

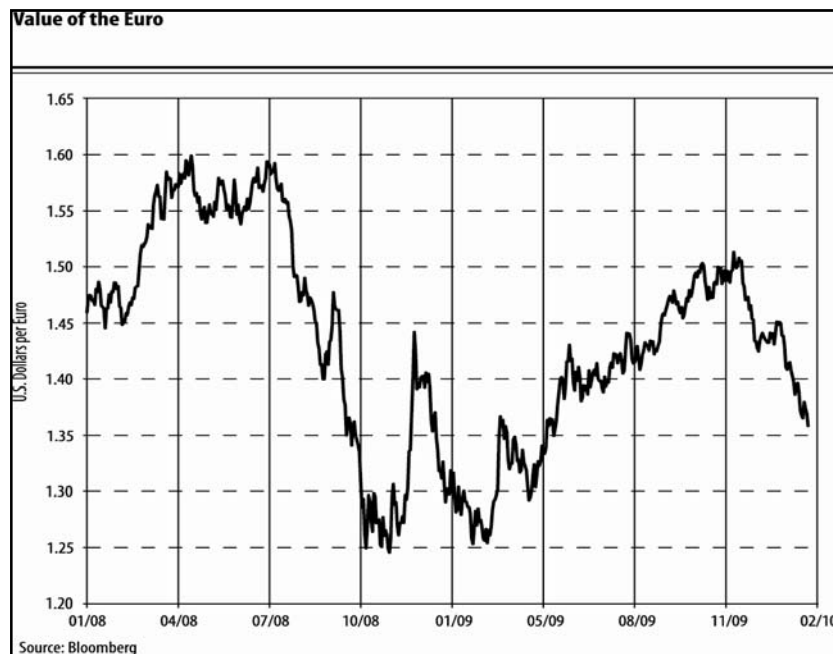
The Week

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Carry trade unwinding signals risk aversion

- Back in December this report focused on the signal from the carry trade that suggested caution was in order for investors in global equity markets. This week's report will expand on that analysis, because the carry trade is now signaling investors are becoming even more risk averse as global equity markets retreat. This suggests there may be further downside risk in the current U.S. equity market correction.
- The carry trade exists because of divergent economic performance between countries. Traders following this strategy borrow money in a low-interest rate country and invest that money in other countries with higher interest rates or better performing equity markets. Consequently, measures of the carry trade are good indicators of when investors are optimistic and willing to take investment risk. Alternatively, when the carry trade is being reversed, investors are turning more cautious and are less willing to take the risk associated with this trade.
- Back in December, we looked at the carry trade between Japan and Australia. Through much of 2009, the Australian dollar strengthened relative to the Japanese yen, because investors borrowed funds in Japan and converted them into Australian dollars before investing in Australia. In December, this exchange rate began to turn down, signaling that the Aussie dollar was weakening as traders lightened up on that carry trade. This was an early sign that investor sentiment was turning more cautious.
- This week's report will focus on the relationship between the U.S. dollar and the euro. During most of 2009, a similar carry trade hurt the U.S. dollar and boosted the euro as investors borrowed funds in the United States to invest at higher short-term interest rates in Europe or in better performing European equity markets. During the past two months, the carry trade with the euro has been reversed, causing the euro to decline in value and the dollar to rally. This trade is not unwinding because of changing interest rates. Instead, it is unwinding because investors are not willing to take as much risk. Sovereign debt problems in Greece and concerns about the stability of the European Union caused much of this shift to risk aversion, hurting global equity markets as well as the euro.
- So what should U.S. investors do? If you are a long-term strategic investor, you should probably not overreact to these developments. That's because these problems, although serious, are not likely to derail the global economic recovery. Therefore, if global equities decline further as the unwinding of the carry trade suggests, long-term investors may see a good buying opportunity. This would be consistent with our 2010 outlook, which anticipates increased market volatility this year and only modest gains compared to last year. In this environment, buying on weakness creates opportunities for better gains than a buy-and-hold strategy.
- If you are a tactical investor, you may want to be more defensive in the short-run. As indicated in last week's report, if the S&P 500 trades below 1039 for several weeks and stays there, this would be an important signal to us that a more prolonged period of weakness is likely, in contrast to the brief market corrections in 2009.
- When assessing the downside risk in U.S. equity markets, it is important to compare the U.S. market to foreign markets. If the U.S. equity market was the only weak market and foreign markets were still rallying, a tactical investor might not do well to sell the U.S. market. The strength in foreign markets could eventually pull the U.S. market up along with the rising foreign markets. This relationship held during most of 2009, with the better performance of foreign markets helping boost U.S. equities last year.

- The relationship between the U.S. and foreign markets is different now than it was last year. The U.S. equity market appears to be declining less than many foreign markets. This makes the U.S. market rich compared to foreign markets that are experiencing deeper corrections. In such situations, history suggests there is more downside risk of the U.S. market being pulled down along with the weaker foreign markets. Thus, the greater weakness in foreign markets means there is a growing risk that the S&P 500 will trade below the 1039 level that would signal a more prolonged period of weakness for U.S. equities.



Past performance is not an indication of future results.

This week's chart looks at the exchange rate between the U.S. dollar and the euro. It is measured in dollars per euro. When the line on the graph is rising, as it was during most of 2009, the euro is strengthening, suggesting more traders are putting on the dollar/euro carry trade. When the line is falling as it has recently, the euro is weakening, suggesting traders are turning more risk averse and are unwinding that carry trade.

The shift to risk aversion has hurt many global equity markets. Consequently, the recent decline in the U.S. equity market is not an isolated event with other markets doing better. Instead, decreased willingness to take risk is dampening many foreign equity markets more than the U.S. equity market. This increases the risk that declining foreign equities could pull U.S. markets down further before the current correction is over.

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