Equity Strategy Weekly

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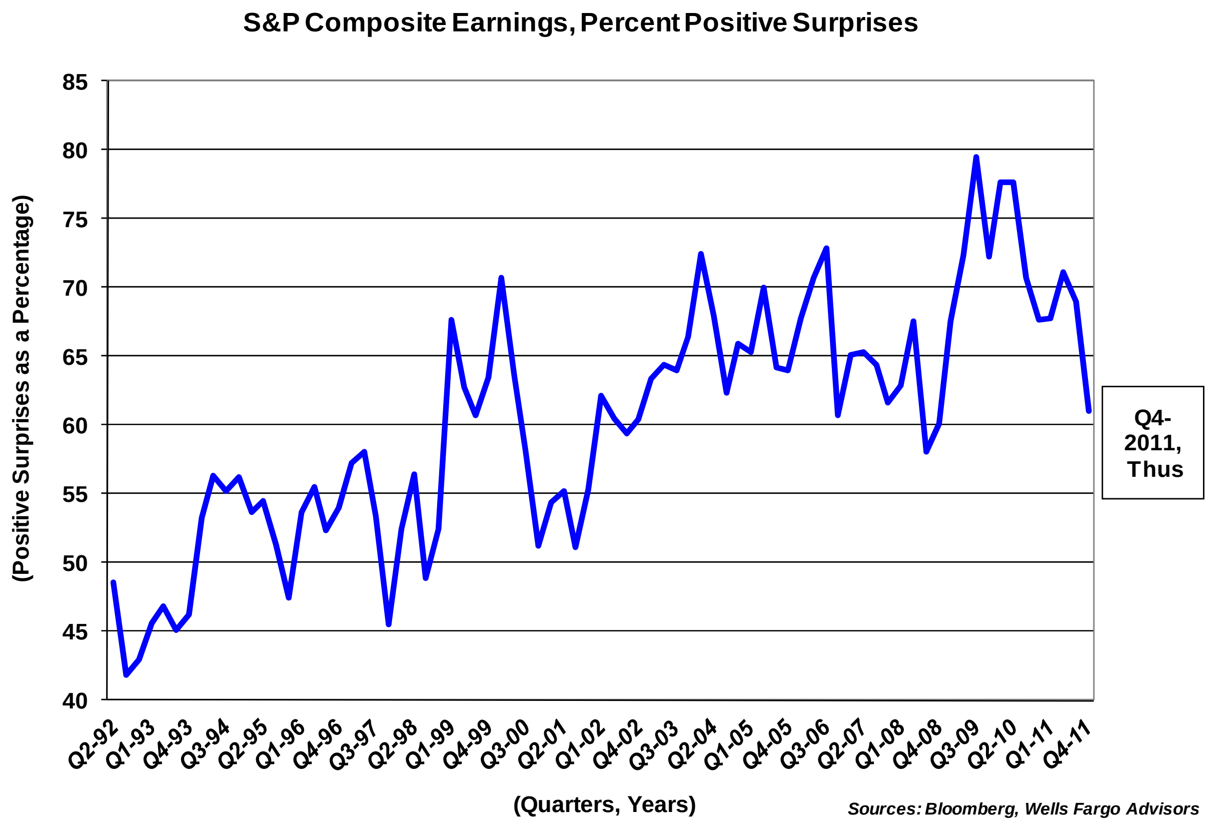
Slowing growth now more apparent in reported numbers

We continue to believe this recovery can continue into 2014 unless a material negative exogenous event spooks consumer confidence. We continue to recommend investors maintain well balanced equity portfolios (with respect to cyclical versus defensives) at this time.

With roughly 15% of S&P Composite companies having reported their fourth quarter results, we thought we would take an early look at the returns. Of course, the totals will change as the reporting season rolls along.

