

The Week

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Another good start to the year

Stock market volatility has subsided considerably during the past few weeks, following the extreme volatility of last summer. As a result, the U.S. stock market advance during the first seven weeks of this year has been almost a steady rise in prices. A year ago, the stock market also rose steadily at the start of the year but conditions deteriorated by mid-year. This report will look at some of the similarities and differences between this year and 2011.

A year ago, the stock market was approaching its two year anniversary of the bull market recovery from the March 2009 recession lows. In February of 2011, the stock market was up almost 100% in 23 months with only one modest correction in the summer of 2010. Consequently, investors were increasingly hopeful that the financial crisis was finally behind us. Unfortunately that optimism did not last very long. The stock market advance started a normal pull back in February 2011, which deepened when the Japanese earthquake and tsunami disrupted the global supply of goods and parts for manufacturing. The U.S. stock market attempted to rally again into early May. However, as the end of the Fed's quantitative easing program approached in June, the stock market started to decline again. Of course, this correction and decline in investor sentiment was aggravated by the Congressional fight over the debt ceiling, disappointing gross domestic product (GDP data), the U.S. debt downgrade and the escalation of the European debt crisis. By September, investor optimism had turned to pessimism as fears of a double-dip recession increased.

This time line of last year's stock market activity shows that unexpected events and the convergence of negative news can lead to a dramatic swing in investor sentiment. However, it is important to remember that this string of unexpected events occurred after a large rally in the stock market and at a time when central banks in many countries were tapping on the brakes.

A year ago, inflationary pressures were rising as the global economic recovery accelerated and the demand for resources, especially from Asia, pushed commodity prices higher. Therefore, central banks in several countries raised interest

rates in order to reduce inflation risks. At the same time, rising energy prices were reducing consumer purchasing power and squeezing corporate profits. The stock market was due for a time-out after the strong two-year rally. Moreover, rising inflation and interest-rate hikes by several central banks added to the risks that the stock market could weaken in the second half of 2011. Unfortunately, the confluence of the debt ceiling downgrade and the European debt crisis caused investor sentiment to drop much more than the economic fundamentals would have suggested. In the end, the positive fundamentals outweighed the negative sentiment, and the stock market rallied in October, finishing the year better than many investors probably expected during the summer turmoil.

The stock market may be starting this year positively like it did last year. But many of the fundamentals are better in 2012 than they were in 2011. Inflation is subsiding this year, and many of the central banks that raised interest rates to fight inflation last year are cutting interest rates this year. As a result, 2011's monetary policy headwinds are a tailwind for the stock market this year.

Another significant difference between this year and last year is the level of investor sentiment. A year ago, investors were relatively optimistic at the start of 2011 because the U.S. stock market was almost 100% higher than it was two years earlier. This year, investors are not very optimistic after the extreme volatility of 2011. Many people are still worried that the U.S. economy might go into recession because of problems in Europe or a hard landing in China. Finally, the S&P 500 is only slightly higher than it was in February 2011. Consequently, the stock market is not over extended despite its orderly 8% advance during the first seven weeks of 2012.

