling other countries along with the upturn in U.S. activity. This time around, economic growth is stronger in Asia than in America. Consequently, the United States is getting pulled up by better overseas growth. The strength in copper prices is a positive sign that the global economy is recovering and not falling back into recession. This helps the U.S. economy too.

The copper-to-oil ratio has also increased because of steady-to-lower crude oil prices, at the same time that copper prices have increased. With energy prices holding steady, U.S. consumers and businesses can stretch their incomes further and buy more goods, boosting the U.S. economic recovery.

We would be more worried about a double-dip recession, if the copper-to-oil ratio was declining like it did before the 2001 and the 2008-2009 recessions. In other words, the risk of another recession would be greater if oil prices were rising faster than copper prices, or if oil prices were rising while copper prices were declining. Fortunately, that is not happening at this time.



Sources: Bloomberg, Wells Fargo Advisors

This week's graph also shows two periods when the copper-to-oil ratio hit a high level, signaling strong growth. The first was during the economic boom of the late 1990s. At that time, energy prices were low and declining, providing very favorable tailwinds to an already healthy economy. The other time that the copper-to-oil ratio hit a high level was in 2006 and early 2007 when the global economy, especially China, was booming. The copper-to-oil ratio is not as high as it was in these two previous periods, but is moving upward even though many investors are worried about deflation and a double-dip recession. It is important to remember that no indicator is perfect, and past performance does not guarantee similar results. Nonetheless, rising copper prices and steady energy prices are positive signs that the U.S. economic recovery is likely to continue rather than turn into another recession.

It is difficult for long-term investors to stay positive when there is so much negative news

about the economy and geopolitical events. We are even cautioning short-term investors about the near-term downside risks during the seasonally weak September – October period. However, we continue to believe that the risk of a double-dip recession is only about 20%. Therefore, we look for the economic recovery to continue into next year, provided there are no unexpected shocks that would turn the favorable tailwinds into more negative headwinds. In other words, if the global economy continues to expand as we expect, the U.S. economy is likely to follow along. Moreover, U.S. consumers and businesses are likely to increase spending at a moderate pace, as long as energy prices do not spike upward sharply. The latest increase in the copper-to-oil ratio is a positive sign that the economic recovery is likely to continue, despite many investors' fears to the contrary. Therefore, we remain positive on equities over the long run, even though we are cautious in the near term.

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