



Out of the Blocks

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Worth Noting

- We believe the data streams currently being generated from the economy and the markets, thus far, suggest that the equity market would typically have upside from here over the next 18 months (and that such upside would most benefit the more cyclically sensitive issues in the marketplace, smaller capitalization issues and increasingly more value-oriented issues as time passes).
- Last week's two-day FOMC (Federal Open Market Committee) meeting held no surprises but did serve a purpose. The Fed used the opportunity to quell any speculation that rate hikes are anywhere on the horizon by stating that "economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period." That is about as clear of a statement as you will ever get from the Fed.

Cyclical Market Model Continues to Point Toward Increasing Market Breadth

Our "Sister Markets" analysis statistically compares the year-to-year performance of 28 S&P industry groups, the S&P Composite index and a number of additional statistical variables derived from these data sets back to 1972. Each 12-month segment of time is statistically divided into one of 200 categories. Those periods with the most similar market performances will appear in the closest of the 200 categories. Those periods with the worst overall percentage performance with strong negative breadth (most or all groups participating in a negative way) are categorized into lower level categories all the way down to "zero". Those periods showing the strongest market performances aided by the most favorable breadth across industry groups will be categorized into higher level baskets (all the way up to 200).

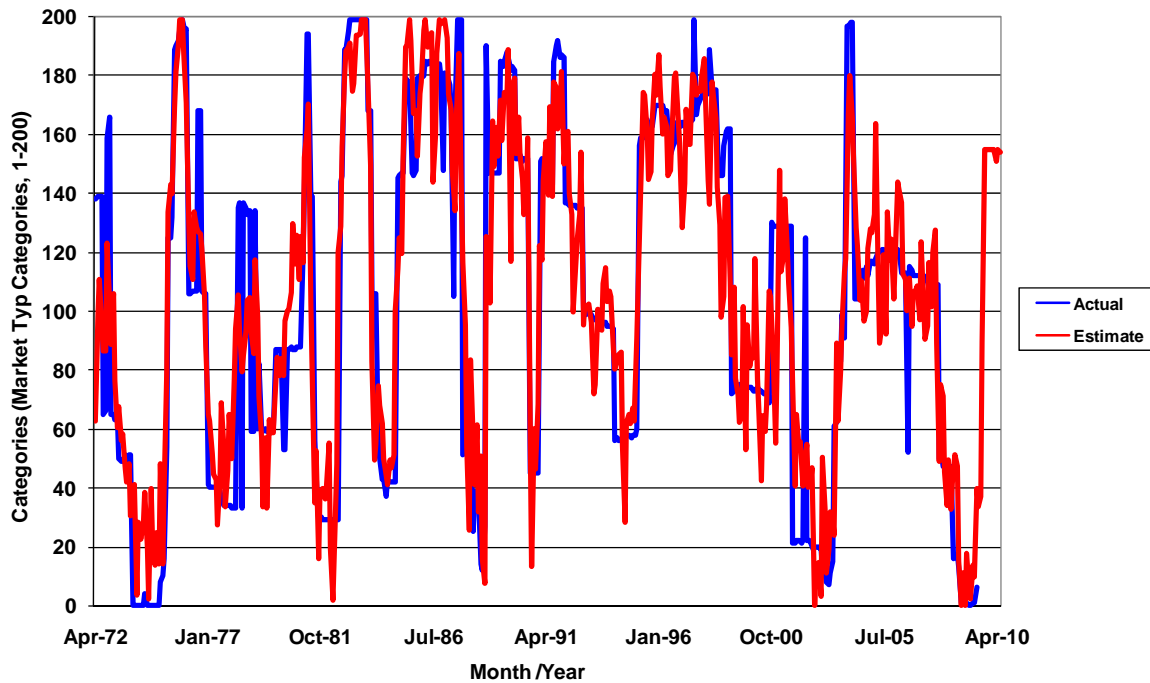
As we look across the cycles in Figure #1, we can see that there tends to be a very abrupt swing from the lowest categories (during recession) to the highest categories (just before the recession ends and into ensuing months). We can see such a swing in this chart from the 1973-1974 recession (a category swing from zero to 200). After the end of the 1982 recession, the model showed a swing from 29 to 199 in just six months (actual results, in blue). After the 1990-1991 recession the indicator moved from 45 to 192 in roughly 10 months. Similarly, the market category jumped from as low as seven to 198 in just 11 months (beginning in March 2003, in this case long after the end of the recession of 2001).

