

The Week

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Fear subsides, caution remains

Recent market action suggests that investors are less fearful than they were last summer. However, investors are still cautious. If the stock market continues to recover as the economic fundamentals suggest, sentiment is likely to turn more positive.

Two weeks ago, the U.S. stock market rallied and appeared to be breaking above a five-month downward trend in the S&P 500. Last week, the stock market pulled back and retested that breakout. As a result, the market is poised to rally further and could move back up to the highs of last spring.

The economic fundamentals actually look better than the stock market at this time. Historically, the stock market generally moves in anticipation of the economy. This is especially true when the economy is strong and investors are optimistic. But when the economy is growing only modestly, and investors are worried about many problems, the market does not always lead the economy. In fact, during periods of uncertainty as we have seen recently, investors often wait for the economy to prove itself before pushing the market higher.

We seem to be in one of those "show-me" markets now. Recent economic news indicates that the U.S. economy is more resilient than many investors thought it would be last summer when a confluence of negative factors shook investor confidence. Investor confidence has recovered somewhat during the past three months; but investors still do not appear optimistic and willing to assume that the economy will get stronger in the future. Nonetheless, we believe the U.S. economy has been gradually improving.

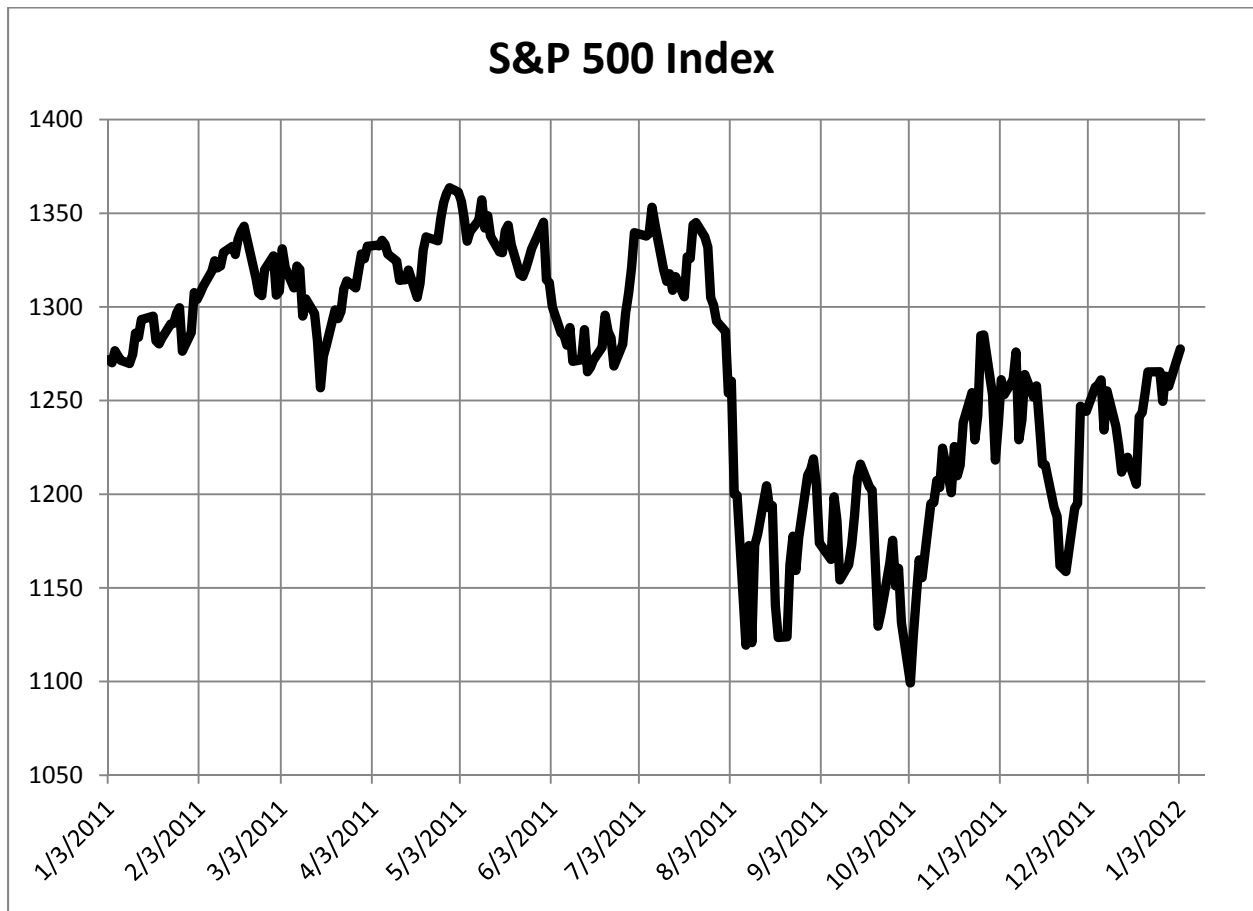
The U.S. economic fundamentals, including low interest rates, declining gasoline prices, increasing corporate profits and fewer job cuts, are better than they were early last year when the stock market was higher than it is now. Unfortunately, investors are still worried about the European debt crisis and the slowdown in the global economy. Therefore, the recovery in the stock market has been slow to unfold. The S&P 500 declined several

times during the past few months. But each time the stock market recovered from a higher level. This succession of higher lows is a positive sign that stock market sentiment is shifting from negative to positive. However, the recovery in the stock market seems to have a defensive character, suggesting investors are still cautious. For example, defensive stocks have been outperforming the economically-sensitive cyclical stocks during the past month. If investors were optimistic, the opposite would probably be true.

On the positive side, the recovery in the stock market has coincided with a decline in gold prices. Last summer, when investors were fearful, stocks prices were falling and gold prices were rising. The current recovery in the stock market along with the decline in the gold market during the past three months suggests that investors are less fearful. Fears could be subsiding because investors are focusing more on the resilient U.S. economy rather than the lingering problems in Europe.

Looking back, 2011 was a year when investors sought safety. As a result, bonds outperformed stocks. Looking ahead, we believe 2012 is more likely to be a year when investors are less risk averse because the U.S. economy has weathered many problems and has not gone into recession like some other European countries have. Consequently, U.S. stocks could do better than bonds in 2012. In fact, in our 2012 economic and market outlook report, our equity strategists call for the U.S. stock market to be modestly higher while our fixed income strategists call for the U.S. Treasury bond market to be weaker. Specifically, the S&P 500 is expected to end 2012 in the 1325-1375 range. At the same time, U.S. Treasury bond yields are expected to increase to 3.0% at the end of 2012, which should push Treasury bond prices lower during the next 12 months.

Please see page 3 of this report for Important Information, Risk Factors and Disclaimers



Sources: Bloomberg, Wells Fargo Advisors; past performance is not a guarantee of future results.

In summary, investor sentiment appears to be improving but investors still seem to be cautious. Current economic fundamentals suggest the U.S. economy is likely to avoid recession and continue to grow in the year ahead, provided there are no

major negative shocks like a spike in oil prices or major bank failures in Europe. If the U.S. economy remains resilient and investors become less risk averse, we believe the stock market is likely to do better than the bond market in the year ahead.

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