We will first review the earnings picture. At this early stage, we are finding that only roughly 61% of companies are reporting better than expected earnings results for fourth quarter 2011 (see Figure #1). The average for this statistic back to second quarter 1992 is 60.3%. However, the average back to the first quarter of 2009 has been 72.1%, outperforming the prior-day expectations of the "Street". Additionally, although it does not have to be so, the first 20% of results tends to show a higher percentage of outperforming earnings reports than the total by the end of earnings season. Therefore, the current 61% recorded, so far, could reasonably be higher than the final result. The trend of operating

Figure 1



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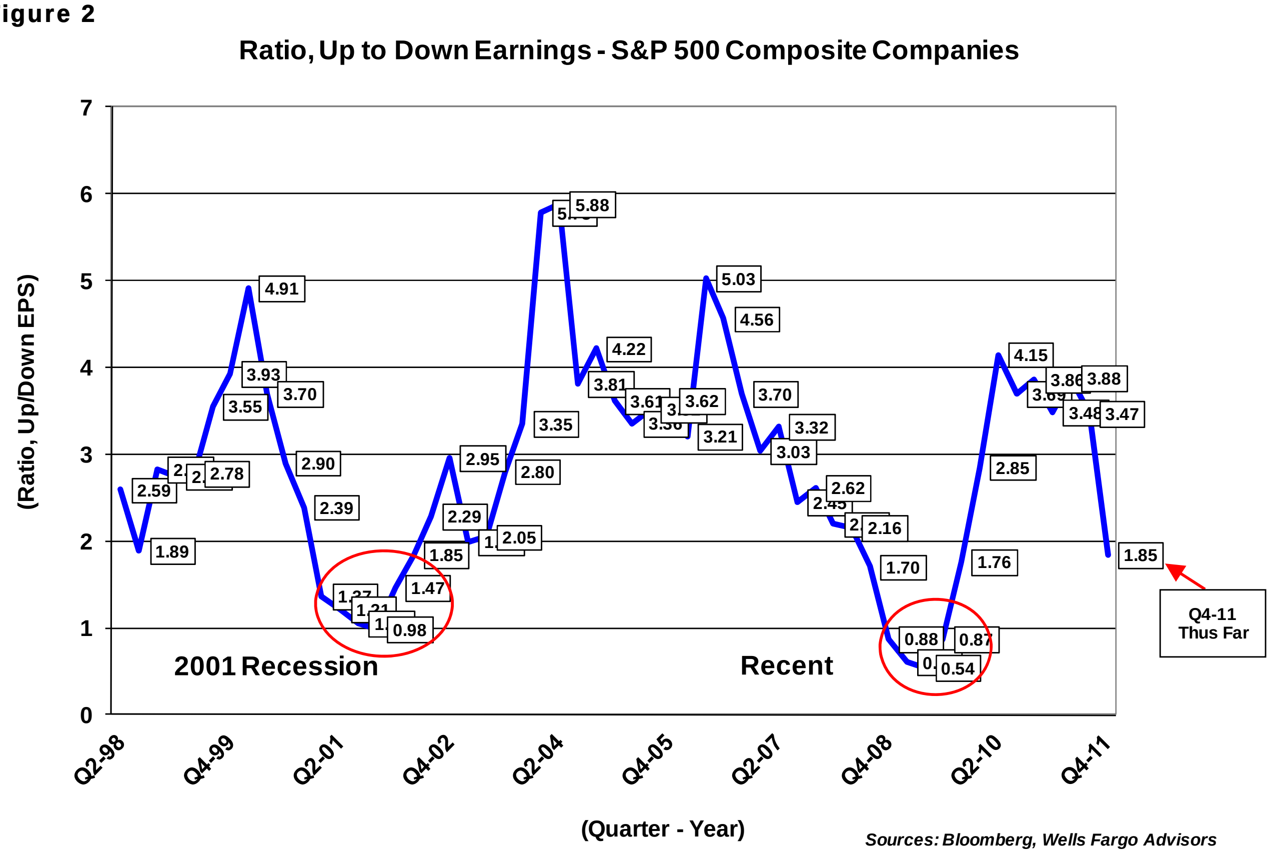
outperformance has progressed from 67.5% in first quarter 2009 to 72.3%, 79.5%, 72.2%, 77.7%, 77.7%, 70.7%, 67.7%, 67.8%, 71.1%, 69.0%, and now 61% in the quarters following first quarter 2009. Analyst expectations, as the recovery has matured, have generally moved higher as earnings growth has slowed, bringing the surprise percentage downward over time. This is a relatively normal state of events as a recovery progresses.

