

QUICK MARKET UPDATE

This is Just Awful!, Take Two

Ron Florance, CFA[®], Managing Director of Investment Strategy
Sean Lynch, CFA[®], Global Investment Strategist

October 4, 2011

The last time we wrote a Quick Market Update with this title, it was February 20, 2009. Back then, the economy was in much worse shape than it is today. The markets had dropped much more than they have now. But the prevailing mood was about the same. This makes any rational investor wonder, "Maybe the world is actually coming to an end?" The excerpt below is an exact quote from the piece written in 2009, and it is fairly accurate today.

"The mood is just awful. Like many of you, I cannot seem to escape it. After a bruising day yesterday, I woke up at 4:00 AM this morning to check on Asian markets and U.S. equity futures. I knew the answer before I looked, but I still needed to make sure that I did not get a good night's sleep. Sure enough, carnage. Asian markets off two percent, European indices sliding more, over a three percent decline, and U.S. futures trading with the Dow set to open nearly 200 points lower. Sweet dreams!

I just kept thinking why is this happening now? Maybe the world is actually coming to an end, and I have missed the call."

Scary how similar the current investor sentiment is to what we saw in the first quarter of 2009.

Today, Europe is mired in a debt crisis that can't seem to get to resolution. The political will to make the tough decisions is not there, yet. The U.S. economy is trending towards a flat line, with the anemic recovery quickly approaching zero, and recession fears growing. Emerging economies are slowing down, with the question lingering "Is this a soft landing or a collapse?" Investors are hitting full market fatigue and willing to move money to assets with very unattractive valuations, simply to avoid the excessive volatility in the capital markets.

As of the writing of this piece, the global equity markets are in full bear market territory. The S&P 500 is down 21 percent from the highs of 2011, developed-market equities are down 26 percent from their year-to-date highs, and emerging markets are down 30 percent. I can give you all the academic statistics that corrections happen every 330 calendar days since World War II, and that this correction is 301 days since the last one in 2010. That won't make you feel better. I can tell you that this is a healthy, yet painful, process of capital market cycles, swinging from greed to fear as traders re-price risk. That won't make you feel better.

Europe is the Focal Point

Europe seems to be the story leading the global markets, so let's discuss that. Europe fatigue has definitely set in with investors, and they're reacting by moving to the sidelines. Europe has deep structural problems. Following recent meetings of the International Monetary Fund and other world leaders, a sea of change seemed to occur within the mindset of the European leaders. A sense of urgency that something needs to be done, and done soon, to avert an even bigger crisis in Europe has started to be articulated by European financial authorities. The rationale for this urgency was a combination of funding pressures, shrinking credit and an increasingly cautious private sector. Lacking confidence, businesses pull back on hiring and capital spending. The longer the uncertainties surrounding the European banks linger, the deeper a recession Europe may experience and the greater its impact on global economic growth. So what are the key issues in Europe?

- The European Banking system is under pressure—compounded this week by severe losses at a French/Belgian bank Dexia.
- The sovereign debt crisis in the Euro zone (particularly in Greece) continues to deteriorate. Greece's one-year bonds yield 130 percent. Essentially the market understands that these bonds will never mature at par. Greece needs to restructure its debt in an orderly fashion, and the banks need to mark down the prices of their Greek bond holdings as much as 50 percent. Otherwise a disorderly default of Greek debt could lead to financial contagion, first affecting the periphery countries of Portugal and Ireland, followed by the much larger economies of Spain and Italy, overwhelming current resources available to authorities.
- The Euro zone needs to restructure for longer term survival. This is a much bigger issue and will take much longer to solve. Our perception is that leaders want this issue resolved before taking decisive action on the first two issues. That is a nice plan but unfortunately, getting all 17 nations to agree on a longer term plan likely will take longer than the frayed banking system can handle.

So what's next? Sometime in mid-October, the Euro zone should have ratified the modified European Financial Stability Facility (EFSF), expanding the fund to 440bn euro. The EFSF may try to expand its powers with these additional monies by injecting capital into banks, purchasing bonds of distressed government, and possibly taking on leverage by guaranteeing a portion of sovereign credit.

Investment Strategy Response

We have made several tactical shifts to guide our strategies through this turbulent year. We are asset allocation strategists, and as such, we tend to be contrarians. We are not market timers or momentum traders, but instead we look for value and opportunity in risk assets when others

are focused on short-term emotional trends. When investors are fleeing for the exits, we tend to look around and evaluate “Is the building really burning down, or is this an opportunity to upgrade my seat in the theater while they are all gone?”

To date, our responses have been to remove risk from the portfolios starting early in the second quarter. In April, we reduced our exposure to developed-market equities as we saw the situation in Europe deteriorating. In July, we reduced exposure to developed-market bonds, commodities, and emerging-market debt as the signals continued to deteriorate. We added cash to the strategies at that time. In September, we increased our exposure to high-yield debt, as credit market spreads became very attractive. Throughout this period we have remained overweight complementary strategies which have significantly helped to reduce volatility in portfolios. *We are not announcing any tactical shifts today, but suggest that a rebalancing trade buying attractively priced risk and selling unattractive yields is compelling.*

Strategies for Today

I hesitate to talk about time horizon, as that may evoke a rolling of the eyes response. Instead, let's talk about when the money will be used. This is a critical parameter that needs to be constantly evaluated when making investment decisions.

