The Week

Gary Thayer, Chief Macro Strategist

Sentiment continues to improve

Recent economic data indicate that the U.S. economy remains resilient despite many problems around the globe. For example, the January employment report showed nonfarm payrolls increased last month at their fastest pace in nine months. At the same time, U.S. purchasing managers' surveys show that both manufacturing and service sector activity increased more broadly at the start of the year. Therefore, investors are feeling better about economic prospects.

We continue to believe that investor sentiment will gradually improve as this year progresses. Obviously, investors won't feel better every week. Markets do not move in only one direction. But, our work suggests that sentiment is likely to improve more than it decreases over the course of 2012.

During the past few weeks, the U.S. stock market has been trending higher. This means that a lot of good news is already discounted in the market. However, market action also suggests that many investors may have missed the rally. In particular, there was only a small correction in the markets this past week as buyers quickly stepped in after only a minor pullback. Therefore, the stock market could become more extended before a normal correction unfolds.

Of course, the stock market is not the only market indicating increased investors sentiment. The credit markets are also reflecting a more positive tone. Specifically, the spread between the overnight interest rate and the three-month euro dollar interest rate has declined during the past month because investors are less pessimistic than they were late last year.

Looking back, investors and lenders were risk averse and preferred to lend at the lower overnight rate instead of the higher three-month deposit rate late last year. That's partly because lenders were worried that financial conditions could deteriorate during the period of the three-month loan and they might not get all their money back. As a result, the spread of the three-month interest rate over the overnight interest rate increased as investor sentiment deteriorated. Fortunately, conditions are stabilizing in Europe. As a result, investors and lenders are more willing to lend in the three-month credit market, and the spread has started to narrow again during the past few weeks.

We have been saying for the past few months that the European debt crisis was probably at about the same stage that the U.S. financial crisis was in late 2008 and early 2009. Back then, policymakers were taking significant steps to increase liquidity but investors were still skeptical and did not think that these policies would work. The European debt crisis appears to be following a similar path. Of course, past performance does not guarantee similar results. Nevertheless, European policymakers have pumped a lot of liquidity into the banking system through the European Central Bank's (ECB) unlimited three-year loan program, as well as the dollar swap agreement among the major central banks. Investors were initially skeptical that these policies would work but are more accepting now. As a result, financial conditions are improving with stock and bond markets turning up in many countries. Looking ahead, the ECB will provide even more liquidity later this month when it offers additional three-year loans. With all the extra liquidity in the market now and coming into the market in a few weeks, investor sentiment is improving.

Other credit market spreads also suggest improving sentiment. Yields have declined in the tax-free credit markets as investors turned less pessimistic and more willing to take risk in state and local government debt. In addition, yields on low-quality high-yield bonds have declined relative to higher-quality Treasury bond yields. Once again, the narrowing of these interest rate differentials historically reflects improving investor sentiment as concerns about financial problems lessen.

Please see page 3 of this report for Important Disclaimers

The global economy still faces many risks. Consequently, investor sentiment could turn down if a lot of bad news hits again. Right now, we are watching the growing tensions with Iran. But at this time, other good news has outweighed concerns about Iran potentially blockading oil shipments through the Persian Gulf.

On the positive side, the purchasing managers' surveys in several countries have turned up recently, indicating that global economic activity may be stabilizing. This week's chart looks at the average of purchasing managers' manufacturing indexes in the United States, China, Brazil and Europe. The average of these four measures suggests that conditions are no longer deteriorating like they were last summer when investors worried about a possible double-dip recession.

In summary, U.S. economic news remains more positive than negative. However, after a string of good news, expectations are higher. Investors now anticipate good news rather than bad news like last summer. As a result, fewer economic reports are beating expectations. If this trend continues, investors may become disappointed that the good news is not good enough. If this happens, sentiment could turn down for a while. Nevertheless, we would still view weakness in the U.S. stock market as a buying opportunity based on our macro outlook for modest economic growth, declining inflation and increasing central bank liquidity in 2012.

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

Important Disclaimers:

- Past performance is not a guarantee of future results.

Wells Fargo Advisors is a trade name for certain broker/dealer affiliates of Wells Fargo & Company; other broker/dealer affiliates of Wells Fargo & Company may have differing opinions than those expressed in this report. Contact your Financial Advisor if you would like copies of additional reports.