

# Dog Days

MARKET UPDATE ■ July 20, 2010



By John Lynch, Chief Equity Strategist

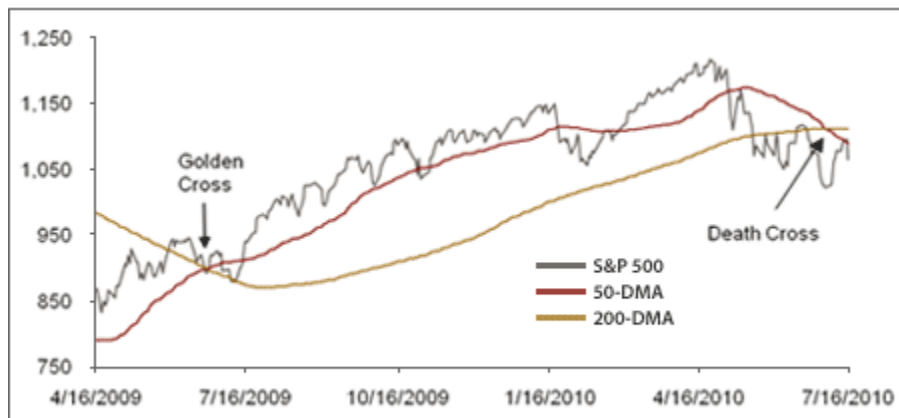
As we enter the dog days of summer, the equity markets continue to be faced with a variety of challenges. Although the global secular pressures persist, other questions have weighed on investor sentiment, including the direction of market technicals, the duration of the expansion, and the durability of asset valuations. We have examined each of these questions to determine whether or not their bark will prove worse than their bite.

## Death Cross—Scary in Name Only

The technical difficulties for the equity markets persist. Despite a 7% rally in the first several trading days of July, the S&P 500 Index still remains below its long-term trend support line, the 200-day moving average (DMA). Perhaps more disturbing, the shorter-term trend, the 50-DMA, has dropped down below this long-term trend in a development market technicians ominously refer to as a “death cross.”

It should be noted that the inverse of this development, a “golden cross” occurs when the market’s 50-DMA climbs above the 200-DMA, signaling an improving trend. To be sure, the golden cross that occurred in June 2009 helped set the stage for what would ultimately prove to be the market’s greater-than-75% rally off the lows achieved in March 2009. See Chart 1.

CHART 1—S&P 500 INDEX VERSUS 50-DMA AND 200-DMA



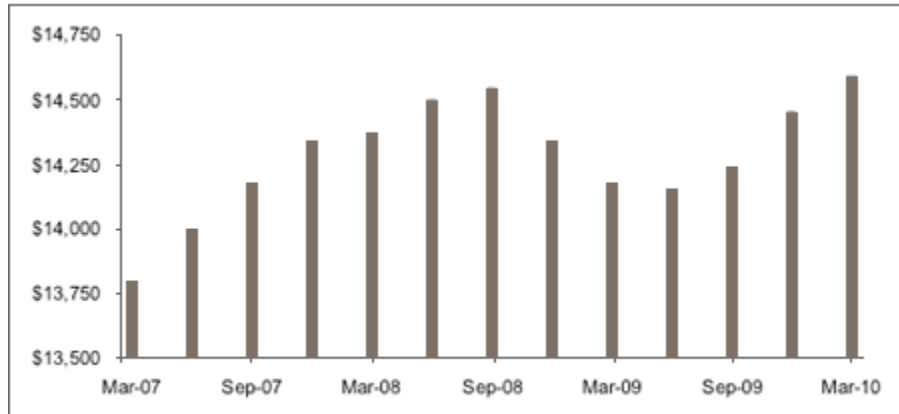
Source: Bloomberg

While history has often shown that a golden cross can signal both improving momentum and the lack of a new cycle low for stocks, the death cross has proven to be far less predictive. Since 1928, this crossover between short-term and long-term trends has occurred 35 times, according to a study done by Strategas Research Partners. Indeed, the most recent example in December 2007 was the worst in history, resulting in a 40% decline in the S&P 500 Index over the ensuing 12 months. Yet the average market performance for the periods following the death cross—one-month (-1.2%), three-month (+3.2%), six-month (+3.4%), and 12-month (+2.1%)—appear far less foreboding. A scary name, yes, and great fodder for media headlines and television broadcasts. It appears, however, that this development lacks the teeth that its name implies.

## Double-Dip Fears

In addition to these technical difficulties facing investors, fundamental concerns have also escalated, as economic growth has moderated. Economic data on housing, employment, manufacturing, and retail sales have all recently come in below consensus expectations, disappointing equity investors. To be sure, the economic recovery surged over the past year, with real gross domestic product (GDP) growth of +5.6% in the fourth quarter of 2009, but the pace of output growth has slowed in recent months as the recovery has matured. It should also be noted that the economy, by definition, does not transition into expansion until nominal GDP (which includes inflation) exceeds that of the prior cycle's peak, which, in this case, occurred in the third quarter of 2008. Since the economy has only recently nudged above the \$14.6 trillion mark, we believe it is too soon for nominal growth to lose its momentum. See Chart 2.

