



# The Week

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## Investing in an uncertain world

*The recent spike in energy prices caused by the turmoil in the Middle East and now the great earthquake in Japan remind investors that we live in an uncertain world. Many events can be anticipated but some others are completely unpredictable. Obviously, there is never a good time for a disaster to occur. However, the impact of a negative shock on the economy depends on the state of the economy when the event occurs. The best investors can do is accept that taking risk is an integral part of investing and determine how much risk they are willing to take. This week's report examines why many investors may be more risk averse now but also why we believe this is a better time to be taking risk than three years ago.*

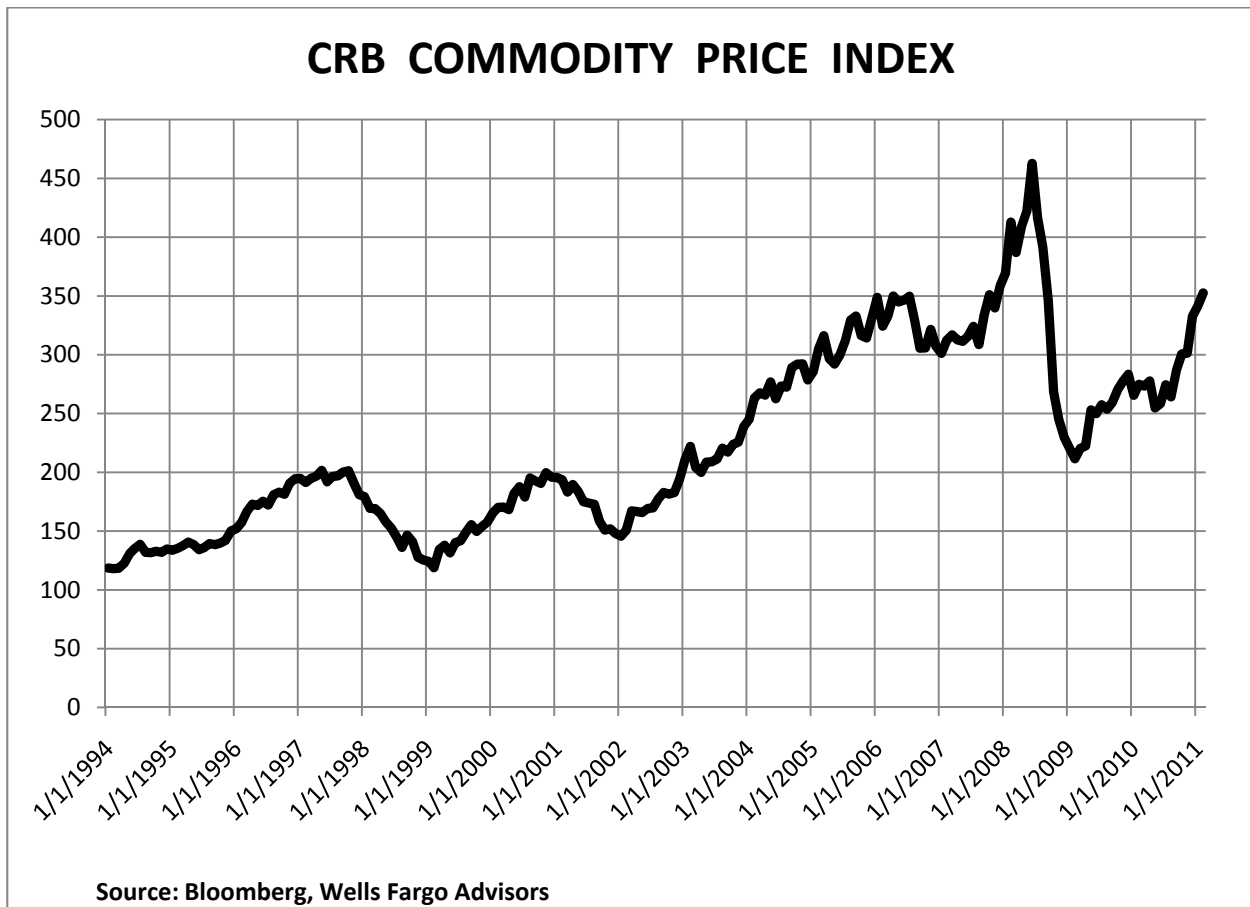
Unexpected events seem to happen frequently, and the media often remind us that bad things could happen tomorrow. However, the world is not completely chaotic. History shows that really big events happen less frequently than more moderate events. And as you might expect, major events, like the Japanese earthquake, usually have a bigger impact than the less dramatic frequent events.

