

The Week

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The election, Fed stimulus and market risk

The U.S. equity market appears to be responding positively to recent opinion polls showing the Republicans are likely to gain many seats in the November elections. In addition, the markets seem to be moving higher in anticipation of further Federal Reserve stimulus. The big question is what could happen if investors are disappointed.

The U.S. equity market was very strong in September, during its historically seasonally weak period. This is encouraging, but it is too early to say that it is clear sailing from here. The S&P 500 is now at our year-end target. Therefore, we could see more volatility during the next three months, especially if investors are disappointed because current expectations prove to be too optimistic.

The upcoming, November 2 Congressional election could be a significant turning point in government policy, if current opinion polls are correct. The Republican Party is likely to become the new majority party in the House of Representatives and may be close to a majority in the Senate. The last time a first-term Democratic President lost a majority in Congress at the mid-term election was in 1994. Many investors may be looking back at that period and remembering that the market did very well the following year, even though U.S. economic growth slowed down significantly.

The big change after the 1994 election was not just that the Republicans controlled Congress. The more significant change was President Clinton moved to the political center in order to work with the new Congress. Today, investors appear to be hoping for a similar outcome from this year's elections, although it is still unclear whether President Obama will move to the political center as President Clinton did. If President Obama decides to dig in his heels and push his existing agenda, then investors could be disappointed.

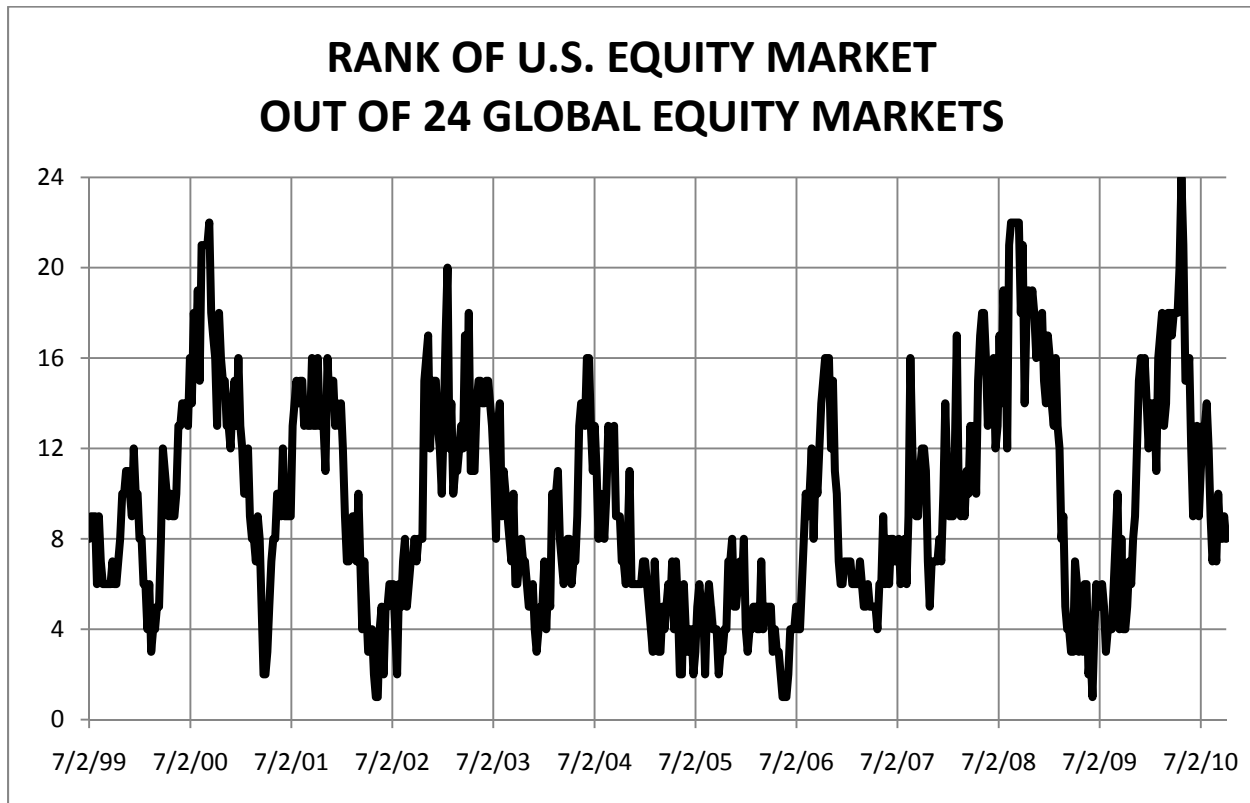
It will be important to watch who the President picks for the open positions in his administration, especially those vacated by the exit of several key economic advisors and his chief of staff. If