CHART 2—NOMINAL U.S. GDP GROWTH (BILLIONS)



Source: Bloomberg

Since the end of World War II, the average economic expansion has lasted just under five years. In addition, the onset of a double-dip recession has been very rare. The most famous example occurred from 1980 to 1982, when double-digit interest rates and inflation placed a chokehold on consumers and investors alike. While there are no shortages of reasons for this new economic expansion to be below average (employment, debt, regulation, fiscal policy), we believe the rumors of this expansion's demise have been greatly exaggerated, particularly since we have only recently entered the expansion phase of the economic cycle. Moreover, the yield curve remains very steep, traditional catalysts such as pent-up consumer demand and increased capital expenditures by businesses have yet to be tapped, and an extraordinary \$400 billion in economic stimulus have yet to be spent. We believe these trends will become manifest in these early stages of expansion—nudging growth higher—but in a less spectacular fashion than in previous periods.

## Stocks Versus Bonds

Consistent with the length of the average economic expansion, the average bull market in stocks has also lasted just under five years since 1928. Moreover, the average gain for a bull market has exceeded 160%, approximately double the gain achieved in the S&P 500 Index from March 2009 through April 2010. If the worst fears of the bears have come to fruition, the rally in the economy and stocks would be among the shortest in history.

We continue to suspect that this is not the case. As mentioned earlier, pent-up consumer demand, cap-expenditure by businesses, and unused stimulus will likely combine to propel the economy further into expansion, albeit at a less spectacular rate. Given this mild trajectory for the economy, we continue to believe that the consensus projections for corporate profitability in 2010 and 2011 are too high and will likely be revised lower in the months and quarters ahead. Even if our below-consensus projections for earnings in 2010 (\$77.50) and 2011 (\$85.00) are close to being correct, however, we believe stocks are attractively priced at current levels.

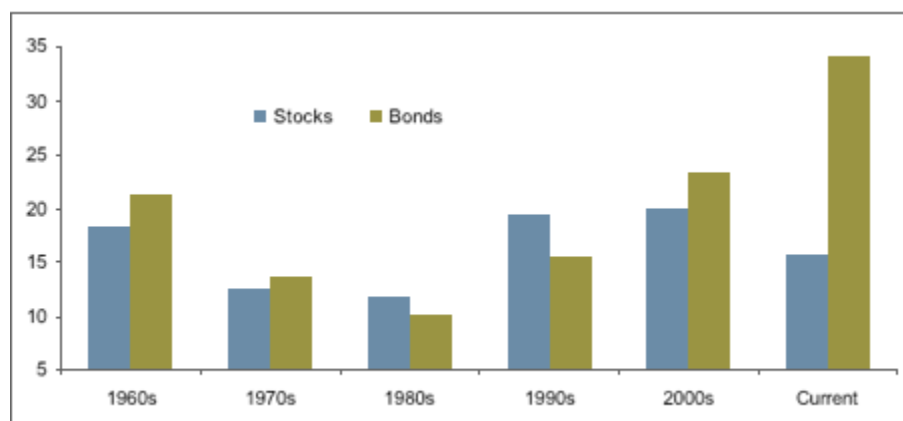
Considering the combination of low interest rates, low inflation, solid corporate balance sheets, and good earnings growth, it is surprising to us that investors are currently willing to pay only 13 times the consensus earnings (\$82.50)

estimate for 2010. This is a deflationary price/earnings (P/E) ratio, in our opinion, and we believe domestic policymakers are employing recovery tactics that will ultimately result in historically average inflation growth over the next few years.

In addition, equity investors have net redemptions from equity funds over the past year, while piling almost \$400 billion into bond funds. Obviously, global secular concerns have resulted in the collective search for return of capital rather than return on capital. We simply want to make the point that, during periods of duress, investors must not abandon proper asset allocation decisions consistent with their investment policy guidelines, as the disparity of investor flows between equity and bond funds seem to indicate they're doing now.

Perhaps this disparity is best illustrated when comparing the effective P/E ratio investors are currently paying for these asset classes compared with previous periods. For example, a 10-year Treasury bond yielding less than 3.0% indicates a P/E ratio (inverse of the 3% yield on a \$100 par value) of 34 times compared with a P/E ratio of just over 15 times earnings over the previous four quarters. See Chart 3. Why pay 34 times to get a yield of 3% when you can pay 15 times for a potential earnings yield (inverse of the P/E ratio) of 7%?

CHART 3—P/E RATIO COMPARISON—S&P 500 INDEX VERSUS 10-YEAR TREASURY



Source: Strategas Research Partners

### Conclusion

Given the many global secular pressures, we continue to believe that the U.S. economy is poised for a less-than-spectacular expansion when compared with previous experiences. Consequently, corporate profit growth will likely come in lower than consensus forecasts over the next several quarters, periodically pressuring stock prices. Fortunately, corporate balance sheets are solid, and interest rates and inflation are low. We suspect the result for investors should be a range-bound market over the next year, with the S&P 500 Index trading between the 1,050 and 1,250 levels most of the time, as stocks look cheap at the low end but could appear expensive to some at the upper end. As always, we continue to recommend a fully diversified strategy for long-term investors, while rebalancing periodically in order to adjust for the anticipated volatility.

### Market Index Descriptions

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value. You cannot invest directly in an index.

Asset allocation and diversification do not assure or guarantee better performance and cannot eliminate the risk of investment losses.

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