

The Week

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“Operation Twist” disappoints investors

Investor sentiment quickly turned negative again last week because of growing concerns about European debt problems, and the limited move by the Federal Reserve to boost economic activity. Earlier this month, it looked like sentiment was stabilizing after the shock to confidence in August. However, the latest decline in sentiment suggests that confidence remains depressed. Consequently, the risk of recession is increasing.

Early last week, the Federal Reserve decided to provide extra stimulus to the economy through a measure that analysts call “Operation Twist”. Investor sentiment appeared to be increasing ahead of the Fed’s policymaking meeting on Tuesday. Unfortunately, investors seemed to be disappointed by the Fed’s action. Given all the problems here and in Europe, investors evidently wanted to see a more aggressive move to boost the economy. By the end of last week, the stock market was down near its summer lows again. This suggests that the probability of recession is increasing. As indicated in this report a couple of weeks ago, if the S&P 500 closes this month around the 1100 level, the market would be signaling the probability of recession would be approximately 58%.

The Fed may have decided to provide only limited extra stimulus because some policymakers may not be as negative as a lot of investors. For example, three members of the Fed’s policymaking Open Market Committee dissented from the Committee’s action. They evidently do not believe that the economy needs the extra stimulus. These were the same three policymakers who voted not to support the Fed’s August action to keep short-term interest rates near zero until the middle of 2013. The Fed may have also decided on only limited extra stimulus because the Fed expects the pace of economic activity to increase in coming quarters. However, the Fed acknowledged that the downside risks to the economy have increased.

Under “Operation Twist”, the Fed will extend the maturity of its portfolio of securities by selling approximately \$400 billion of short-term securities and buying a similar amount of longer-maturity securities between now and the middle of next year. This action is designed to push long-term interest rates down in order to lower mortgage interest rates and potentially support the prices of other longer-maturity financial assets.

“Operation Twist” is different from the Fed’s previous stimulus measures because the Fed is not adding a lot of extra liquidity to the economy; it is only reallocating its current holdings. In other words, the Fed is not purchasing more bonds outright as it did during its previous two quantitative easing programs. Under those programs, the Fed bought more securities and expanded the size of its balance sheet. Now the Fed is only extending the maturity of its portfolio by selling shorter maturity securities and buying longer-maturity securities. The size of the balance sheet will not increase, only the average maturity of the portfolio.

Fortunately, not every indicator is signaling recession. Last week, the Conference Board reported that the index of leading economic indicators increased 0.3% in August, following an upward revised 0.6% increase in July. No indicator is perfect, but during the past 50 years the economy has never gone into recession when this measure was increasing at a healthy pace as it has during the past year. In fact, a probability of recession model based on the leading indicator index alone would put the probability of recession at only about 5%.

LEADING ECONOMIC INDICATORS INDEX

2004=100



Past performance is not a guarantee of future results.

Our probability of recession model based on a broader sample of economic indicators has been signaling that the risk of recession was about 25%. However, given recent weak economic data the probability of recession is increasing to about 35%. Nevertheless, we still believe that a recession watch condition exists, not a recession warning. In other words, some of the conditions that could lead to recession currently exist, but a recession may still not occur. The key will be whether confidence recovers or stays depressed.

Right now, sentiment is suffering because of increasing problems in Europe. Investors want to see more concrete action by European policymakers. Unfortunately, this takes time. In the meantime, investors seem to be assuming that the European economy is close to a major financial crisis. European leaders, the International Monetary Fund and the European Central Bank

need to show concrete measures to boost the size of the European Financial Stabilization Fund in order to reassure investors that problems in one part of the continent will not spread to other countries. Several proposals have been discussed but policymakers need to take more definitive action.

In summary, the drop in the U.S. stock market last week after the Federal Reserve announced "Operation Twist" suggests that investors think that policymakers are behind the curve and are not doing enough to avoid another financial crisis or recession. The decrease in investor sentiment suggests that the risk of recession may be increasing, especially since the economy continues to grow at a below-average pace. Of course, the index of leading economic indicators still points to further growth in activity at this time, not a recession.

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- Past performance is not a guarantee of future results.
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