



The Week

Gary Thayer, Chief Macro Strategist

What's wrong with this picture?

Many investors are worried that the economy is about to fall back into recession. These concerns are normal at this point in the economic cycle. As long as the economy can avoid any unexpected negative shocks that depress confidence and spending, another recession is unlikely at this time.

We have an American gothic style picture at home of a country house. If you look at the print closely, you see there is something wrong with the picture. Clothes drying on a line to the right of the house are blowing to the right while a flag on the other side of the house is blowing to the left. This makes it look like the wind is blowing in opposite directions at the same time. A close look at the economy and investor sentiment shows a similar discrepancy with sentiment declining while the economy slowly improves.

Investors are worried that the economy is falling back into recession, yet recent reports show the economy is expanding not contracting. The expansion has slowed during the past few months, but economic output is increasing, not decreasing like it does in recession. You do not have to look very far to find inconsistencies between positive economic reports and negative investor sentiment. For example, many companies reporting second quarter earnings are saying that business is getting better. However, investors seem to be worried that things are not as good as companies say.

This negative investor sentiment probably reflects the media coverage of the economy that tends to focus on the negative rather than the positive. Obviously, there are still many problems in the economy, including high unemployment, a weak housing market, high debt levels and the prospect of higher taxes in the near future. Therefore, the media has a lot to talk about. But news reports discussing these problems do not usually point out that the economy is dealing with these problems and is still crawling out of the deep hole that it fell into during the recession.

In our mid-year outlook, we listed several positive factors that currently support an economic recovery.

Expanding that list slightly, these include:

- Monetary policy remains accommodative and interest rates are low.
- Credit markets are functioning more normally.
- Corporate profits are rising.
- Consumers are spending cautiously. Companies are slowly hiring workers again.
- Businesses are ordering goods to rebuild depleted inventories.
- Global trade is growing again, increasing the demand for U.S. exports.
- Businesses are resuming capital equipment purchases that were postponed during the recession.
- Inflation is low, allowing consumers and businesses to stretch their spending further.

We do not believe that the economy is heading back into recession. However, we do acknowledge that investors are worried about another recession, especially since the memories of 2008 and early 2009 are still fresh. In addition, we are headed into a seasonally weak period for the stock market during September and October. Therefore, in a tactical tilt, we recommended a week ago that short-term investors underweight large-cap U.S. equities slightly at this time.

It is important to remember that investor sentiment does not always track the economy precisely. For example, before a recession, the economic fundamentals are deteriorating but since a recession has not happened for many years, people are often not worried about a downturn until things get bad. After a recession, the economic fundamentals are improving during the recovery but people are still worried about another recession. This is happening again today. The

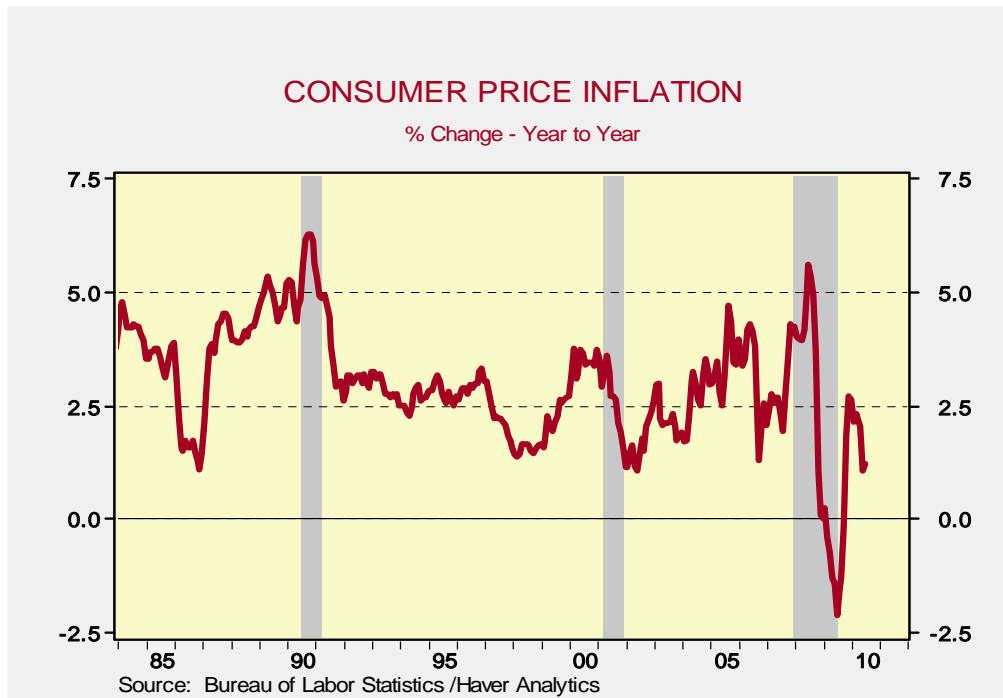
fundamentals favor a recovery but investors fear that the economy will decline instead. Obviously, anything can happen, but a double dip recession is unlikely unless something unexpected derails confidence and spending.

History shows that inflation is a major reason why the economy falls into recession. When inflation goes up, consumers and businesses have to cut back on non-essential purchases to afford necessities. This often starts the downward spiral into recession. Alternatively, when inflation is low and declining, as it is now, consumers and businesses can afford to buy more than just necessities, helping the economy recover.

The latest inflation report from the Labor Department shows that consumer prices increased only 1.2% in the 12 months ended in July. The risk of a double-dip recession would be much greater if prices were increasing rapidly while the economic recovery was slowing down. Fortunately, that is not happening. We continue

to believe the risk of a double-dip is only 20%. However, if an unexpected event causes inflation to jump sharply, the risk of a double dip would increase.

In summary, investors are worried about another recession even though many of the conditions which historically lead to recovery currently exist. Something seems to be wrong with this picture. We believe that the most likely scenario is for continued growth not recession. Nevertheless, we believe there is more downside risk in equities in the short run because people are focusing on the negatives rather than the positives. Investors do not want to go through another downturn like 2008, and we are headed into the seasonally weak period for equities in September and October. Equities are likely to remain volatile this year until the economy improves enough to reduce recession concerns. If the fundamentals remain positive and the market declines this fall as it sometimes does, this could create a buying opportunity for long-term investors later this year.



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