President Obama picks more centrist people, this would be an important sign that he may be moving to the center like President Clinton did. If he appoints people with the same views as his previous advisors, investors may be disappointed.

Investors are also anticipating that the Federal Reserve could undertake additional stimulus to boost economic growth and prevent deflation. Of course, such a move is not a certainty. The Federal Reserve pledged to provide additional stimulus, if needed. However, recent statements by several Fed officials suggest that policymakers are still divided on the need for more action. If the economy stabilizes and does not need extra help, the Fed may not undertake any additional quantitative easing. This could also disappoint investors.

So what is the risk to the market, if investors are disappointed because the election results do not move the President to the center or the Federal Reserve just talks about providing stimulus but does not do anything? It is impossible to say for sure. But one way to judge the downside risk is to compare the U.S. market to foreign markets. This comparison shows that the U.S. market is not over priced relative to foreign markets, even though the U.S. market was strong in September.

This week's chart shows the ranking of the performance of the S&P 500 with 23 other global equity markets. This analysis includes 14 emerging markets and 10 developed markets. When the U.S. is ranked number 24, the S&P 500 was the strongest of the 24 markets in this analysis during the past six months. When the U.S. is ranked number 1, the S&P 500 was the weakest of the 24 markets during the past six months.



Sources: Bloomberg, Wells Fargo Advisors. Past performance is not a guarantee of future results.

A rank of 24 means that the S&P 500 was the strongest of 24 global equity markets in this analysis during the past six months. Whereas a rank of 1 means that the S&P 500 was the weakest of 24 global equity markets in this analysis during the past six months.

History suggests that the downside risk to the U.S. market is greatest when its ranking is 24, and the other markets are weaker, pulling the U.S. market lower. This is where the S&P 500 was in April, just before the market correction that lasted until early July. Fortunately, the U.S. market is in a better position now. It has a rank of 8 out of 24 as of the week ended Oct. 2. That means that two thirds of the 24 global equity markets in this analysis were stronger than the U.S. market during the past six months, helping to lift the U.S. market as they advanced during this period.

If the election results are not as anticipated or the Federal Reserve decides that no further easing is necessary, investors are likely to be disappointed. However, the downside risk at a rank of 8 might not be as great as it would be if U.S. investors were overly optimistic and the U.S. rank was 24.

In other words, since 16 other global equity markets were stronger than the U.S. market during the past six months, they are helping to support the U.S. market during pull backs.

We remain long-term positive on the U.S. economy and U.S. equity market. But we continue to be cautious during the next few months, until the election uncertainty is cleared up and Federal Reserve intentions are more definite. Of course, U.S. equity markets are also vulnerable to downside risk if there are other negative events that depress better-performing foreign equity markets. These could include, disappointing growth out of China, further banking problems in Europe or a drop in the dollar that pushes foreign currencies up to a high level that hurts foreign economic growth. With all these uncertainties, we may still see choppy waters during the next few months rather than smooth sailing.

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- Past performance is not a guarantee of future results.
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- 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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