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Please see Page 5 of this report for important disclosures.

Sister Markets and Projection through June 2010



Source: Factset. Baseline. Wells Fargo Advisors

Past performance is not a guarantee of future results.

Over the 37-year period shown, the longest period of time that the indicator was at its worst reading occurred during the 1973-1974 recession. The indicator stayed between zero and four for 14 months. At no other time during this period was the market as broadly negative as that period. However, the most recent bear market was close. Most recently, the indicator remained between zero and one for eight months. The one-year performance and breadth indicator picked up for the first time in that period to a "six" level in June.

In red on the attached chart, we have taken the created market category indicator and projected its level looking forward. The result is the "out-of-sample" projection of market strength (performance and performance breadth) for the period through June 2010 (in red, at the right side of the graph). This favorable move from a low of zero to a 155 level between now and then (and even sooner) suggests several things. First, it would suggest that the performance of the market over the course of the last year (and the types of stocks performing over that year) is historically suggestive of a period of continuing forward-looking upside with favorable performance from a wide breadth of industry groups. Of course, this finding is in line with the favorable readings investors have been receiving from a broad swath of leading economic indicators.

Second, these findings would suggest that while a correction is not out of line over the course of the first year of market reaction to economic recovery, such corrections are typically rather shallow and rotate back to another leg of the developing bull market. Finally, we would say that these results remain in line with our expectations for a 1015 S&P target for the end of 2009 or early 2010. We took a look at the implications of our projected indicator performance for the performance of the S&P Composite Index (based upon the long-term data). While our S&P target for year-end 2009 was developed specifically from our base operating earnings projection for 2010 and an applied below-average P/E valuation of roughly 14x, the "Sister Markets" indicator level achieved in our projection in Figure #1 is pointing to a target of a similar magnitude. The 1015 level represents 10%-11% upside potential (before dividends) for the S&P Composite Index over roughly the next half year.

Of course, we continue to monitor the progress of a variety of leading indicators that currently continue to point toward economic recovery. We also continue to monitor not just the market's action but also its behavior versus our expectations for its behavior at this early stage of a market recovery (and most likely near the low point for the economy for this recession). Obviously, should unexpected events (external geopolitical, virus-related events or even unexpected negative events surrounding a major financial institution) offer the potential for consumer or investor confidence to fade at this stage of the economic cycle, our targets and timing for those targets would also have to be adjusted.

Nonetheless, we believe the data streams currently being generated from the economy and the markets, thus far, suggest that the equity market would typically have upside from here over the next 18 months (and that such upside would most benefit the more cyclically sensitive issues in the marketplace, smaller capitalization issues and increasingly more value-oriented issues as time passes). We believe aggressive long-term oriented investors should use periods of near-term correction, consolidation or weakness as opportunities to acquire such perceived "higher risk" vehicles.

Specific Recommendations:

The Consumer Staples sector makes up roughly 12% of the total market capitalization of the S&P 500. This sector's index has fallen slightly less than 14% over the last 12 months versus a 28.4% decline for the S&P 500. Shares in the Consumer Staples sector generally outperform the overall market during the middle stages of an expansion through most of a recession. They tend to be underperforming issues late in a slowdown or recession and in the early stage of the following economic growth phase. As we have seen over the last 12 weeks since the early March stock market lows, when investors feel better times are on the horizon, defensive sectors like Consumer Staples typically underperform by a substantial margin. Currently, for clients with average risk tolerance, we recommend carrying an evenweight (12%) equity allocation to the Consumer Staples sector. "Buy" rated Consumer Staples stocks among our correspondent research providers total 71 companies. The companies listed below are currently "Buy" rated by at least three correspondent research providers:

- Coca-Cola Co. (KO-NYSE-\$47.99)
- Kellogg Co. (K-NYSE-\$46.57)
- Kraft Foods Inc. (KFT-NYSE-\$25.34)

Weekly wrap and look ahead:

The three major indices finished mixed in last week's trading. The S&P 500 lost 0.3% (year-to-date up 1.7%), the Dow Industrials fell 1.2% (YTD down 3.9%) and the NASDAQ Composite gained 0.6% (YTD up 16.6%). Five of 10 S&P sectors outperformed the Index and the same number managed to finish higher on the week. The best performing sectors were Telecom Services (up 3.7%), Health Care (up 1.3%) and Utilities (up 1.0%). The worst performers were Energy (down 2.7%), Financials (down 1.3%) and Industrials (down 1.0%). The market pullback over the last few weeks has featured outperformance by the more defensive sectors.

