



Perspective

Economic and Market

2010-Issue 4

"Bringing you national and global economic trends for more than 25 years"

In This Issue:

The Greek Crisis???

A "Fear-Freeze" Is Fundamental!??!

Government Deficits Primarily Cyclical!?!?

Economy Just Ramping Up!!?

Money Velocity Starting To Rise!!!

S&L Governments Back In Balance??!

Top-Line Growth Returning!!!

Amazing Revaluation!?!?

A Refreshing Pause ... We Hope!??

The "crisis-psychosis" investment culture is back! Greece and the other PIIGS have captured full attention and left little role in the financial markets lately for "fundamentals." Indeed, since the "Flash Crash" on May 4, the financial markets have been trading almost exclusively on emotion.

How serious is this latest Armageddon fear? Is the Euro region actually fundamentally bankrupt, placing the world at risk for a broader contagion? Or, does this crisis episode have more to do with a jittery investor mindset that has learned to sell first and ask questions later? Even if it is mostly about panic, couldn't another "fear freeze" result similar to 2008, and ultimately produce some real fundamental damage to the global recovery? Bottom line? Is this an opportunity for investors to scoop up panicky-priced stocks or a sign the recovery rally begun in March 2009 has come to an end?

The Greek Crisis? Fundamental, Fear Or Both???

The current crisis revolves around potential sovereign debt defaults, a concern heightened by a surge in debt to GDP ratios among governments about the globe. Several points are noteworthy.

First, there has been a serious deterioration in government finances. However, rather than due to out-of-control government spending, this primarily reflects a record-setting collapse in economic activity during the 2008 recession. For example, in Greece, between the mid-1990s and 2007, government debt grew "more slowly" than nominal GDP. It was the collapse in GDP during the 2008 recession that caused the debt-to-GDP ratio to surge. While most believe today's fiscal problems are primarily structural and will require significant austerity programs to correct, governmental debt problems may be much more "cyclical" than widely perceived. In the U.S., for instance, the current deficit-to-GDP ratio is between 9 and 10 percent, which is also the percent by which the current level of real GDP is below its long-term trend line average! The cyclical collapse in economic activity has produced an equally remarkable cyclical ballooning in government deficits.

Whether the problem is primarily structural (out-of-control governments) or mostly cyclical (reflecting a huge collapse in economic activity) is very important. If it is structural, the problem cannot be solved by economic growth. Alternatively, if it is mostly cyclical, "kicking the can down the road" and allowing "time and economic growth" to wash over the globe could prove a very effective solution. The picture may appear much brighter after a few years of persistent economic growth, after a revival in the taxable base of revenues, incomes, and profits, and after a cyclical reduction in social safety net expenditures.

Second, the Euro crisis is widely perceived as the sequel to the Lehman crisis, whereby toxic-debt problems in the private sector have simply been shifted to the public sector. But sovereign debt woes are not about "toxic debts." Bad fundamental subprime debts are a very different problem than whether there is enough tax base (economic growth) to eventually lower governmental debt-to-GDP ratios. The Lehman crisis was about "absorbing" fundamentally bad debt. The Euro crisis is more about buying time to allow global commerce to revive and lessen public-debt ratios. While the former required fresh capital injections (TARP) to offset toxic-debt writeoffs, the current crisis seems more about the "aftermath of a nasty cyclical recession" and requires a "backstop" (a \$1 trillion policy official guarantee) and "time for a return to economic growth."

Third, it is important to realize how different the global economic cycle is today versus what it was prior to the 2008 crisis. Then, policy officials had been engaged in a multi-year tightening strategy whose lagged contractionary forces were still intensifying while the economic recovery cycle was clearly losing momentum. Today, policy officials have been in an accommodative mode; the lagged impact of these policies are still expansionary, business and consumer behaviors are slowly but steadily regaining aggressiveness, and overall global economic momentum was clearly positive as the Euro crisis emerged.

Fourth, the real issue for Greece and the other PIIGS is whether they can continue to issue new debt and roll existing debts at a reasonable interest rate. Escalating government bond yields pushed the Greek crisis toward panic mode. In mid-April, Greece 2-year government note yields were around 7 percent. By early May, however, they had exploded to more than 18 percent! Suddenly, a government that was struggling but okay, had almost overnight become technically insolvent at this prohibitive interest rate. Perhaps Greece and other Euro governments are fundamentally insolvent, but they surely are technically insolvent irrespective of their fundamentals if 2-year bond rates remain near 20 percent! Consequently, regardless of actual fundamentals, a market panic that keeps the finance rates for PIIGS elevated at prohibitive levels would eventually create its own fundamental crisis.

Therefore, the almost \$1 trillion backstop guarantee recently announced by EU policy officials was necessary in order to calm market fears and return sovereign bond yields to accessible levels. Unlike the TARP program implemented in the U.S., this EU backstop is not intended to be a capital injection that can be used to offset sovereign bond losses. Rather, it seems more analogous to the U.S. guarantee extended to money market mutual funds during the 2008 crisis. Simply the threat of a potential \$1 trillion buyer of EU sovereign bonds may be enough to calm market fears and return government finance rates among PIIGS to reasonable levels. Since it was introduced, this program seems to be working better than most appreciate. Greece 2-year government bond yields, after exploding toward 20 percent, have since returned and remained near 7 percent. Similarly, the 2-year sovereign bond yield in Portugal has again declined to about 2.5 percent after briefly rising above 6 percent prior to the backstop announcement. If the “threat” of a \$1 trillion buyer allows these countries to roll existing debts and issue new bonds at reasonable (even if elevated) rates, the fear at the heart of this crisis will eventually subside even if the need to address fiscal austerity in the region remains ongoing.

Fifth, the “fear-based” nature of the European crisis is highlighted by the shifting focus of market participants as the crisis has unfolded. Initially, investor anxieties were centered on a surge in short-term sovereign finance rates. However, the \$1 trillion backstop announcement seems to have calmed this trend. No matter. Once in a panic, market fears just move to something new. So while policy officials addressed finance rates, investor concerns shifted to a “run on the Euro.” Although setting a marginal new crisis low in recent days, the Euro currency rate against the U.S. dollar has stabilized in the last couple of weeks. No matter. Most recently, the markets are no longer worried as much about a weak Euro since concerns have shifted yet again toward rising LIBOR rates, widening swap spreads and an interbank lending freeze. If the issue is truly fundamental, policy actions can help reduce the problem. When panic is dominant, however, is there really anything a policy official can do to please Mr. Market? The constantly shifting focus on exactly “what” the problem is leads us to believe this crisis is more about fears than about fundamental challenges. Consequently, if it can soon be calmed and investor

attention shifts back to global economic fundamentals, the ultimate fallout from this crisis may be minimal.

A “Fear-Freeze” Is Fundamental!??!

As the 2008 crisis illustrated, too much fear for too long can lead to real fundamental economic damage. If Euro crisis headlines remain dire and financial market volatility remains extreme, eventually economic players (business and consumers) will begin to curtail behaviors. That is, even if the Euro crisis is more about fears than fundamentals, a “fear-freeze” could produce fundamental problems. Our primary concern is not that the Euro region is overwhelmed by toxic debts that need to be restructured. Rather, our concern is whether “panic” will be left to smolder and elevate to a point where “fear itself” becomes the primary fundamental threat to the economic cycle.

Indeed, in recent weeks, there have been signs of a renewed “fear-freeze.” LIBOR rates and swap spreads have risen some around the globe. Although most signs suggest only a minor tightening of credit conditions in the U.S., these will be worth monitoring for further potential erosion. Sometimes it seems as though “fundamental analysis”—be it economic or investment-related—doesn’t matter anymore. Perhaps we all need to go back to school and get psychology degrees. It appears both economists and investors have found themselves in the “panic prediction” business. Who cares whether the economy will be good or bad or whether earnings are rising or falling? The only thing which seems to matter is “what and when is the next panic?”

Economy Is Just Ramping Up!!!

The longer Euro crisis fears persist, the more likely the current crisis will have real fallout for U.S. and global economic growth. Currently, however, if it can soon be calmed, the likely fundamental fallout appears limited.

The U.S. economy has grown for three consecutive quarters, but in many respects, the recovery is just getting under way. In the last quarter, the economy finally began to create jobs and for the first time inventories were increased. In both cases, these trends will likely persist and strengthen during the next few years. U.S. corporate profits rose by more than 30 percent in the last year and at a 24.1 percent annualized pace in the first quarter! Moreover, among S&P 500 companies, total sales rose by about 12.5 percent in the first quarter—a solid top-line result in a world with less than 1 percent core consumer price inflation, only slightly more than 2 percent wage growth, and with only about a 4 percent long-term Treasury bond yield. Because of ongoing stellar profit performance, the U.S. corporate net cash flow to capital spending ratio remains at a post-war high! There is tremendous business buying power yet unleashed that should continue to drive job creation, inventory restocking, and business investment spending.

