WELLS FARGO ADVISORS

The Week

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Worth noting

- Recent economic data show the U.S. economy is still recovering from recession despite investor concerns about sovereign debt problems in Europe and weak global stock markets.

- History suggests that equity markets often consolidate and give back some earlier gains after a strong rally coming out of a recession.

- The U.S. equity market correction that began in late April continues, creating a buying opportunity for long-term investors.

Correction continues

Investors continue to worry that the global economy is slowing down after a year of recovery from recession. However, the economic data still looks much better than it did when the economy was falling into recession in 2008. The economy is growing now. It was contracting then. The difference is investors are disappointed that the recovery is not as strong as it could be, if many countries were not dealing with big government debt problems. Nonetheless, the global economy is still growing; it's just not growing at a robust pace.

The problem with the equity market is not that the economy is bad like it was in 2008. Rather, the problem is that investors are worried about the economy after the strong advance in equities during the economic recovery. In particular, the U.S. equity market, as measured by the S&P 500, rallied 80% in 13 months from March 2009 to April 2010. After peaking in late April, the stock market has entered a sharp correction, as it works off the excess optimism and complacency built up during the rally.

A correction after a strong rally is natural. However, the correction could go in several different directions. First, the correction could be a long period of modest price weakness. Second, it could be a quick sharp decline that gives back one third or more of the recovery in prices. Or Third, it could be a little of both. A long period of volatile price swings.

So far, the current correction looks like the second possibility, a sharp quick decline in prices, rather than a long period of moderately weak prices. Last week the U.S. stock market started to recover after testing support and holding at the February low. Unfortunately, the stock market often does not do what investors expect, or want it to do. The recovery was cut short by the end of the week with stock prices dropping sharply again on June 4. The excuse for the drop in equity markets was a disappointing increase in nonfarm payrolls, and the dollar was getting too strong when the euro dropped below 1.20 dollars to a euro.

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Six months ago, when payrolls were declining and the dollar was dropping, investors wanted to see strong job growth and a stronger dollar. Now jobs are growing again and the dollar is getting stronger. So why are investors disappointed? They are disappointed that problems still exist, and the economy is not as strong as it could be. In April, investors were optimistic that the economy was finally creating jobs and the dollar was getting stronger. Now, investors are disappointed that the job growth is not strong enough, and the dollar is too strong. This just shows that when a market goes too far in too short a period of time, buyers will turn cautious and use almost any excuse to hold back on additional purchases. That is because they have already put money into the market, causing the big rally in the first place.

The latest flow of funds data from the Investment Company Institute show that during the recession in 2008 and early 2009, investors were pulling money out of equities and putting it into bonds and money market funds. However, money market funds had very low yields, and during the past year, investors have been putting more funds into equities and higher yielding bonds.

Now that investors have put more funds into potentially volatile stocks and bonds, they are turning more cautious. That is why the markets seem to be worried about the economic recovery rather than optimistic about it. In other words, after investors take more risk, it is natural for them to turn cautious and concerned, causing the market to correct and consolidate, especially after the big 13-month, 80% advance.

Of course, the stock market is not the only market to reflect these concerns. A few weeks ago this report highlighted the copper/gold ratio which was signaling increased investor concerns. It is interesting that as the equity market started to recover last week, the copper market continued to weaken, breaking to a new low for the correction. Thus commodity markets are also reflecting an increasing concern that the economic recovery may not be as strong as anticipated.

Last week we said that it is still too early to say that the current correction in the equity market is over. After a 13-month rally, it is likely to take more than one or two months to fully adjust to investor worries. This means that even though equity markets are more attractively priced in June than they were in April, buyers may still be reluctant to purchase more equities after making a commitment to that market earlier this year. Nevertheless, long-term investors wanting to add to their equity positions would be getting a better value now, after the big correction.

We continue to expect the U.S. and global equity markets to be volatile through the rest of this year as the market correction continues. If the U.S. stock market drops below the February low and declines further, this would be an important sign that the market could remain weak through the summer and into the fall. Long-term investors might get several opportunities to add to equity positions in this environment.

12-Month Cumulative net investment flows, $ Billions

	Equities	Bonds	Money Market Funds
Apr- 2009	-230	48	329
May-2009	-227	63	257
Jun-2009	-210	87	215
Jul-2009	-174	120	89
Aug-2009	-150	155	6
Sep-2009	-109	204	-39
Oct-2009	-44	291	-260
Nov-2009	-26	342	-430
Dec-2009	-9	375	-540
Jan-2010	-2	386	-703
Feb-2010	24	395	-775
Mar-2010	61	413	-852
Apr-2010	63	412	-955

Source: Investment Company Institute http://www.ici.org

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