

The Week

Gary Thayer, Chief Macro Strategist

Buying opportunity

Two months ago, investors seemed to be increasingly optimistic that the worst of last year's troubles were behind us. But at the same time, many were reluctant to get back into the stock market because it had already rallied strongly during the first quarter. The stock market has pulled back since early April, creating a buying opportunity. However, sentiment is not as positive now, and many investors may again be reluctant to get into the market. Our work suggests that pull backs are still buying opportunities. We continue to expect the stock market to be modestly higher at year end.

We believe that moderate economic growth, low inflation and easy money policies in many countries are positive fundamentals that could boost sentiment this year. The latest readings on consumer sentiment and small business optimism are consistent with our views. Specifically, the University of Michigan's preliminary May consumer sentiment index increased to its highest level in more than four years. Similarly, the National Federation of Independent Business's March small business optimism index matched its highest level since December 2007. Sentiment is still below its pre-recession peak, but is improving as we have been projecting.

Looking at the market, investor sentiment does not increase every week, even when other sentiment indicators are hitting the highest levels in several years. Instead, investor sentiment tends to swing back and forth with the news of the day. Recently, investors turned less optimistic as disappointing news caused stock market prices to decline from their April high. Sentiment is not as negative as it was last summer during the market turmoil but the decline in sentiment during the April-May stock market correction indicates that a lot of negative news and investor worries may now be factored into stock market prices. If so, then good news could push the market higher as sentiment swings from negative to positive again.

Investors trying to weigh the risk of buying on market weakness may ask what would be the catalyst to push the market higher. One positive development has been the decline in gasoline

prices during the past two months as the global economy slowed down. Lower gasoline prices allow consumers to spend more money on other goods and services, boosting the economy. Second, many investors may be worried that the stock market could decline again this summer as it has during the past two summers. Anything is possible; but we believe conditions are more favorable for stocks this year than during the previous two summers. If the market does not weaken over the summer as many fear, then investors could be pleasantly surprised and sentiment could increase, lifting stocks during the next few months. Finally, the U.S. economy continues to perform better than many other developed economies, especially the European economies. A continued shift in sentiment toward U.S. equities over foreign developed stocks could also lift U.S. stock prices in coming months.

Of course, the U.S. economy probably needs to expand in order for the domestic stock market to advance further. We continue to believe that conditions remain favorable for modest economic growth in the United States. In particular, credit availability appears to be improving again, providing more fuel for consumer spending.

This week's chart looks at the willingness of banks to lend to consumers. Each quarter, the Federal Reserve surveys financial institutions to determine if lenders are relaxing or tightening lending standards. This quarter's survey showed that a greater percentage of banks are relaxing lending standards to consumers than last quarter.

BANKS WILLINGNESS TO LEND TO CONSUMERS

Percent more willing less percent less willing



Historically, this increased willingness to lend usually supports further economic growth, not recession. The risk to the economy and the stock market would be greater if banks were less willing to lend rather than more willing to lend. In fact, a review of the chart shows that during the past quarter century, the U.S. economy was close to or in recession when the willingness to lend turned negative. Fortunately, those conditions do not exist today.

Looking ahead, our Equity Strategy team's year-end target for the S&P 500 is 1400-1450, modestly higher than current levels. However, our Equity Strategy team also anticipates that market volatility could increase in the second half of this year. This would be consistent with our work on market seasonality ahead of elections. (See the May 7th edition of The Week).

Our research shows that the average monthly increase in the U.S. stock market is greater in years when inflation is declining (as it is this year) than it is in Presidential election years. This is one reason we remain positive on the U.S. stock market. However, the report also indicates that the stock market could experience some volatility or weakness in the month or two ahead of the election if investors turn cautious.

In the meantime, we believe that the pull back in the stock market since early April creates a favorable buying opportunity. Investors who are underweight stocks in their portfolios should consider increasing allocations up to an even weight.

Important Disclaimers:

Past performance is not a guarantee of future results.

An index is not managed and is unavailable for direct investment.

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