Households are enjoying and responding to improved job creation, rising home prices, rising net worths, and some easing of credit conditions. Consumers are also hoarding a post-war record high of more than \$7 trillion in cash assets. There is plenty of dry powder to ignite a healthy consumer driven

economy awaiting only a calming of anxieties and a rise in consumer confidence.

Policy officials have yet to raise interest rates, drain liquidity, flatten the curve, or restrict fiscal spending. Moreover, monetary velocity (the rate at which the existing money supply is converted into economic activity) has just begun to rise, and its acceleration could add handsomely to real GDP growth during the next couple of years. The lagged impact of this collective policy cocktail is still acting as a positive force for improved economic growth and it is hard to see much loss in economic momentum “before” policy officials begin a tightening process. Moreover, the recent Euro crisis has produced a silver lining for economic growth. Undoubtedly, growth in the Euro region will remain slower than it would be without the sovereign debt crisis, but this crisis has also allowed the 10-year U.S. Treasury bond yield to decline by about 75 basis points, it has caused the 30-year national average fixed-mortgage rate to decline again below 5 percent, it has brought oil prices down by about \$20, and it has stalled any Fed tendency toward an early tightening of interest rates as well as probably stopping recent tightening moves by Chinese policy officials. Overall, policy conditions remain accommodative, in part, because of the Euro crisis.

Finally, while the U.S. dollar has risen significantly against the Euro since late last year, it has changed little against the Yen and Canadian dollar, nor against most emerging world currencies. While real U.S. trade flows may show some weakness in the coming year with Europe, overall U.S. international trade flows should remain more favorable than currently anticipated.

Overall, we are concerned about and will continue to monitor the potential fundamental fallout from the ongoing Euro crisis. However, we remain optimistic the underlying economic momentum evident throughout much of the globe including in the U.S. will not likely be stopped and ultimately we expect this favorable economic undertow to again rule investor sentiment.

Proceed As Though ... FUNDAMENTALS Do Matter?!??

The stock market “flash crash” in early May was a frightening event. Stock prices collapsing essentially to zero in a matter of minutes irrespective of any fundamental news? If these episodes continue to occur with any frequency, “investors” will stop playing. If securities prices are no longer tied to any fundamentals on Main Street, investing simply becomes a random experience left to those who feel they can benefit from predicting emotional panics. For this reason, long-term investors will likely keep the pressure on regulators to get more and more aggressive until such episodes are eliminated.

In the meantime, “investors” should approach the potential for such panics with “diversification” rather than by exiting the markets. Essentially, while we share some concerns about the “workings” of the financial markets, we would recommend investors continue with the premis “main street fundamentals” do eventually matter. And currently, on this score, there is a lot to like!

Total U.S. corporate profits continue to surge higher and should reach an all-time record high by next year. U.S. real GDP growth has averaged 3.6 percent so far in this recovery and appears to be on pace to post about this same growth rate in the current quarter. The growth rate outside of the U.S. is even stronger despite the ongoing problems in Europe. The U.S. core consumer price inflation rate and wage inflation rate are close to post-war lows, short-term interest rates are zero, the 10-year Treasury yield is currently 3.25 percent, private liquid buying power (cash holding among U.S. businesses and households) is at an all-time record above \$10 trillion, and although the unemployment rate remains extremely high, the U.S. economy has been creating jobs again since late last year!


Despite this rather cheery list of positive fundamentals, the “wall of worry” being climbed by the stock market in this recovery remains immense. Market concerns seem endless—toxic debts, government spending out of control, future taxes, health care legislation, financial regulations, a China bubble, a run on the U.S. dollar, a double-dip recession, a Euro contagion, etc. “Fears” have come and gone, but “fear” has remained a constant! The persistence of fear has produced an attractively priced stock market. The earnings yield on the S&P 500 Index (based on current year-end mean earnings estimates) is about 8 percent—nearly twice the current 30-year Treasury bond yield! Crises be damned! If “fundamentals eventually rule,” there is still considerable upside potential in this stock market before the end of this economic recovery.

What A Decade It's Been!!!!

In early 2000, the S&P 500 broke above 1,500. Since then, it has declined by about 27 percent (1,500 to about 1,100 currently) while total U.S. profits have “doubled” (risen from about \$800 billion in 2000 to about \$1.6 trillion today) and while the 10-year Treasury bond yield has fallen by “one-half” (from about 6.5% in 2000 to about 3.25% today)!

In 2000, if someone knew with certainty that in the coming decade profits would double while the long-term risk-free discount rate would drop in half, nearly everyone would bet heavily on the stock market—and lose! There has been an amazing stock market revaluation on all three fronts (i.e., stock prices, earnings and competitive interest rates) during the last 10 years! Despite one of the biggest revaluation decades ever, most still don't want to touch the stock market, let alone be overweight.

This highlights an equally amazing “investor reassessment” that has taken place during the last decade. If 2000 was the era of “irrational exuberance” (many were buying stocks of companies without earnings and without regard to values), today must be the era of “irrational pessimism” (the culture is more influenced by potential Armageddon fears than by current economic results). Too many were too exuberant then—too many are too pessimistic now. Just as it proved correct to bet against the “irrationality” in 2000, it will likely prove correct to bet against it again today!!!



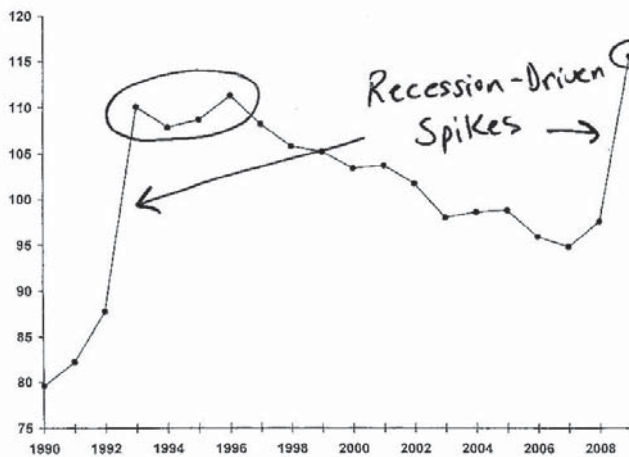
James W. Paulsen, Ph.D.
Chief Investment Strategist, Wells Capital Management

The Greek Crisis???

Many Euro region governments face formidable financial challenges in the coming years. Much of the immediate problem, however, is simply a panic in the financial markets. What initiated the “Euro crisis” in the minds of investors was a surge in Greece’s debt-to-GDP ratio shown in the top chart. During 2009, this ratio exploded by 20 percent to about 115 percent! Interestingly, however, in the five-year period between 1993 and 1997, Greece’s debt-to-GDP ratio was little different than it was at the end of 2009. Why is today’s debt ratio an Armageddon while in the middle-1990s the nearly identical ratio wasn’t? “Fundamentally,” the ratio is essentially the same, but the collective investor mindset today is much more spooked. Certainly, fundamental problems are a part of the Euro crisis and will need to be addressed during the ensuing economic recovery, but much of the contemporary crisis seems closely tied to a market panic. Any sovereign body can be driven to technical bankruptcy, whether its debt-to-GDP ratio is high or low, simply by investors driving the interest rate at which a sovereign can

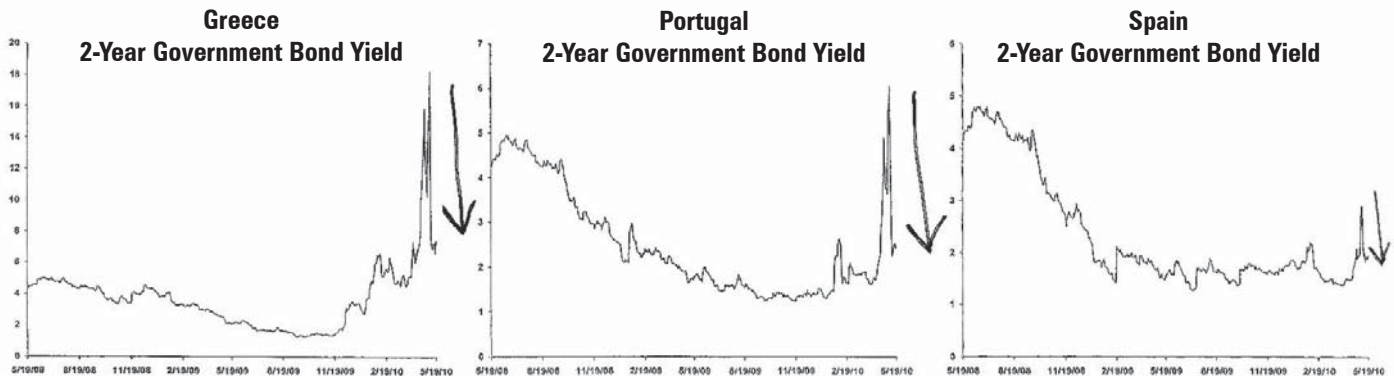
roll over existing debt or issue new bonds to prohibitive levels. Perhaps the actual financials of Greece (and other Euro governments) are fundamentally insolvent, but they are surely technically insolvent regardless of fundamentals if 2-year government bond rates surge and remain near 20 percent! For this reason, we are encouraged by the almost \$1 trillion backstop provided by the EU to ensure these countries have access to the capital markets at do-able, even if elevated, interest rates. So far this backstop seems to be working better than most appreciate. The 2-year Greece note was more than 18 percent a few weeks ago, but since the backstop announcement, it has declined and “stayed” at around 7 percent. Similarly, the 2-year sovereign bond yield in Portugal has declined to about 2.5 percent from a recent peak above 6 percent. If the “threat” of a \$1 trillion buyer allows these countries to roll over existing debts and issue new bonds at reasonable (even if elevated) rates, the “fear” at the heart of this crisis should eventually subside even while the need to address fiscal austerity in the region will be ongoing.