We are also reviewing the ratio of "up" to "down" earnings reports (versus one year earlier, see Figure #2). In the figure, we have plotted the ratio of the companies whose earnings came in higher than one year before versus those that came in lower one year before. Note that the recent peak was 4.15 higher earnings reports for every lower one at the peak in second quarter 2010 as only a small portion of S&P Composite Index company earnings were coming in lower than a year ago, early in the recovery. That ratio remained in the 3s area in following quarters, it was still 3.47:1 in third quarter 2011, but (so far) looks to be down to 1.85:1 in the early stages of fourth quarter 2011 reporting. In recent quarters, the early results for this ratio have tended to come in stronger but then weaken as the balance of companies reported. We believe it to be likely that roughly two companies will report higher company earnings for every one reporting lower ones as the balance of fourth quarter 2011 results come through. The average level for this ratio is 2.96:1 going back to second quarter 1992 (which includes both recessionary and recovery periods). It has averaged 3.63:1 since first quarter 2010. The breadth of earnings growth is slowing. However, one would expect this at mid-recovery and beyond. We currently expect that 2012 S&P Composite Index operating earnings will be roughly 5% higher than in 2011. Thus far for fourth quarter 2011, market-capitalization weighted earnings are 5% higher than the year-earlier quarter. Non-weighted earnings are up 1%.

It is early in earnings season, as we suggested earlier. If we look to the progress of revenue growth, we experienced 9.2% growth in first quarter 2011, 11.1% in the second quarter, 10.2% in the third quarter, and with 15% reported for fourth quarter, the number is -8.4%. The number is +2% excluding the Financial sector stocks that have reported thus far. We expect revenues will be up mid single-digits once all results are in for the fourth quarter. If we look to the percentage of S&P Composite companies that have reported

Figure 2



higher revenues than a year ago, the trend has been 74% in first quarter 2011, then 83% and 79% in the second and third quarters, respectively, and so far 70% for fourth quarter 2011. The breadth of revenue growth is softening, yet it is still strong.

While we are still seeing roughly 70% of revenues coming in higher than a year ago, the dramatic operating margin growth (which is what materially drove earnings early in the cycle) has slowed. The progression from first quarter 2011 has been 50.1% higher than one year ago to 48.9% and 39.2% in second and third quarters and now, early in fourth quarter reporting, roughly 32% higher than a year ago. We suspect this number will be somewhat higher once all earnings are in for the fourth quarter.

However, the overall point is that the breadth of earnings growth is slowing but still adequate, the rate of earnings growth is slowing, the breadth of revenue growth is clearly slowing but still strong, and the breadth of margin expansion has slowed rather dramatically. The numbers we are seeing, thus far, for fourth quarter 2011 remain consistent with our expectation of 5% S&P Composite Index operating EPS growth in 2012 versus roughly 12%-13% in 2011 and 33% in 2010. In a normal growth recovery, we would expect operating growth to be increasing at a faster pace than what we are currently experiencing and project for this year. However, most all metrics have shown slower growth, across the board, in this recovery with slower inflation and lower interest rates.

We continue to believe this recovery can continue into 2014 unless a material negative exogenous event spooks consumer confidence. For all of these reasons, we continue to recommend investors maintain well balanced equity portfolios (with respect to cyclical versus defensives) at this time. For example, we are still modestly overweight Industrials and Materials, but modestly underweight the defensive Health Care and Consumer Staples sectors. Other overweights include the Utilities and Telecom Services space, and underweights include the Financial and Technology areas.

Weekly wrap and look ahead

All three major indices rallied nicely in last week's trading. The S&P 500 rose 2.0% (year-to-date up 4.6%), the Dow Industrials gained 1.9% (YTD up 4.1%) and the NASDAQ Composite jumped 2.8% (YTD up 7.0%). Looking at S&P sector performance, four of 10 outperformed the Index while nine of 10 finished the week with gains. The best performing sectors were Information Technology (up 3.3%), Energy (up 2.8%) and Financials (up 2.5%). The worst performing sectors were Utilities (down 0.6%), Consumer Staples (up 0.9%) and Telecom Services (up 1.1%). Stocks are continuing to advance on low volume. Most retail investors still appear to be hesitant to get back into the market.