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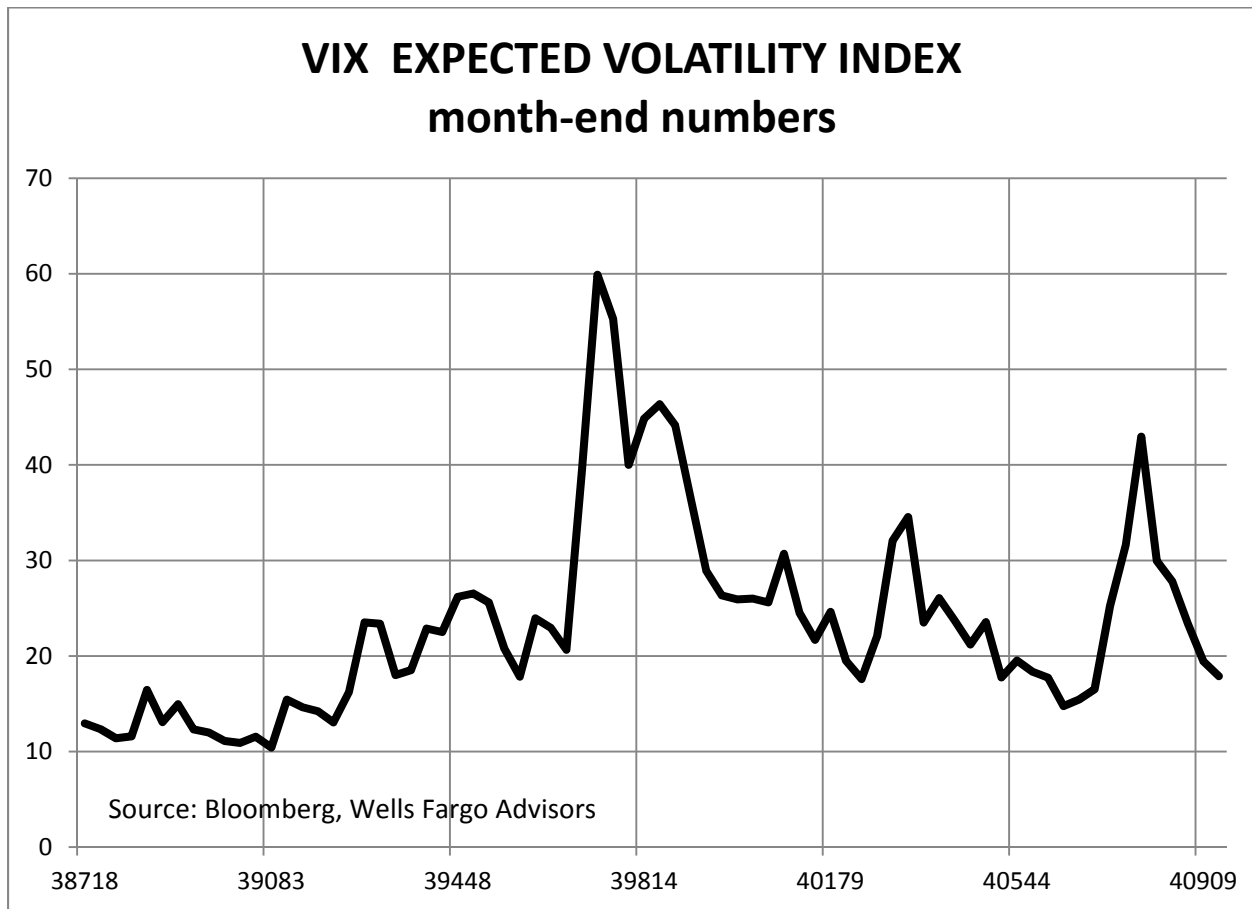


Figure 1. This index reflects the expected annualized percentage change in the S&P 500 over the next 30 days.

History suggests that stock market volatility is unlikely to stay at the current subdued level throughout this year. Unexpected events will likely occur, and the stock market could turn volatile at some point in 2012 as investors digest new worries. Nevertheless, it is important to remember that the U.S. stock market has fewer headwinds and more tailwinds at the start of this year compared to the start of 2011. The U.S. stock market is not over extended or substantially higher than it was a year ago. In addition, inflation is moderating this year, not increasing like it was last

year. Finally, central banks are cutting interest rates, not raising rates like they were last year. Therefore, we continue to believe that investor sentiment has room to improve.

At this point, our Equity Strategy team is not looking for the stock market to be substantially higher than current levels at the end of this year. However, the stock market may move above our year-end target at some point during the year if investor sentiment continues to improve as we anticipate.

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- Past performance is not a guarantee of future results.
- An index is not managed and is unavailable for direct investment.

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