Greece Government Debt as a Percent of Nominal GDP



when it started... Greece's Debt/GDP Ratio was not much higher than the mid-1990s! what changed?

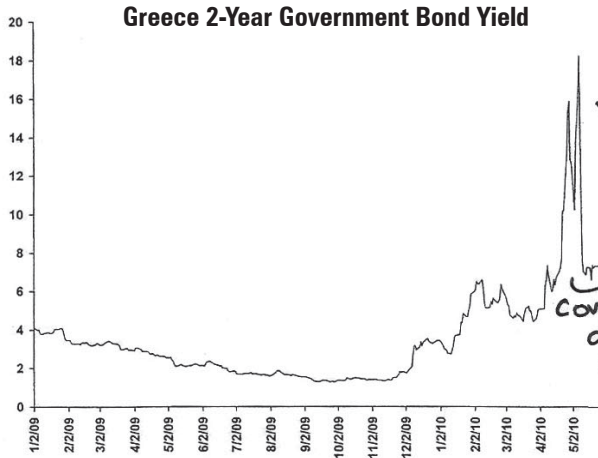
The \approx \$1 Trillion Euro BACKSTOP WORKED!!?



What Does Mr. Market Want???

The “fear-based” nature of the Euro crisis is illustrated by a shifting focus among market participants. Initially, investor anxieties were heightened by a surge in short-term Euro sovereign finance rates. However, the \$1 trillion backstop guarantee seemingly calmed this trend. Didn’t matter though. Market fears simply shifted toward concerns surrounding a “run on the Euro.” The Euro, however, has shown signs of

stabilizing in the last couple of weeks. No matter, market worries have already refocused on rising LIBOR rates, TED spreads, and an interbank lending freeze! The constantly shifting focus on “what” constitutes the problem leads us to believe this crisis is more about fear than fundamentals. Consequently, if it can be calmed soon, the ultimate fundamental fallout may prove minimal.



Initially, Mr. Market was worried About Prohibitive Sovereign Finance Rates...

come down + stayed down!?



... then about A Run on the Euro...

stabilized?!

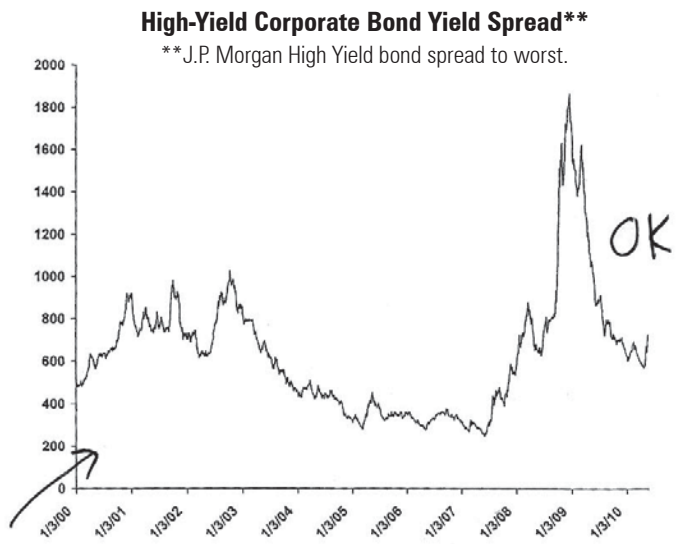
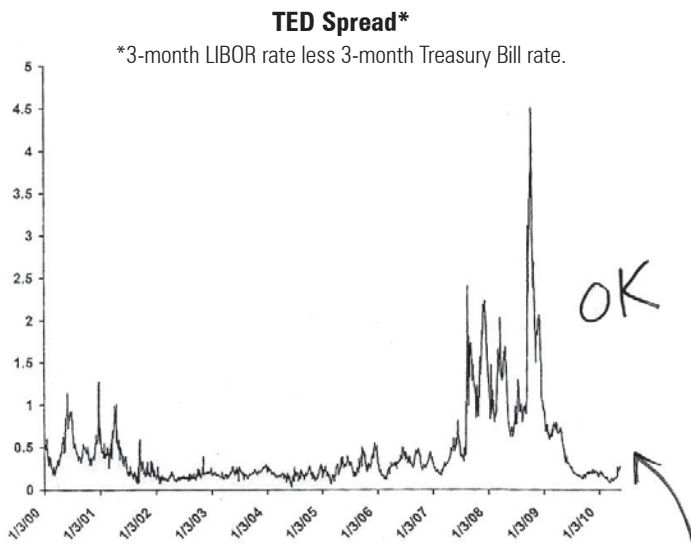


... Now the Crisis Worry Has Shifted to Inter-BANK Lending Rates?!?

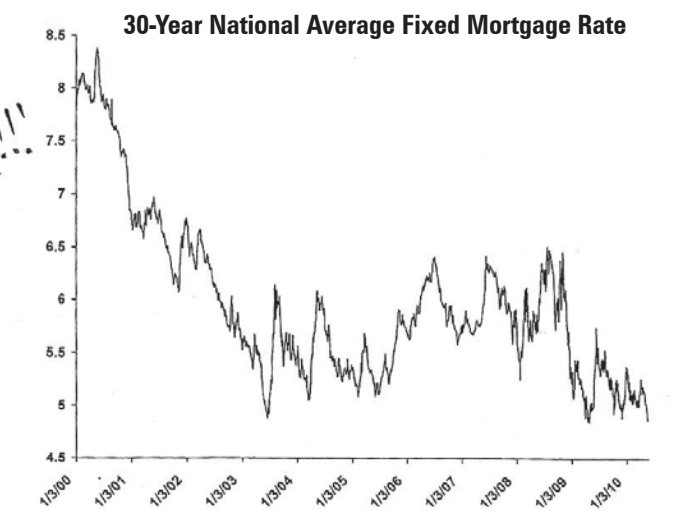
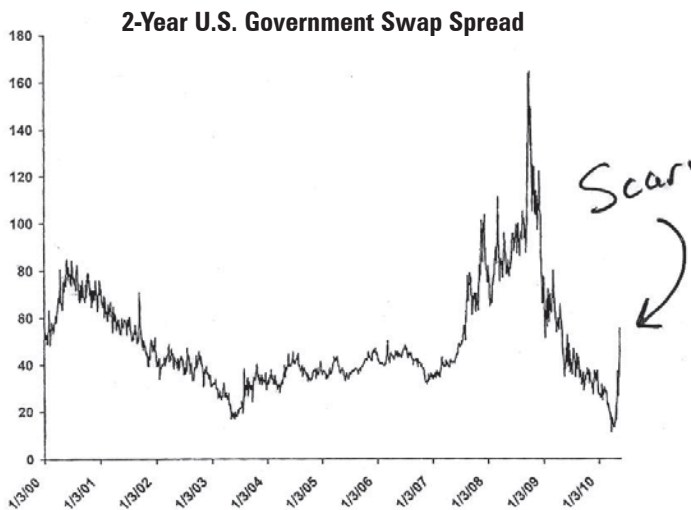
A "FEAR-FREEZE" Is Fundamental!!!?

As the 2008 crisis illustrated, too much fear for too long can lead to real fundamental economic problems. If the headlines remain dire and financial market volatility remains extreme, eventually economic players will begin to curtail behaviors. That is, a "fear-freeze" can create real fundamental damage. This page illustrates various indicators which monitor whether the panic is starting to impact fundamental conditions. So far, while these indicators show some elevated concerns, none yet suggest significant fundamental fallout should be anticipated.

Indeed, unlike the 2008 crisis, mortgage rates have actually declined since Euro concerns escalated and 2-year U.S. swap spreads were beginning to look scary, but have recently subsided again. Our primary concern is not that the Euro region is overwhelmed by toxic debts that need to eventually be restructured. Rather, our concern is whether "panic" will be left to smolder and elevate to a point where "fear itself" becomes the primary fundamental problem. So far...OK.... but stay tuned.



Not Bad Yet... But the longer it goes on...
... the greater the potential "Fundamental" Fallout?!?

