

# The Week

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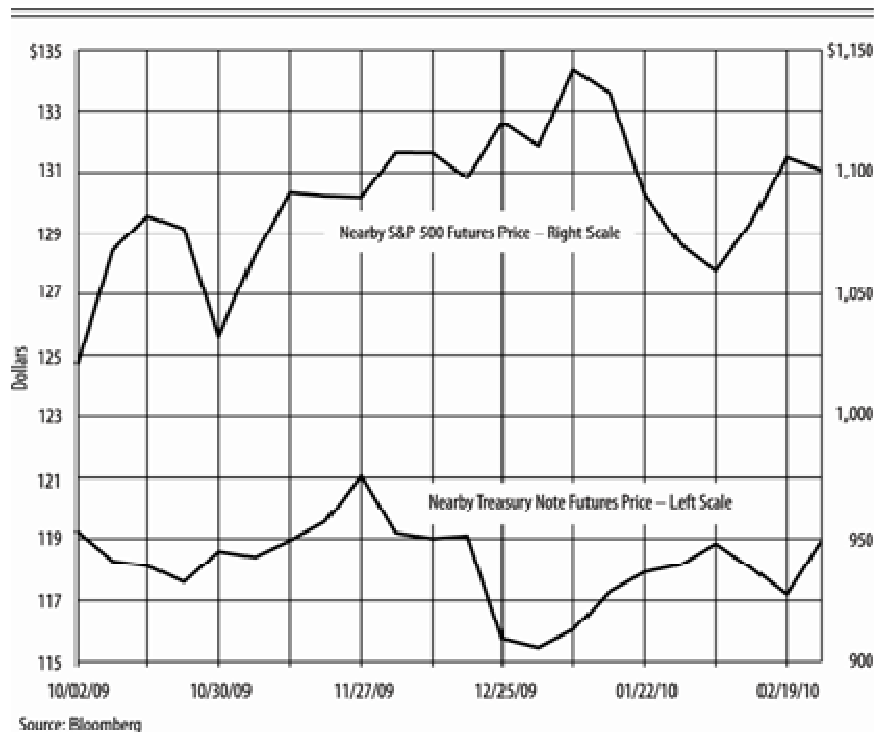
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## **Other indicators of a reduced risk appetite**

- During the past two months, the U.S. equity market has been soft, at the same time that the U.S. Treasury note market has been firm. These two markets appear to be signaling that investors are concerned about the strength of the economy and are less willing to take risk. This week's report will look at the risks faced by investors in the current environment.
- Recent market action shows the U.S. stock market has entered a trading range. However, after the strong advance last year, the U.S. market is not as undervalued as it was in early 2009. In addition, prospects for a strong global economic recovery have dimmed, because of weak consumer spending and sovereign debt problems in several European countries. Consequently, in the near term, downside risks in U.S. equities persist.
- Two weeks ago, we looked at the carry trade and discussed the risk that weakening foreign equity markets could pull the U.S. equity market down along with them. That analysis showed that successful investors need to look beyond an individual asset's expected return and market volatility to assess its true risk. Investors also need to look at the correlation of one asset to another to determine how movements in one market may affect others. In other words, the U.S. equity market has been doing better than several foreign markets. But, since global equity markets often move together, there is a risk that foreign equity market weakness could hurt U.S. equity markets too.
- The U.S. equity market and many foreign equity markets are highly correlated. This means that over the long run they tend to move up and down together, although not necessarily at the same rate. If investors want to reduce the risk of holding positions in a weak European equity market, they may not escape the downside risk by shifting to a U.S. equity market, because these markets often move together. Therefore, investors may also want to look at other types of assets to reduce risk.
- If a tactical investor is turning cautious, he or she needs to consider assets that could rise in price when others fall. For example, the weakness in the U.S. equity market during the past two months has coincided with firmness in the U.S. Treasury market. History shows that these two markets often move inversely, in periods of low inflation. When the U.S. equity market declines, the U.S. Treasury market frequently rallies. This inverse relationship between stocks and bonds often makes the Treasury market a safe haven for investors seeking to reduce risk in equities. Of course, past performance does not guarantee similar results.
- The recent firmness in the U.S. Treasury market is not just because U.S. investors are reducing equity exposure and are moving into Treasuries. The increased demand for U.S. Treasuries is also related to the weakness in the European economies and equity markets. Investors in Europe, seeking a safe haven from weakening European equity markets, appear to be shifting funds into high quality German government bonds. Similarly, investors holding Greek or Spanish sovereign debt may be shifting into German bonds. This increased demand for German 10-year government notes has pushed yields on those securities down below the U.S. 10-year Treasury note yield. Consequently, U.S. Treasury notes appear to be a good value compared to German bonds. This attractive valuation is encouraging more purchases of U.S. Treasury notes, pulling U.S. Treasury note yields down along with declining German yields.

- This week’s chart illustrates the inverse relationship between U.S. equities and U.S. Treasury notes during the past five months. Specifically, the chart compares the nearby S&P 500 index futures price to the nearby 10-year Treasury note futures price. These futures markets tend to be good proxies for the U.S. equity and bond markets. Since the beginning of this year, the S&P 500 futures price has weakened while the 10-year Treasury note futures price has firmed. This relationship is another indicator, like the carry trade, that is signaling investors’ risk appetite has diminished compared to late last year. This is another reason why tactical investors may want to be more cautious in this environment. If the S&P 500 breaks to a new low for this year, the current correction in the U.S. equity market is likely to be longer and more substantial than the brief corrections experienced this past June and October.
- Tactical investors are not the only ones who should consider the relationship between assets when choosing a strategy. Long-term investors should also incorporate the correlation between assets in constructing strategic investment portfolios. Proper diversification and asset allocation, discussed in last week’s report, requires careful consideration of the long-term correlation between assets. Portfolio risk is usually reduced when investors hold assets that are not highly correlated or are inversely correlated.
- Proper diversification may allow long-term strategic investors with balanced portfolios to ride through moderate market fluctuations, like we seem to be experiencing now, with losses on some assets at least partially offset by gains or smaller losses on other less correlated or uncorrelated assets. Of course, some long-term growth investors with a greater appetite for risk are often willing to accept the risk of holding a portfolio of highly correlated assets in order to earn a potentially higher return commensurate with that risk. Diversification does not guarantee a profit or protect against loss.

**Weekly Nearby S&P Futures Versus Nearby Treasury Note Futures**



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- Carry trades involve investors borrowing overseas at low rates to fund portfolio strategies that attempt to take advantage of the wide “spread” between carrying cost and available yields and returns.
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- Futures trading is volatile, and even a small movement in market prices could cause large losses. An investor could lose all or substantially all of an investment.
- Investing in fixed income securities involves certain risks such as market risk if sold prior to maturity and credit risk, especially if investing in high yield bonds, which have lower ratings and are subject to greater volatility. All fixed income investments may be worth less than the original cost upon redemption or maturity. Bond prices fluctuate inversely to changes in interest-rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment.
- Correlation refers to a statistical measure of how two securities move in relation to each other.

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