

The Week

Paul Christopher, CFA, Senior International Investment Strategist

Worth noting

- A new, broad-based sentiment indicator indicates that carry trade popularity may soon reach levels that in the last year have signaled a short-term pullback in international markets.
- Long-term, strategic investors should take their portfolios up to even weight on international markets.
- For clients who are tactically inclined, we would preserve cash and wait to buy commodities and emerging market equities and currencies on the pullback.
- We are currently underweighting developed market equities.

International sentiment may soon indicate pullback

Two recent editions of this report, in February and December, focused on the sentiment signal from the carry trade and pointed to the risk aversion that had built in international markets. This week's report extends the prior analysis in two ways. First, we introduce an indicator that captures investor sentiment, measured by the carry trade, across a very broad range of countries and currencies. Second, we ask whether this broad measure of sentiment continues to point to risk aversion, or whether sentiment indicates new opportunities in international markets.

We consider first how our broad carry indicator measures market sentiment. In a carry trade, the investor borrows in a currency that has low interest rates, and then invests the loan proceeds in another country, where yield is higher or equity markets are expected to perform well. The carry trade can be a useful sentiment indicator, because the trade gains in popularity when global risks fall but loses popularity when risks rise.

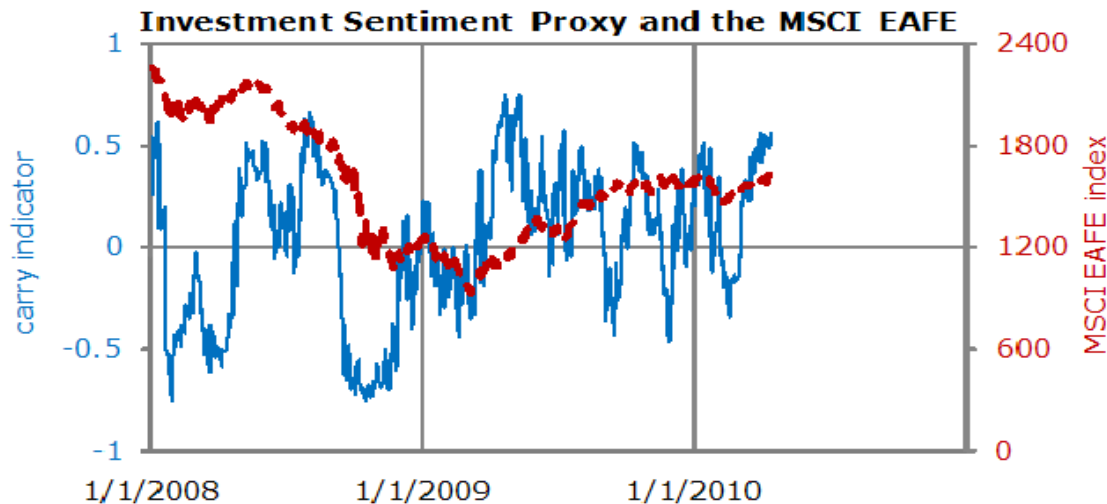
Our carry trade indicator tracks the recent ebb and flow in sentiment. When the carry trade is popular, those countries with the highest interest rates (compared to U.S. rates) should also see their currencies appreciate the most against the dollar, since carry traders have the highest demand for the currencies where yield is the highest. The larger the yield advantage, the larger the currency appreciation. This positive correlation indicates strong carry popularity and risk appetite. By contrast, when risk appetite is weak and risk aversion is strong, then traders buy safety and low yields. (The world's most frequent safe havens are Japan, the United States, and Switzerland, and all have low-yielding currencies.) In this case, the smaller the yield advantage, the more the currency appreciates, and this negative correlation suggests carry unpopularity and weak risk appetite.

The chart on page two illustrates how sentiment, based on the carry trade popularity, moved recently with the MSCI EAFE index (compiled by MSCI; the Morgan Stanley Europe, Australasia and the Far East Index is a value-weighted index of the equity performance of major foreign markets. In effect, it is a non-American world index of over 1000 stocks.) The EAFE index rose significantly when the carry indicator moved from extremely negative to extremely positive correlations (e.g., in the second quarters of 2008 and 2009, when investors felt that risks were diminishing). The indicator predicted large index declines in January and October 2008, as pessimism climaxed.

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The indicator declined sharply early this year but has since rebounded, and the question remains what sentiment may signal for investors going forward. We note that sentiment seems to be breaking higher in mid-April, consistent with positive U.S. economic news and Europe's detailed rescue package for Greece. Risk appetite is growing and carry trades are on the rise. However, the indicator currently is near a level that, in the past year, has meant imminent short-term pullbacks in carry trade sentiment and international equities.

For perspective, we continue to believe the world economic recovery is solid. Nonetheless, carry trade popularity may soon signal a short-term pullback in international equities, currencies, and commodities. Long-term, strategic investors should take their portfolios up to even weight on international markets. For clients who are tactically inclined, we would preserve cash and wait to buy commodities and emerging market equities and currencies on the pullback. We are currently underweight in developed market equities.



Sources: Bloomberg for data; Wells Fargo Advisors for calculations

The carry indicator is the correlation between the U.S. dollar exchange rates and spreads over U.S. short-term rates, for a sample of 22 countries from Europe, Latin America, Africa, and Asia.

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

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