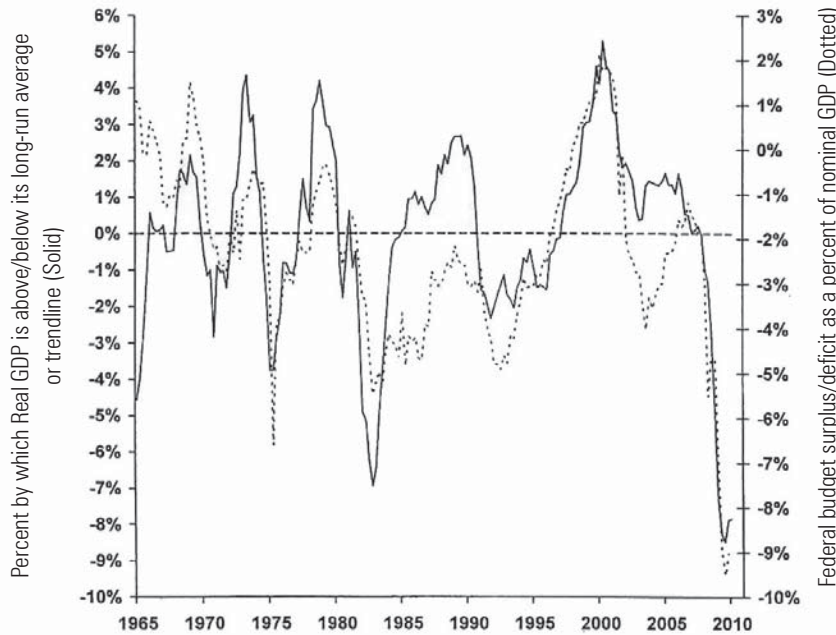


U.S. Government Deficit Primarily Cyclical??!

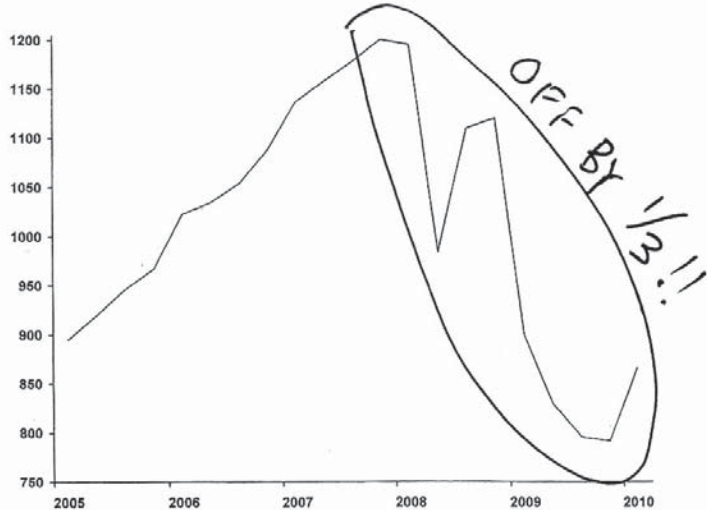
The ballooning U.S. government deficit (currently at a post-war record of about 9 percent of nominal GDP) is a concern for all investors. Certainly, some of the deficit is structural and will be hard to eliminate. However, the top chart suggests most of the contemporary deficit is cyclical and should respond better than most anticipate to a period of persistent economic growth. This chart overlays the U.S. deficit ratio (i.e., trailing 1-year deficit as a percent of nominal GDP) with the percentage deviation of real GDP from its long-run trendline average. As would be expected, these two charts move very closely together. Deficits and surpluses in the government budget mostly reflect periods of sub-par or above-average growth in the overall economy. Not always, of course. In the 1980s, the deficit did not improve near as much as would have been expected by the pace of economic growth (due perhaps to accelerating cold war spending and tax cuts?). Similarly, in the mid-2000s, the deficit worsened

far more than suggested solely by the pace of economic growth (maybe the result of the Iraq war and homeland security expenditures?). Mostly, however, government budgets have moved closely with economic growth, and the 2007 to 2010 period is not an exception. Currently, both the budget deficit and the percent by which the level of real GDP is below trendline are at about 9 percent. Seems reasonable—an almost 10 percent collapse in the level of real economic activity produces an almost 10 percent shortfall in the government budget. The severity of the fiscal crisis mostly reflects the severity of the last recession. Personal tax receipts declined by one-third and corporate tax receipts were off by almost two-thirds! While fears have escalated surrounding potential fallout from an explosion in the size of the U.S. government, since the deficit appears mostly cyclical, government finance may look considerably better after a few years of persistent economic growth.

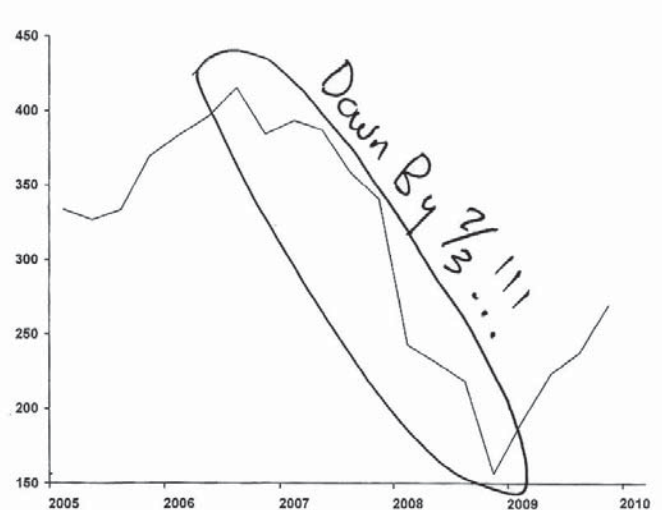
Trendline GDP and Federal Deficits



Federal Government Personal Current Tax Receipts



Federal Government Corporate Tax Receipts

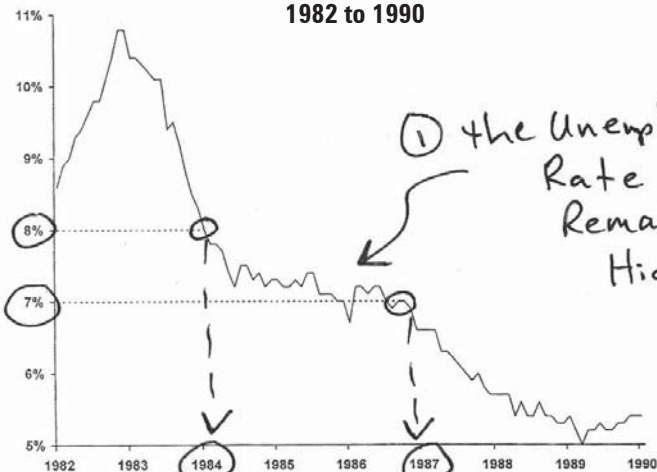


"Issues" Remain ... But Economic Growth Will Continue!?!?

Even though the global economy has been growing for more than a year, economic issues seem to have lessened very little. Actually, this is not uncommon. The 1980s Reagan recovery serves as a good example that fears don't evaporate simply because the economy is back in a sustainable recovery. Despite a solid recovery commencing at the end of 1982 and persisting until 1990, the unemployment rate remained extraordinarily high throughout the 1980s (as it will in the contemporary recovery), federal deficit issues were record-setting when the Reagan recovery began and improved very little through much of the recovery (i.e., the U.S. still had a 5 percent deficit-to-GDP ratio in late 1986) and bank failures accelerated once the recovery began and rose throughout the

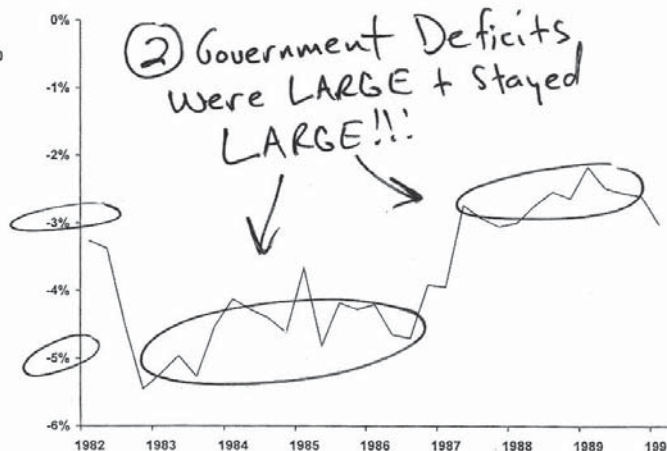
decade. In addition, state & local finances were a concern for much of the recovery, a large bank (Continental Illinois) went down in 1984 (almost two years "into" the recovery), the Great 1987 Crash occurred 5 years into the recover, and finally, farming, oil, and third-world debts continued to be written off throughout the expansion. Currently, the global economy has been in recovery for more than one year and the recovery looks increasingly sustainable. Despite this, anxieties, fears, and issues remain (e.g., health care, financial reforms, taxes, government deficits, a run on the US dollar, the break-up of the Eurozone, a bubble in China). However, similar to the 1980s, although worries and issues persist, so will the economic recovery.

**U.S. Unemployment Rate
1982 to 1990**



During the Robust Reagan Recovery...