So what should investors do? Avoid all risk? Unfortunately, there is no way to avoid all risk. Instead, investors need to determine how much risk to take and whether it is a good time or bad time to be taking risk. Experience also shows that it is a good time to be taking risk when the economy is healthy and better able to withstand the impact of negative events. Conversely, it is a bad time to be taking risk when the economy is weak and vulnerable to unexpected bad news.

For example, during the past decade, investors have had to cope with the negative news of the

terrorist attacks on 9/11/2001 and the financial crisis in late 2008. Unfortunately, both of these shocks happened when the U.S. economy was very weak and in recession. Consequently, the economy and the stock market were severely impacted for quite some time. On the other hand, hurricane Katrina in August 2005 happened when the U.S. economy was strengthening, four years after the 2001 recession. The destruction from Katrina was very damaging to the Gulf Coast, but the overall U.S. economy was not impacted as bad as the Gulf Coast, and U.S. economic activity strengthened after the hurricane, helped by rebuilding.

The good news is that the latest spike in energy prices and the losses from the Japanese earthquake are happening when the global economy is once again strengthening after the 2008-2009 recession. As a result, the global economy is probably better able to deal with these problems today than it would have been if they had occurred several years ago.



This week's chart shows a history of the CRB commodity price index going back to the early 1990s. The recent spike in commodity prices has pushed this index up to its highest level since 2008, raising investor concerns that the economy could suffer like it did the last time commodity prices were this high. However, the economy does not always fall into recession when commodity prices increase. In particular, commodity prices were increasing consistently from 2003 through 2006, and the U.S. economy continued to expand through that period. More recently, commodity prices have been increasing since the end of the recession in 2009, and yet the economy is still growing, not contracting.

Once again, the impact of negative events depends on the health of the economy. Right now, the economy seems to be resilient, and may only slow down in reaction to the spike in oil prices and the Japanese quake. One example of this resiliency is the widespread increase in corporate profits during the past year. Looking back, when commodity prices were rising in 2008, profit growth was very narrow, not widespread. As a result, fewer companies were able to absorb the increase in

costs. Instead, companies cut output and reduced employment. We do not expect the same negative impact today even though commodity prices are near those same levels.

Another important indicator of the resiliency in the U.S. economy is the fact that business sentiment is improving more than consumer sentiment. As a result, companies are likely to increase hiring this year not cut jobs as they did several years ago. Back in 2008, business sentiment was deteriorating more than consumer sentiment. Consequently, the U.S. economy was much more vulnerable to the negative effect of high energy prices.

In summary, it is too early to say what the full impact of the Japanese earthquake will be or how far the turmoil in the Middle East will spread. However, we believe the U.S. economy is in better shape to deal with these problems than it was when the financial crisis hit in 2008 or when 9/11 occurred. As a result, we remain longer term positive on the economy and the stock market. However, as we said last week, we are near-term cautious given the uncertainty of current events.

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- An index is not managed and is unavailable for direct investment.
- Buying commodities allows for a source of diversification for those sophisticated persons who wish to add commodities to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any purchase represents a transaction in a non-income-producing commodity and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.
- Investing in foreign securities presents certain unique risks not associated with domestic investments, such as currency fluctuation and political and economic changes. This may result in greater price volatility.

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