Last week's economic calendar contained several reports that helped to build our confidence that the economy is on the mend. Looking at the housing market, existing home sales (about 80% of total sales) rose 2.4% to an annual rate of 4.77 million. New home sales were down a touch (0.6%) to a 352,000 annual rate. Both existing and new home sales volumes appear to be stabilizing at low levels. In addition, while pricing is down on a year-over-year basis in most parts of the country, overall declines are decelerating. Real estate is moving in this market if potential sellers can come to grips with current pricing realities. Buyers now need to jump through a few more hoops to obtain financing but money is available. One aspect of the "new" housing market we find quite disturbing (and we never hear politicians mentioning) is that buyers can still purchase using FHA loans with as little as 3% down. Has the housing meltdown not taught us anything? Buyers need some "skin in the game" in the form of a substantial down payment (remember when 20% was standard?). In our opinion, much (if not all) of the current financial sector woes could have been avoided by simply requiring a 20% down payment on any home loan. OK, we will get off our soapbox now.

In other news last week, orders for durable goods excluding aircraft rose 1.1% in May. Within this report, orders for non-defense capital goods excluding aircraft (our favorite gauge of business capital spending) rose a strong 4.8%. This is the kind of upside surprise we want to see. We have not been looking for a near-term surge in business capital spending but perhaps our expectations are too low. Overall consumer sentiment and confidence has also been improving in recent months. Last week's reading from the University of Michigan came in better than expected.

Confidence and sentiment are coincident indicators that have probably risen in large part as a reaction to the stock market rally since early March. Government stimulus helped personal incomes rise in May and spending was up as well (although not as much). The savings rate increased again and now stands at 6.9%. This is good news in the long run, but a higher savings rate means consumers are cutting back on purchases, a near-term negative. The two-day FOMC (Federal Open Market Committee) meeting held no surprises but did serve a purpose. The Fed used the opportunity to quell any speculation that rate hikes are anywhere on the horizon by stating that "economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period." That is about as clear of a statement as you will ever get from the Fed.

This week's holiday shortened economic calendar contains additional data on home prices, consumer confidence, manufacturing, construction spending, auto sales and factory orders. These reports are all parts of a large puzzle that will help us confirm (or refute) our projection for where the economy is headed over the next 12 to 18 months. The most watched report this week will be Thursday's employment data for June. The unemployment rate likely climbed to 9.6% from May's 9.4% level. It appears the 10% level will be reached before we see improvement. Remember that the unemployment rate typically continues to climb even after the economy starts to improve. As the economy rebounds, employers are initially slow to hire additional help until they are sure the economy will translate into sustainable new cash flow. We suspect this will be especially true in the current cycle.

It would be typical for the stock market to experience a 10% to 15% pullback after the 40%-plus move higher from the early March lows. We have been looking for a period of consolidation/pullback that might last a couple of months. Already, from the June 11 intraday high to the June 23 intraday low, the S&P 500 retraced 7% of the rally. Is there more pullback in store for this market? We think so. It may be a tradable move for those very light on their feet, but we continue to recommend that investors use this opportunity to get ready for the next 12 to 24 months. In our opinion, investors should increase their cyclical exposure during this consolidation/pullback and get ready for the next leg up in the market.

Wells Fargo Advisors Sector Weighting Recommendations:

<u>Sector</u>	<u>S&P Weighting*</u>	<u>Wells Fargo Advisors Guidance</u>	
Industrials	9.9%	Overweight	15.0%
Telecom Services	3.5%	Overweight	7.0%
Consumer Discretionary	9.0%	Evenweight	10.0%
Consumer Staples	12.0%	Evenweight	12.0%
Energy	12.4%	Evenweight	15.0%
Financials	13.6%	Evenweight	10.0%
Information Technology	18.4%	Evenweight	18.0%
Health Care	13.9%	Underweight	11.0%
Materials	3.2%	Underweight	0.0%
Utilities	4.1%	Underweight	2.0%

Source: Bloomberg, Wells Fargo Advisors

*Weightings May Not Add To 100% Due To Rounding
Pricing: based on June 26, 2009 close

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