**Federal Budget Surplus/Deficit as a Percent of Nominal GDP
1982 to 1990**



**Number of U.S. Bank Failures
1983 to 1990**

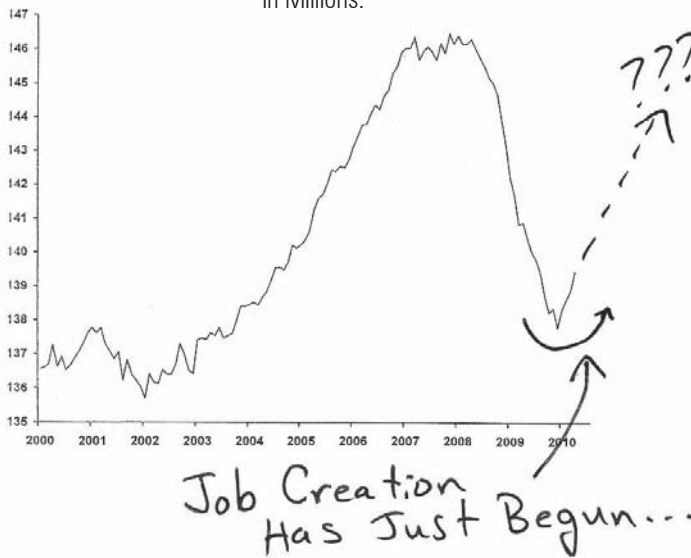


Economy Just Ramping Up!!!?

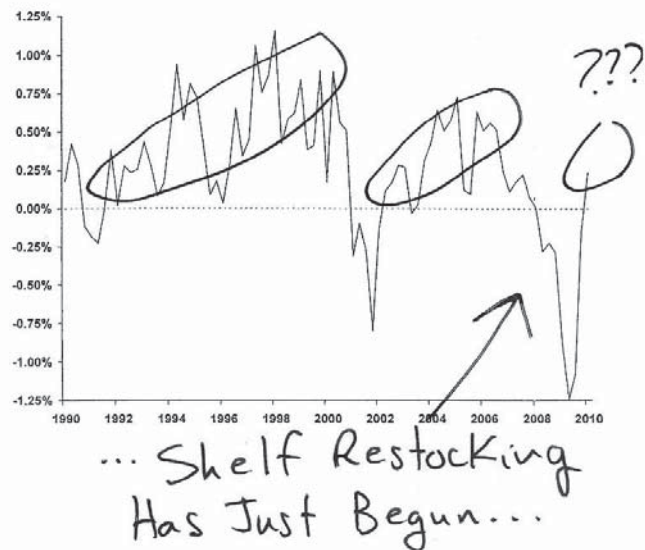
The U.S. economy has grown for three consecutive quarters, but in many respects the recovery is just getting under way. In the last quarter, the economy finally began to create jobs, and for the first time inventories were increased. In both cases, as the charts suggest, these trends will probably persist and strengthen during the next few years. Currently, the corporate net cash flow to capital spending ratio is at a post-war high of almost 1.75. This level dwarfs the previous post-war high of about 1.55 times established in the mid-1960s and is more than twice as great as the peak in this ratio between 1970 and 2007! There is tremendous business buying power yet unleashed,

which should continue to drive job creation, inventory restocking, and business investment spending. Moreover, while personal consumption spending has recently revived, it remains almost 8 percent below its long-run trendline average. Similarly, although consumer confidence has increased sharply since early 2009, it remains near a level reminiscent of past recession lows. Therefore, household economic momentum is likely to improve substantially as consumer confidence continues to slowly rise. The "best of the recovery" still lies ahead. Despite current European Armageddon fears, the economic party is probably just getting started!

U.S. Household Employment
in Millions.



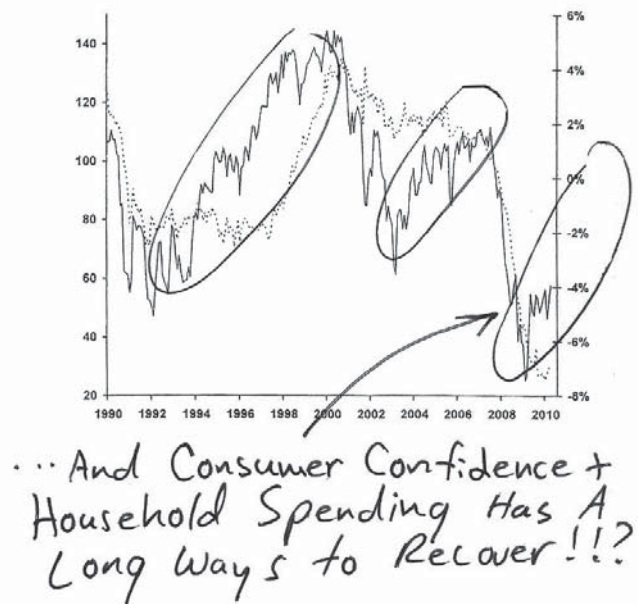
Change in Real Business Inventories as a Percent of REAL GDP



U.S. Corporate Net Cash Flow to Business Equipment Spending Ratio



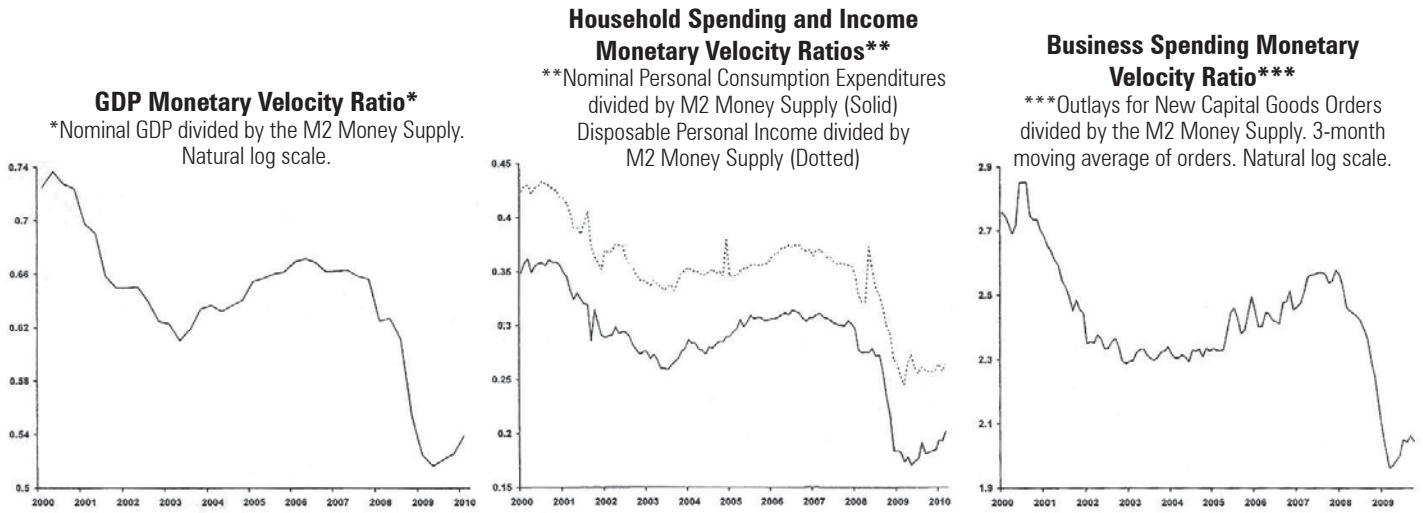
Consumer Confidence vs. Real Personal Consumption Expenditures



Money Velocity Starting to RISE!?!?

The positive impact of monetary policies on real economic activity is beginning to rise across the economy. Overall, GDP velocity (i.e., the rate at which the money supply is converted into nominal GDP) has increased in each of the last two quarters by a sequentially accelerating pace. While income velocity has shown little improvement beyond a clear bottoming, household spending velocity also exhibits a sharp acceleration in recent

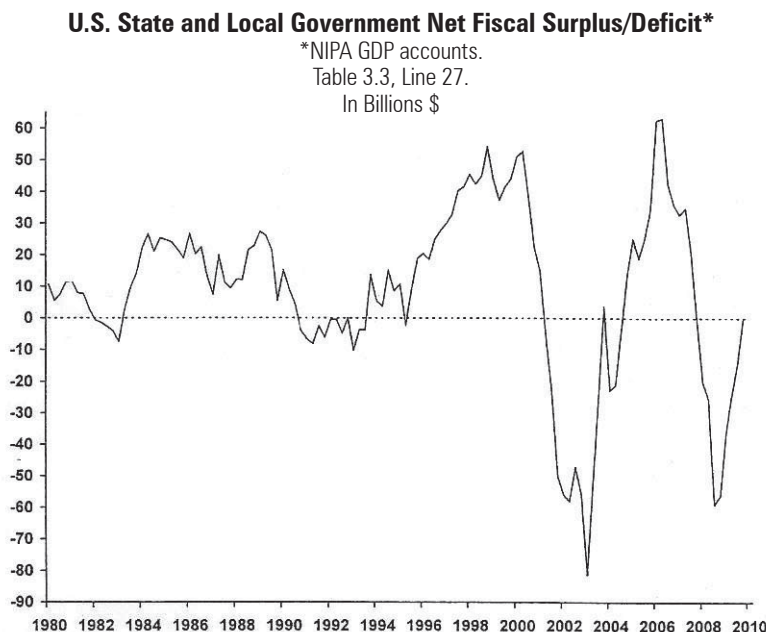
months. Finally, after a precipitous collapse, business spending velocity is also recovering. There are significant liquid asset holdings throughout the private economy (private sector cash holdings are currently about \$10 trillion), and economic activity could be enhanced considerably if cash hoarding eases and transaction velocity accelerates.