While all of the economic reports from last week did not meet analyst expectations, they did show the economy was slowly improving and likely moving away from the double-dip recession scenario that many have feared over the past year or so. Both regional manufacturing surveys posted positive readings. The six-month forward looking segments of these indicators also improved, which bodes well for the first half of the year. Recall that both surveys spent time in negative territory during 2011. The Empire State reading came in at a better than expected 13.5, the best reading since early last year. The Philly Fed survey notched a 7.3 reading, below expectations but still positive. Readings above zero indicate expansion when looking at these regional manufacturing surveys.

December inflation data out last week showed few signs of pricing pressures building in the economy. At the wholesale level, headline PPI (Producer Price Index) actually fell 0.1% last month while core PPI rose 0.3%. Core inflation readings exclude the effects of food and energy prices. The Federal Reserve pays more attention to core inflation because, historically, increases in the price of food and energy tend to be "transitory" in the Fed's eyes. The headline Consumer Price Index (CPI) was flat in December from the prior month with core CPI up only 0.1%. Core CPI is 2.2% higher than the year-ago period, just a touch higher than the Fed's preferred 1% to 2% range. We think the Fed would actually welcome a little inflation at this point.

Also last week, initial jobless claims fell to a better-than-expected 352,000 and December industrial production was reported to have risen 0.4%. These are both good signs that the U.S. is moving away from the double-dip contraction scenario. We look for industrial production to move ahead modestly this year as gross domestic product (GDP) grows a touch more than 2%. We also think unemployment will move down to the 8% area by the end of the year versus the current 8.5% level.

This week's calendar shows reports covering orders for durable goods, new home sales, leading indicators (LEI), fourth quarter GDP and consumer sentiment from the University of Michigan. In addition, the FOMC (Federal Open Market Committee) will hold a two-day meeting on Tuesday and Wednesday to discuss monetary policy.

Market participants will be paying close attention to the durable goods report for signs that business investment in capital equipment is picking up. Business investment was up nicely over the last 12 months, but the end of 2011 was disappointing. The FOMC meeting is unlikely to yield any change in monetary policy but will feature inflation and fed funds rate estimates from voting members. This is part of the Fed's effort to become more "transparent" in its operations.

Investors will also be looking closely at the government's first "guesstimate" of fourth-quarter GDP on Friday. It is likely this first read will come in near 3%. We caution investors not to be overly confident and try to extrapolate this level of economic growth through 2012. The markets could get a push higher if this first estimate comes in above 3%. As mentioned above, we look for the economy to grow at a below-trend 2.2% pace in 2012.

At this time we recommend that investors keep a more balanced portfolio allocation in terms of the 10 sectors. Our year-end target range for the S&P 500 is 1325-1375.

Wells Fargo Advisors
Sector Weighting Recommendations / S&P 500 EPS Estimates / S&P 500 Target:

Sector	S&P Weighting*	Wells Fargo Advisors Guidance	
Industrials	10.9%	Overweight	12.0%
Materials	3.7%	Overweight	4.0%
Telecom Services	2.8%	Overweight	5.5%
Utilities	3.6%	Overweight	7.0%
Consumer Discretionary	10.8%	Evenweight	11.0%
Energy	12.1%	Evenweight	12.0%
Consumer Staples	11.0%	Underweight	9.5%
Financials	14.2%	Underweight	11.0%
Health Care	11.7%	Underweight	10.8%
Information Technology	19.3%	Underweight	17.2%
S&P 500 Earnings Estimate for 2012:			$103.00
S&P 500 Year-End 2012 target:			1325-1375

Sources: Bloomberg, Wells Fargo Advisors
**Sector Weightings May Not Add To 100% Due To Rounding*
Pricing: based on January 20, 2012 close

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