For investors that need this money within the next 12 months, we suggest holding cash or ultra-short term fixed income investments. Though the yields are very unsatisfying, maintaining liquidity, transparency, and principal stability is important for such short duration financial needs.

For investors that are going to spend the money over the next five years, look to a strategy similar to our Income or Balanced Income asset allocations. These investors need to have a high level of liquidity, cash flow, and risk diversification. Our four asset group strategy provides exposure to significant global fixed income and global dividend paying equity investments along with comprehensive diversification designed to address these investors' needs and the risk and opportunities in today's global markets.

For investors who are going to spend the money over the next 25 years, look at our Balanced and Balanced Appreciation strategies. These provide the appropriate global diversification designed to help immunize portfolios against the three most corrosive aspects of wealth decline: inflation, taxes and consumption. Having assets that capture global demographic trends, global economic opportunity, and cash flow opportunities designed to trump inflation is critical to investment goals with this long time horizon.

In Conclusion

The world is not coming to an end, but there are aspects of the global economy that are ending. Working in Greece until you are 50, and retiring for 40 years is ending. Working in the U.S. until you are 55, and expecting government entitlements to fund your retirement until you are 90, is ending. The hope of beating inflation by investing in long-term Treasury bonds, is ending.

As I stated in February of 2009: *So, what should we do about it?* If I suggest to stay the course, stick with long-term asset allocations, rebalance portfolios, and be greedy when others are fearful (all of which I firmly believe in), someone is going to throw a shoe at me. The reality is investors have two choices. Sit it out until they feel better, or start buying risk on sale. Personally, I am choosing to buy risk on sale, because my investment time horizon gives me that luxury. When do I need to spend the money that I am investing? When I see "mitigated risk" investments with yields below five basis points, I realize that those returns will not give me what I need. When I see yield spreads for municipal bonds, corporate bonds, and high-yield debt at high levels, I start to see benefit. When I see price-to-earnings ratios of good companies below 10, I see benefit. When I see dividend yields above three percent, I see benefit. When I see well designed asset allocation strategies that include fixed income, equities, real asset, and complementary strategies positioning me for recovery, I see benefit.

Are we at the exact bottom? *I have no idea.* Will the current global crisis of Europe get resolved? *Most likely it will.* Will Europe look the way it did five years ago? *Not likely.* Will the market respond favorably to that? *Most likely it will.* Will the market turn before the all clear is sounded for the U.S. economy? *Most likely it will.* Do I want to be there to benefit? *You bet.*

This is just awful! Every time I look at my computer screen to check the market levels, I feel a wave of nausea. I continue to struggle on a daily basis between reacting emotionally and being opportunistic. I have decided to be prudently opportunistic, and utilize the global four asset group investment strategy to provide me with the appropriate amount of liquidity, cash flow, diversification, and economic opportunity to address my financial need for not just tomorrow, but years to come.

Data for this QMU sourced from Bloomberg unless otherwise noted.

Disclosures

Wells Fargo Wealth Management provides products and services through Wells Fargo Bank, N.A. and its various affiliates and subsidiaries.

The information and opinions in this report were prepared by the investment management division within Wells Fargo Wealth Management. Information and opinions have been obtained or derived from sources we consider reliable, but

we cannot guarantee their accuracy or completeness. Opinions represent Wells Fargo Wealth Management's opinion as of the date of this report and are for general information purposes only. Wells Fargo Wealth Management does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

Asset allocation and diversification do not assure or guarantee better performance and cannot eliminate the risk of investment losses.

Past performance does not indicate future results. The value or income associated with a security may fluctuate. There is always the potential for loss as well as gain. Investments discussed in this presentation are not insured by the Federal Deposit Insurance Corporation and may be unsuitable for some investors depending on their specific investment objectives and financial position.

This report is not an offer to buy or sell, or a solicitation of an offer to buy or sell the securities or strategies mentioned. The investments discussed or recommended in the presentation may be unsuitable for some investors depending on their specific investment objectives and financial position.

Some alternative investments and complementary strategies may be available to pre-qualified investors only.

Some real assets may be available to pre-qualified investors only.

Fixed income securities are subject to availability and market fluctuation. These securities may be worth less than the original cost upon redemption. Certain high-yield/high-risk bonds carry particular market risks and may experience greater volatility in market value than investment grade corporate bonds. Government bonds and Treasury bills are guaranteed by the U.S. government and, if held to maturity, offer a fixed rate of return and fixed principal value. Interest from certain municipal bonds may be subject to state and/or local taxes and in some instances, the alternative minimum tax.

Investing in foreign securities presents certain risks that may not be present in domestic securities and may not be suitable for all investors.

Indexes represent securities widely held by investors. You cannot invest directly in an index. S&P 500 Index is a capitalization-weighted index calculated on a total-return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation and financial companies.

Wells Fargo and Company and its affiliates do not provide Legal advice. Please consult your legal advisors to determine how this information may apply to your own situation. Whether any planned tax result is realized by you depends on the specific facts of your own situation at the time your taxes are prepared.

© 2011 Wells Fargo Bank, N.A. All rights reserved.

Investment Products: ► NOT FDIC Insured ► NO Bank Guarantee ► MAY Lose Value