State and Local Governments No Longer Running Deficits!?!?

Many state and local government budgets face a challenging period ahead, and public sector austerity programs may detract from overall economic growth. While state and local debt levels have been elevated by this crisis, it is encouraging that

total state and local budgets have recently returned to balance. At a minimum, this illustrates how fast a simple return to economic growth can improve what recently appeared to be overwhelming budgetary problems.



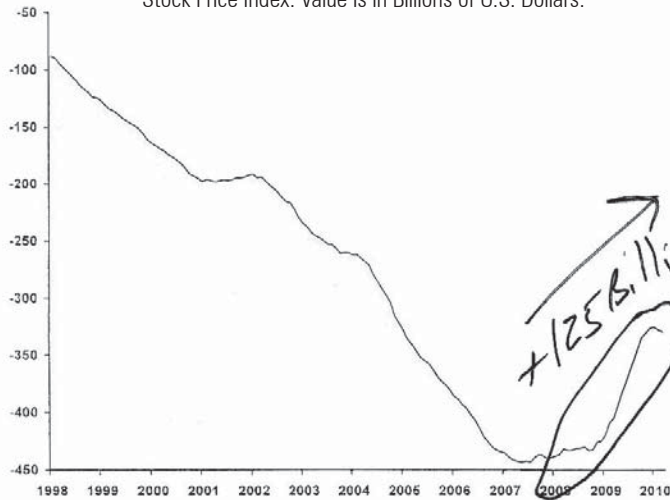
Biggest Improvement Ever in U.S. Emerging Markets Trade Deficit!?!

For the first time ever, the U.S. is experiencing a positive contribution from trade with emerging world economies (EM). Since late 2008 the U.S. trade deficit with the EM has improved by almost \$125 billion! While imports with the EM still exceed exports, EM imports are still about 20 percent

below pre-crisis peak levels, while EM exports have risen by about 45 percent from crisis lows and are near an all-time record high! In a “new-world” way, marking a watershed change, this U.S. economic expansion is being “subsidized” by EM consumers like never before!!!

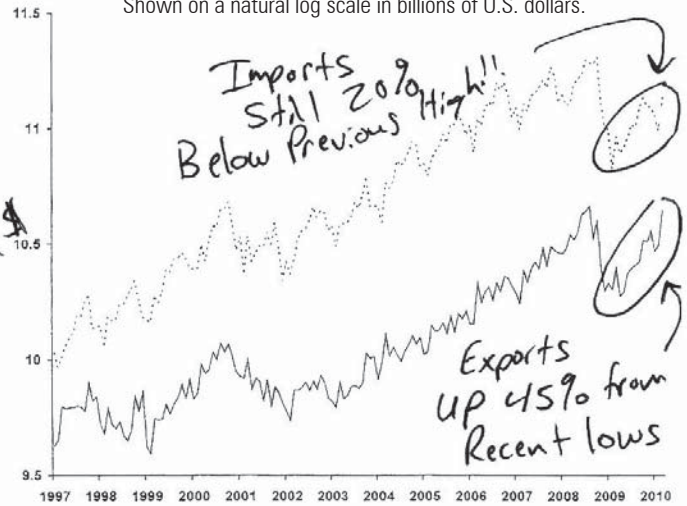
U.S. Emerging Markets* Trade Balance

*Trailing 12-month sum of monthly net exports with the 22 countries comprising the Morgan Stanley Emerging Market Stock Price Index. Value is in Billions of U.S. Dollars.



U.S. Exports and Imports with Emerging World Economies**

**Monthly Sum of U.S. Exports (Solid) and imports (Dotted) with the 22 countries comprising the Morgan Stanley Emerging Market Stock Price Index. Shown on a natural log scale in billions of U.S. dollars.



Econ-Sensitive Stocks Maintain Leadership???

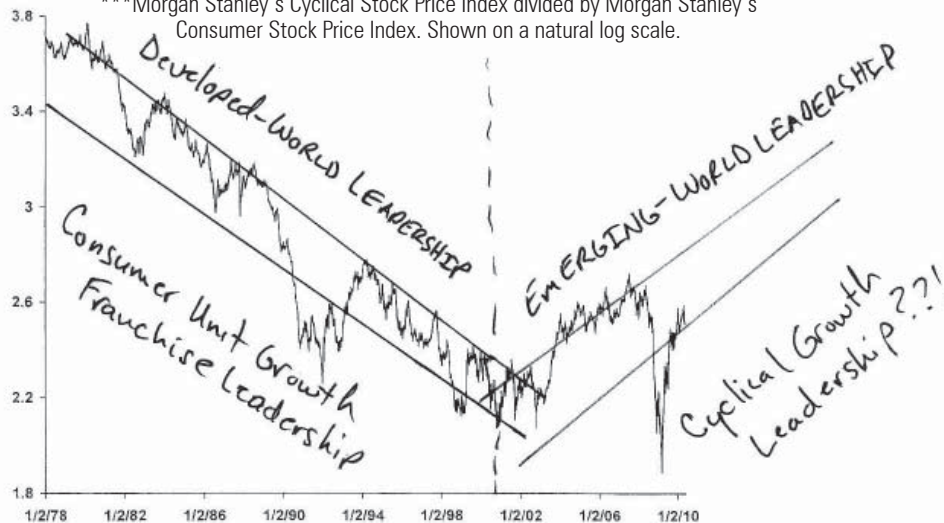
This is the second consecutive global recovery in a row led by the EM. Reflecting this new global economic leadership is a change in stock market “sector” leadership. During the 1980s and 1990s, when the globe was led by developed world economies, stock market leadership was primarily characterized by large-cap multinational, consumer unit-growth, franchise companies. Small cap stocks and economically sensitive stocks typically underperformed. Since 2000, however, small caps and cyclically oriented stocks have

mostly outpaced the overall market. While these stocks were hit hard during the worst of the 2008 crisis, their comeback in the last year has been amazing. We expect emerging economies to continue leading the global recovery and consequently expect stock market leadership to remain concentrated among small and mid cap companies that are economically sensitive. Thus, old sector rotation rules may no longer work in the new EM led global economy??!

Economically Sensitive vs. Economically Defensive Stocks***

Relative Stock Price Performance

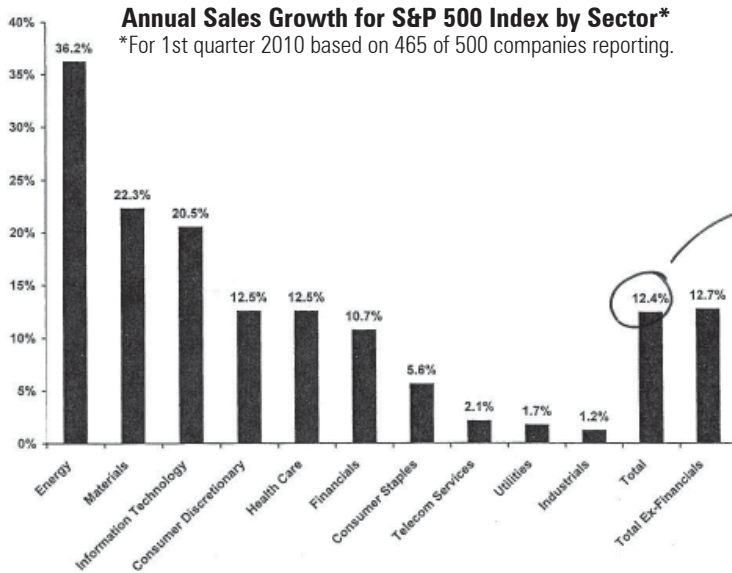
***Morgan Stanley's Cyclical Stock Price Index divided by Morgan Stanley's Consumer Stock Price Index. Shown on a natural log scale.



Top-Line Growth is Returning!!!

Top-line results are back! For 465 of the S&P 500 companies that have reported first quarter results, total sales rose by 12.4 percent! This is really remarkable considering annual core inflation has slowed below 1 percent in the last year and wage inflation is only slightly more than 2 percent. Widespread fears during the recession caused most companies to engage

in a “crisis purge” that dramatically escalated business profit leverage. This newfound operating leverage is now being taken out for a sales drive. The combination of strong operating leverage and reviving sales growth should keep profit results ahead of Wall Street expectations.



