

The Week

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A good time to take profits after the election and the Fed's announcement

Several U.S. stock market indexes advanced to new yearly highs last week, following the election and the announcement that the Fed would provide additional stimulus to the economy. The rally may be encouraging some investors to add to positions, but this may be a good time for short-term investors to take profits instead.

Investors know that it is good to buy low and sell high. However, people often do just the opposite. That's because when the market is going up, there are many good reasons for the advance, leading many people to buy as the market rises. Unfortunately, buying on strength can lead to buying at high prices not low prices.

We believe that the recent strength in the equity market represents a risk to short-term investors

buying at these levels and would recommend taking profits in some positions instead. As a result, the Investment Strategy Committee recommended a tactical tilt last week to reduce positions slightly in both U.S. and foreign developed equity markets. This recommendation is for short-term investors who are sensitive to market volatility. Long-term investors willing to ride through market volatility should remain invested.



Past performance is not a guarantee of future results.

There are several reasons that warrant securing gains at this point. On the fundamental side, the market has already discounted a lot of good news. Specifically, the election results were in line with market expectations. Moreover, the Fed's announcement of additional quantitative easing was close to expectations. Finally, several recent economic reports were better than previous data, suggesting that the economy may have improved slightly. In other words, a lot of good news is already discounted in the market. At this point, it may be difficult for the news to get a lot better. Rather, once the market has discounted a lot of good news, it is often vulnerable to weakness if unexpected bad news hits.

Short-term investors should look at market signals such as bullishness and complacency because they can indicate when there is a risk of buying at the highs or selling at lows. However, these signals cannot pinpoint market extremes. They just suggest when emotions may be pushing the markets too far in one direction, setting the stage for a shift in the opposite direction once those emotions subside. For example, the market has been moving up for several months, and bullishness is high. Therefore, the market may be overbought at these levels. When bullishness is high, it usually means that a lot of traders are long the market, expecting it to go higher. Consequently, there are fewer buyers left to push the market substantially higher. Complacency is also currently high while fear is low. History suggests that investors are most fearful at major lows and least fearful when the market is high. Finally, the correlation between stocks has dropped during the past couple of weeks. Decreased correlation can be a sign that some people are jumping into stocks late at the same time that others are getting out because the market is extended. In other words, this decrease in correlation often means that emotional traders are buying at high prices at the same time that more disciplined traders are selling at high prices.

As we have said in recent reports, we remain long-term positive on the economy and the markets. The election and the Fed's new quantitative easing policy do not change our long-term favorable view. Nevertheless, we recognize that there is a risk of gridlock if the Republican leadership and the President cannot find a way to compromise on important legislation. Likewise, we remain

concerned that the Fed could go too far and pump too much liquidity into the economy, hurting the dollar and increasing the risk of rising food and energy prices, which could hurt the economy. In other words, the afterglow of the election and the Fed announcement looks good now, but the reality is likely to be more sobering. Consequently, volatility remains a risk for short-term investors in the equity markets.

Foreign equity markets are also benefiting from the anticipated extra liquidity from the Federal Reserve. As a result, the U.S. equity market is not overpriced compared to foreign markets. One risk is foreign currencies could be pushed up too far as the dollar declines and money flows overseas. If the dollar drops too much and foreign currencies get too strong, foreign economies could suffer. In fact, several foreign central banks have been looking into defensive measures to prevent excessive speculation in their markets. This could include raising interest rates to fight inflation, restraining domestic lending in their economies in order to offset the impact of foreign money inflows or imposing taxes on the returns of foreign investors in order to discourage speculative inflows. If such measures dampen foreign equity markets, the U.S. equity market might also suffer.

Finally, our equity strategy team continues to believe that we are in the second year of a cyclical bull market. History suggests that market gains in the second and third year are relatively modest compared to the strong advance in the first year of the cyclical bull. So far, the character of the current cyclical upturn has been in line with previous similar periods. Of course, past performance does not guarantee future results. Nevertheless, market advances in the second and third year of a cyclical bull market are often relatively short and are usually interrupted by periods of weakness as the market works its way modestly higher. In other words, if the character of this cyclical bull market remains consistent with other similar periods, the U.S. equity market is likely to move modestly higher over the next year as the economic recovery continues. However, the equity market is unlikely to experience an uninterrupted advance. Therefore, short-term investors sensitive to potential market volatility may want to use periods of market strength to take profits.

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- Past performance is not a guarantee of future results.
- An index is not managed and is unavailable for direct investment.
- Diversification does not guarantee a profit or protect against loss.
- Investing in foreign securities presents certain unique risks not associated with domestic investments, such as currency fluctuation and political and economic changes. This may result in greater price volatility.

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