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WELLS FARGO ADVISORS

Investment Strategy

A weekly overview of today's investment environment

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Talk of tapering created buying opportunity

The financial markets have been volatile during the past few weeks as investors weighed the likelihood that the Federal Reserve could begin to reduce or taper its current bond buying program. Bond prices and stock prices declined as investors worried that reduced Fed bond purchases could decrease some of the liquidity that has been going into the financial markets. We believe it would be pre-mature for the Fed to reduce bond purchases at this time because the global economy is still weak and inflation is not an immediate threat.

Earlier this year, the Federal Reserve indicated that it would probably stop its current bond purchase program called quantitative easing when the unemployment rate declined to 6.5% or inflation increased to more than 2.5%. Right now the U.S. economy is not that strong. The latest jobs report showed that the unemployment rate increased slightly to 7.6% in May from 7.5% in April. In addition, the latest inflation report showed that consumer price inflation declined to only 1.1% in the 12 months ended in April.

The inflation and unemployment data reveal that the U.S. economy is not yet at the point where the Fed would end its bond purchase program. However, the Fed is now indicating that it could reduce or taper its bond purchase program before it ends it completely. That is why the markets seem to be hanging on every statement from Fed officials, looking for any clues as to whether that tapering will begin soon.

The current Fed bond purchase program is actually the Fed's third round of quantitative easing since the financial crisis and recession in 2008 and 2009. Looking back, the Fed started and stopped the two previous rounds of quantitative easing as inflation expectations changed. The Fed started to buy bonds when expected inflation was below the Fed's long-term target. Alternatively, the Fed stopped bond purchases when expected inflation was near the high end of the Fed's long-term inflation target. Fed action seems to suggest that policymakers wanted to avoid deflation when the economy was weak and prevent inflation when the economy got stronger. We believe this is still the Fed's goal, and that is why it is important to look at inflation expectations when judging when the Fed will taper its current bond buying program.

Recent Fed statements about tapering its bond purchases however are not coinciding with a rise in inflation expectations. Rather, inflation expectations have decreased not increased during the past few weeks. Even precious metals prices have dropped this spring, suggesting that investors' concerns about inflation are diminishing.

So why is the Fed talking about tapering? We believe that the Fed is also watching investor enthusiasm as well as inflation expectations when trying to adjust its bond purchase program. After all, policymakers probably do not want to create an

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asset bubble by supplying too much liquidity to the financial markets.

If the Fed is worried about asset bubbles, then talk about tapering its bond purchase program may only be designed to manage expectations and dampen some of the optimism that pushed the U.S. stock market to new record highs this spring. In other words, the Fed may be trying to take some of the steam out of the financial markets.

We do not believe that the Fed is trying to hurt the financial markets, just cool things off a bit. If we are correct, then the Fed may have done investors a favor by creating a healthy pull back in the stock and bond markets. We would be more concerned about the financial markets if inflation was increasing and inflation expectations were rising. That is not happening now. Inflation is low and inflation expectations have actually declined during the past few weeks, suggesting that the financial markets are not overheating.

Many investors have been waiting for the stock market to dip this spring in order to buy equities at more attractive prices. Unfortunately, the recent decline in the stock market was relatively brief and not that large. Therefore, many investors who were waiting on the sidelines may have missed the opportunity. In the meantime, the stock market could move higher during the next couple of months.

We remain long-term positive on the U.S. economy and the U.S. stock market looking into next year. In addition, we anticipate that investors are likely to get other opportunities to purchase stocks because market volatility could increase in the next few months after the strong advance during the first half of this year.

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