Not Bad in A world of only 1% core CPI Inflation and only 2.3% Wage Inflation!!!

Adjusted for Labor Force Growth ... Recovery Stronger than Perceived???

The V-shaped recoveries of earlier post-war years were made much stronger by the fact the U.S. exhibited much faster demographic growth. Until the 1990s, economic recoveries were boosted by labor force growth rates between 1.5 and 3 percent! By comparison, in the last five years, labor force growth has only been 0.7 percent. Past labor force growth was a combination of both baby boomers and women entering the workforce. Today, these trends are largely complete and labor force growth has been and will likely remain far less by

comparison. This is not a “new-normal” since slower labor force growth has been noticeable since 1990. But it does imply “today’s” V-shaped” recovery may be slower compared to the demographically charged (not just cyclically charged) 1970s or 1980s V-recoveries. However, adjusted for the differences in labor force growth, today’s recovery may be much closer to past V-recoveries (after severe recessions) than many perceive. Just some food for thought!??



Where to Hide in the Euro Crisis ⇒ U.S. and Emerging Markets!??

Even though many investors have boosted U.S. investment weightings because of the European crisis, the valuation of the U.S. stock market relative to the rest of the world has not become expensive. More surprising, perhaps, relative to the

MSCI global All-country ex-U.S. Stock Price Index, emerging market stocks have also done well on a relative basis. It is a new world indeed—investors running toward the “safety” of the EM during a global crisis??!

**Relative 1-Year Forward Price Earnings Multiple
U.S. S&P 500 vs. MSCI Global Ex-U.S. Index**



Relative Stock Price Performance

U.S. Stocks and Emerging Market Stocks

MSCI U.S. Stock Price Index divided by MSCI Global ex-U.S. Index (Solid)
MSCI Emerging Market Stock Price Index divided by MSCI Global ex-U.S. Index (Dotted)

Note: Both relative stock price indexed set at 1.0 on June 1, 2009.



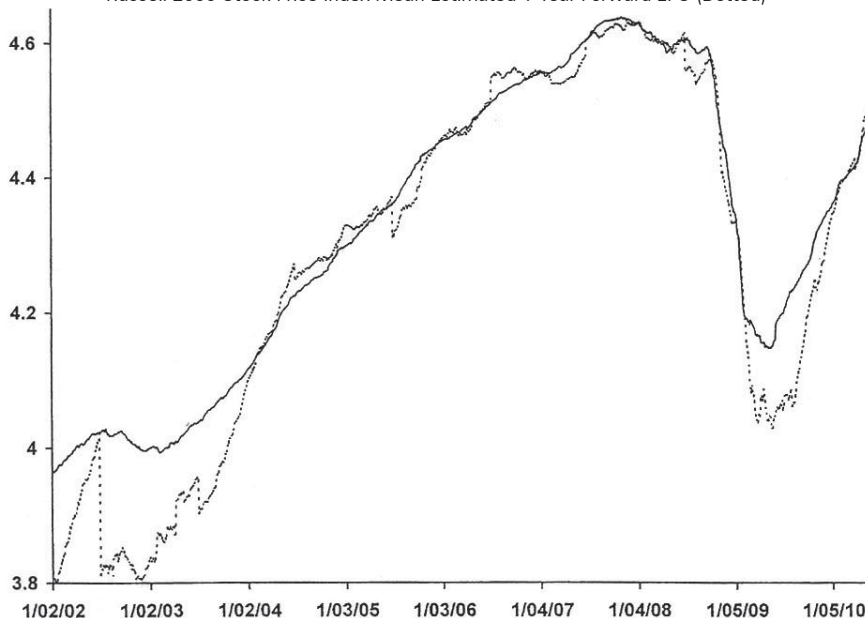
Earnings ... “Large and Small” ... Are Rising!!!?

Earnings estimates among both large and small companies continue to rise. There is a perception the economic recovery has been slower among small companies. This may well be the case; however, profit estimates for the Russell 2000 small company index have increased more from cycle lows than have

estimates for the large company S&P 500 Index. Maybe payroll trends and borrowing abilities have improved more slowly for small companies, but the profit cycle in this recovery seems to be broadly based and indiscriminately positive!!!

**Mean Estimated Forward 1-Year Earnings Estimates
S&P 500 Index vs. Russell 2000 Small Cap Index**

S&P 500 Composite Stock Price Index Mean Estimated 1-Year Forward EPS (Solid)
Russell 2000 Stock Price Index Mean Estimated 1-Year Forward EPS (Dotted)



Amazing Revaluation!!!?

These charts reinforce just how much revaluation the stock market has undergone in the last decade! Since 2000, the S&P 500 index has declined by about 27 percent, while economy-wide profits have “doubled” and the 10-year Treasury bond yield has fallen by “one-half!” Unbelievable! In 2000, if someone knew with certainty that in the next decade profits would double while long-term yields would fall by half, nearly everyone would put big money on stocks! How did prices

fall so far while profits rose and yields declined? Certainly, this primarily reflects how grossly overvalued the stock market was in 2000. However, it also reflects an investment culture oscillating from “irrational exuberance” (in 2000) to “irrational pessimism” (in 2010)! Too many were too exuberant then—too many are too pessimistic now. Just as it proved correct to bet against the “irrationality” in 2000, it will again likely prove correct to bet against it again today?!!

**S&P 500 Composite Stock Price Index
2000 to 2010**



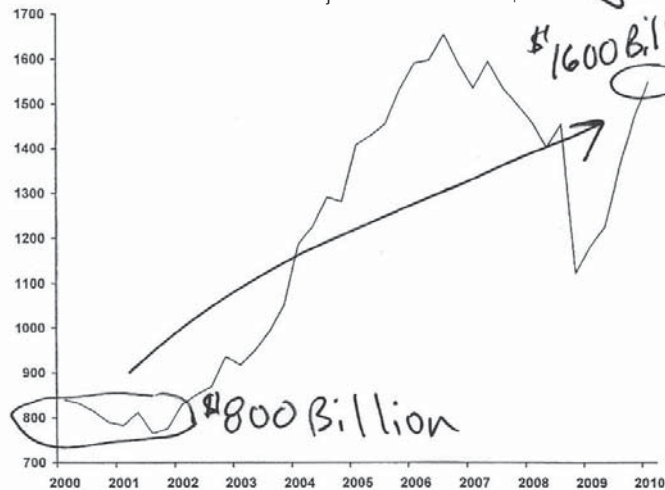
In the last decade ... the stock market is off $\approx 27\%$...

...while PROFITS
HAVE

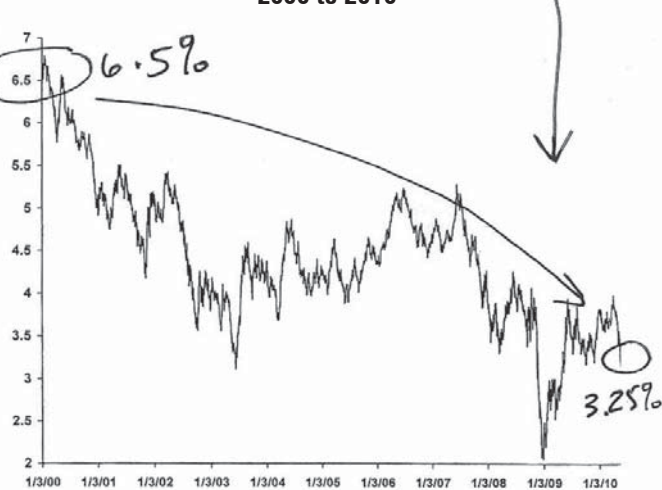
DOUBLED... AND...

... Bond Yields Have
DROPPED
IN HALF!!!

Total U.S. Corporate Profits
With IVA & CCA adjustments. In Billions \$.



**10-Year U.S. Treasury Bond Yield
2000 to 2010**

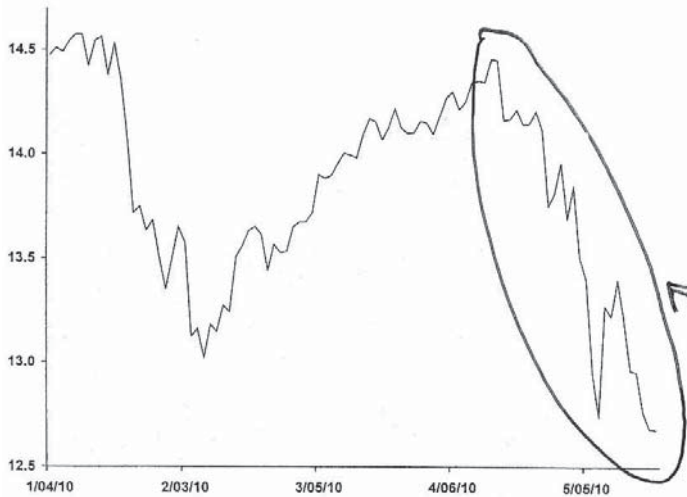


A Refreshing Pause? ... We Hope!!!

