

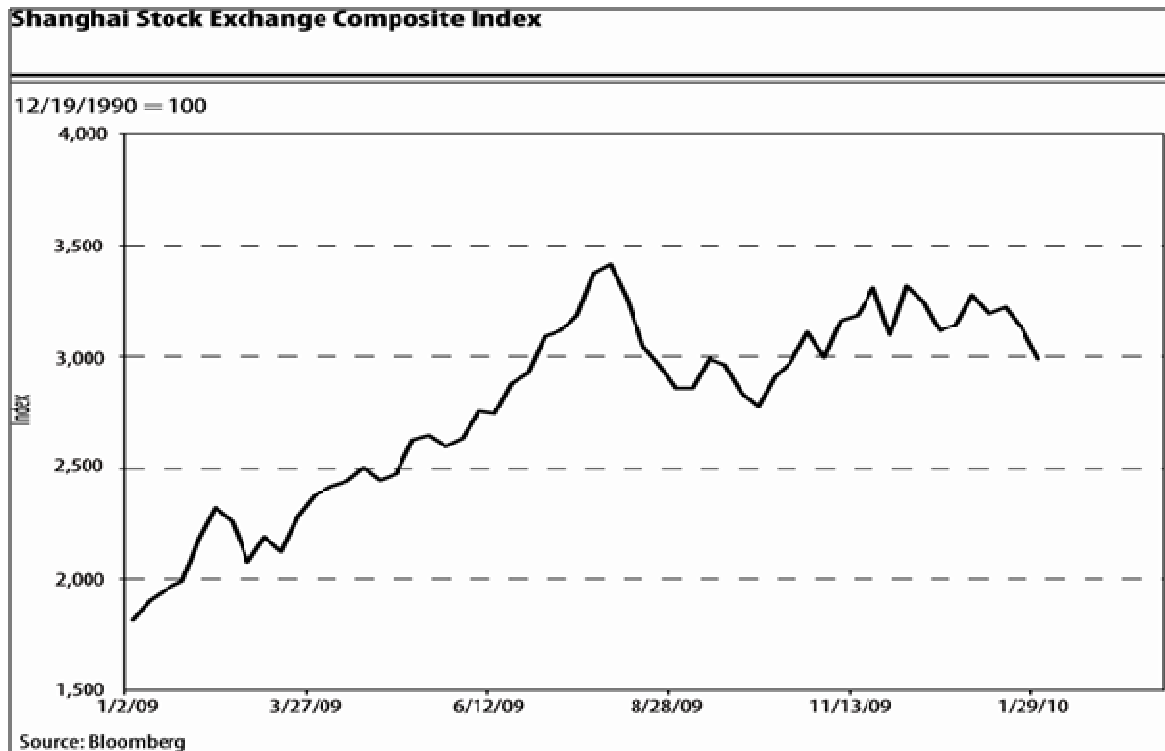
# The Week

---

*Gary Thayer, Chief Macro Strategist*

## **Market volatility increases**

- The U.S. economy does not change much in a week but market sentiment can. On January 19, the Dow Jones average hit a new 15-month high. By the end of that same week, the market had dropped to the lowest level since early November, erasing the gains from the prior 10 weeks of trading activity. In our 2010 outlook, we noted that equity markets historically have only modest gains and greater price volatility in the year following a strong market recovery. In fact, one of our themes for 2010 was to expect volatility this year. This already appears to be happening even before the end of January.
- The big question is what has changed during the past two weeks? The economy still appears to be in recovery. Even the Federal Reserve acknowledged this for the first time in its statement after the January 26 and 27 Open Market Committee meeting. The change has been a shift in investors' concerns about when policymakers will begin to remove the monetary stimulus that has fueled the equity market recovery.
- In mid-January, China announced that it was clamping down on lending in order to fight inflation. Investors took this news poorly, fearing that tighter credit in China was just the first step toward tighter credit in other countries. These concerns were well founded. India announced on January 29 that it was raising reserve requirements to tighten credit.
- In our 2010 outlook, we discussed how the withdrawal of liquidity after a year of strong market gains is historically a concern to investors leading to more market volatility after the initial surge. But this time around, investors are more concerned about foreign central bank action rather than a change in Federal Reserve policy.
- The Federal Reserve continues to say that it will keep interest rates at exceptionally low levels for an extended period of time. U.S. policymakers have been repeating this guidance since December 2008. However, the vote for this policy at the January Fed. meeting was not unanimous. Kansas City Fed. President Hoenig voted against maintaining this position because he thought that the U.S. economy has recovered enough and may no longer need very low interest rates.
- Even European policymakers appear to be leaning toward removing excess stimulus this year. If China and other countries begin to withdraw liquidity, then the Federal Reserve may eventually have to follow suit. That's because foreign investors own a lot of U.S. Treasury debt. If U.S. interest rates do not remain competitive with foreign interest rates, then demand for U.S. debt could decrease, making it harder for the U.S. government to finance its big deficit.



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

- This week's chart looks at weekly closes of the Shanghai Stock Exchange Composite Index during the past year. China's move to restrict lending this month was not the first time that China took such action. Last summer, China announced that it would try to limit lending during the second half of 2009, and the Chinese market dropped sharply, declining 24%. Fortunately, equity markets in other countries did not react as negatively as the Chinese market.
- Unfortunately, China's initial effort to restrict lending did not work. Lending surged again during the first two weeks of this year. Consequently, Chinese officials have stepped up their pressure. This time, China's move to tighten credit hurt other global markets not just the Chinese market.
- A review of the chart shows that the Chinese equity market only partially recovered from the sell-off last summer before it started to decline for a second time. This renewed weakness in the Chinese market is making investors more risk averse in other markets too. Global liquidity has not dried up, but investors are beginning to anticipate that global liquidity will be less abundant this year. Investors now see the glass as half empty rather than half full. This has caused global equity markets to weaken.

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

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. The Standard & Poor's indexes are unmanaged, weighted indexes of stocks providing a broad indicator of price movement. Individual investors cannot directly purchase an index.

Wells Fargo Advisors is the trade name under which Wells Fargo & Company provides brokerage services through two registered broker-dealers: Wells Fargo Advisors, LLC, Member SIPC, and Wells Fargo Advisors Financial Network, LLC, Member SIPC. Each broker-dealer is a separate non-bank affiliate of Wells Fargo & Company.  
©2010 Wells Fargo Advisors, LLC. All rights reserved.