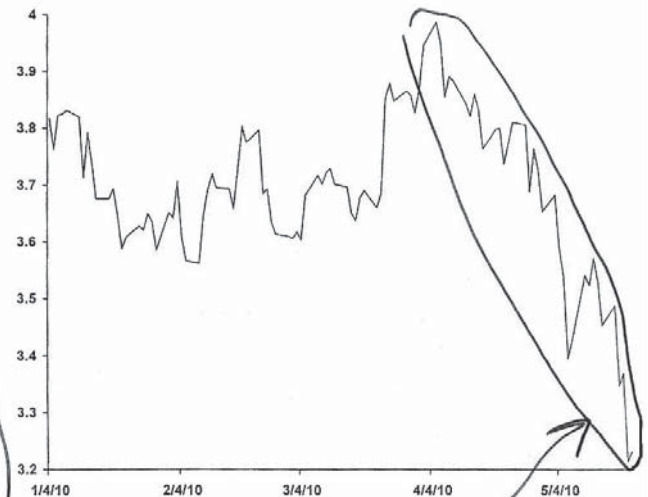
While we share concerns about the potential for the European crisis to worsen and perhaps evolve into a “fear-freeze,” which could impair the global recovery, most likely this period will prove to be a refreshing pause in an ongoing cyclical bull market recovery. The valuation of the stock market has improved—the forward price-earnings multiple of the S&P 500 Index has declined from about 14.5 to about 12.5 since mid-April! Meanwhile, in early April, the 10-year bond yield was threatening to push above 4 percent, the national average 30-

year mortgage rate was heading above 5.25 percent, an earlier-than-expected Fed tightening was looking increasingly likely, oil prices were surging toward \$90, and investment optimism was rising. Now, values have been “corrected,” the potential bite from higher bond yields, mortgage rates, and oil prices has been aborted, the Fed will likely remain accommodative longer and if any excessive optimism existed, it doesn’t any longer. We are once again “climbing a perpetual wall of worry,” which is what is required to keep this bull run going!!!

S&P 500 Forward 1-Year Estimated Price-Earnings Multiple

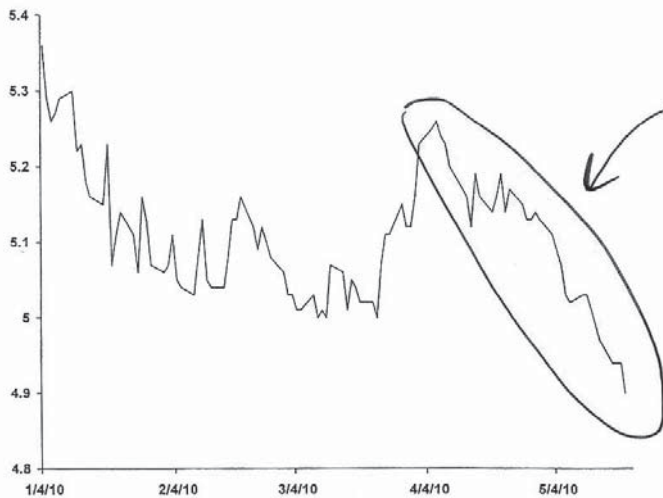


10-Year Treasury Bond Yield

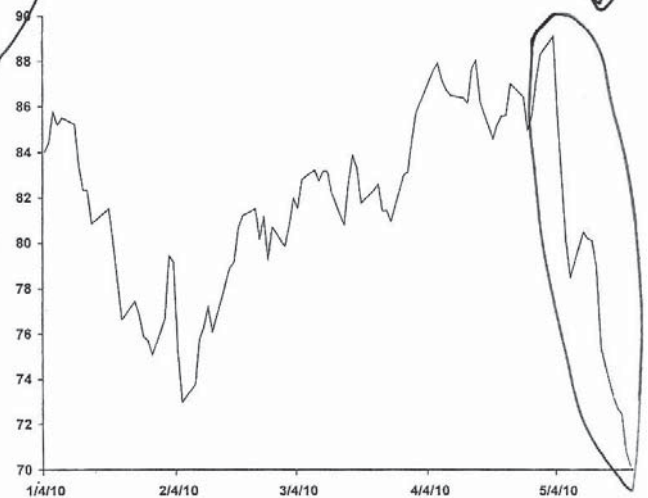


- Since Mid-April... ① PE has declined by 2 points!
 ② Competitive Bond Yield Down by 75bps!!
 ③ Mortgage Rates + Energy Prices Biting Less!!!
 ④ Optimism has Been "Gut-checked"!!!

National Average 3-Year Mortgage Rate



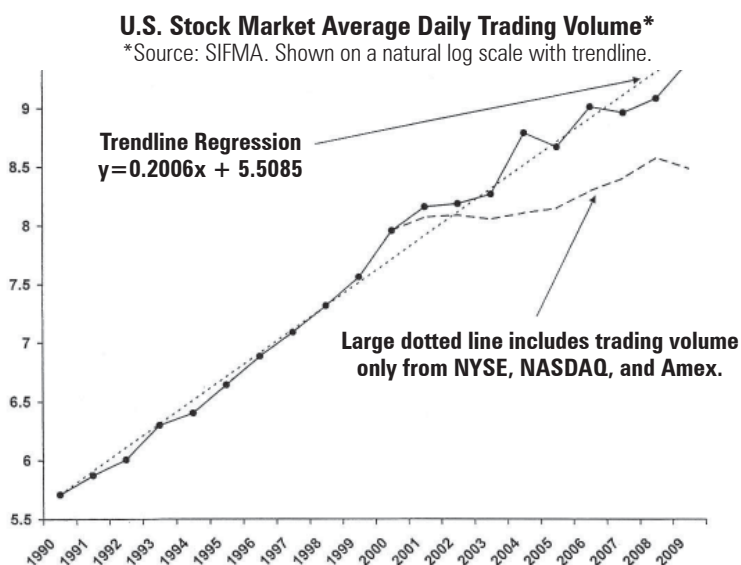
Crude Oil Futures Price



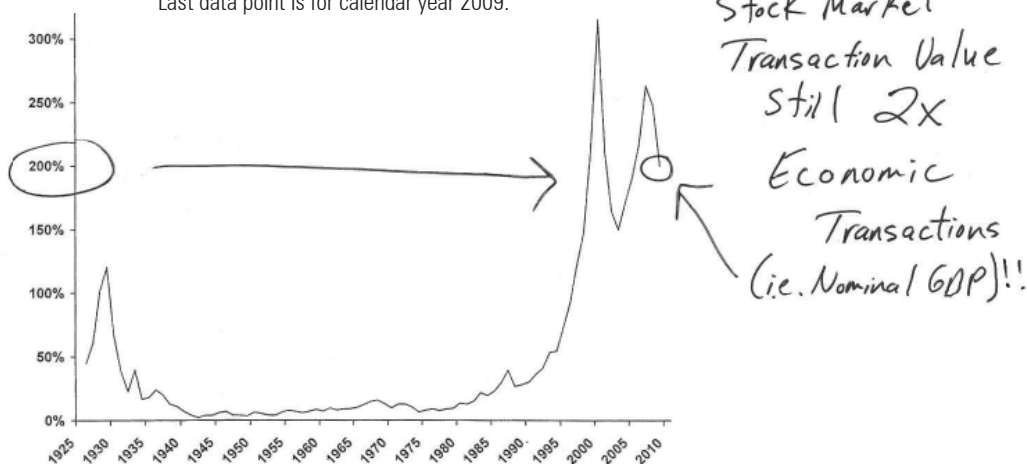
Stock Market Trading Volume Stronger than Thought???

The long dotted line in the top chart records the stock market trading volume from the NYSE, NASDAQ and Amex. Trading volume on these three exchanges has grown below trendline after the dot-com meltdown in the early 2000s. Many suggest risk-taking simply isn't coming back and retail investors are not returning during this recovery cycle. However, data from the Securities Industry and Financial Markets Association (SIFMA) tells a different story. Their data implies trading volumes in the stock market have remained near trendline during the last decade, but trading has moved to other venues outside traditional exchanges. The solid black-dotted line shows SIFMA's estimate for "total" stock market trading volumes regardless of "where" the

trades are executed. It shows a brief slowdown in 2008 during the crisis, but an acceleration in the pace of trading volume to slightly above trendline during the 2009 stock market recovery! Maybe risk-taking and willingness to participate in the stock market has not been impacted nearly as much as widely believed? The bottom chart also reinforces the idea that risk-taking has not died. In relation to economic transaction (i.e., nominal GDP), the dollar value of stock market transactions has remained mostly above 2x the level of economic transactions since it surged higher in the 1990s. Investors may be more anxious today than they have been in some time, but these charts illustrate an ongoing willingness to participate in the "risk" markets!!



U.S. Stock Market Dollar Value of Trading Volume as a Percent of Nominal GDP**
 **Until 1990, data on dollar trading volumes was from NYSE. After 1990, the data source was SIFMA and includes NYSE, NASDAQ, BATS and Pink OTC trading. Last data point is for calendar year 2009.



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