



Equity Strategy Weekly

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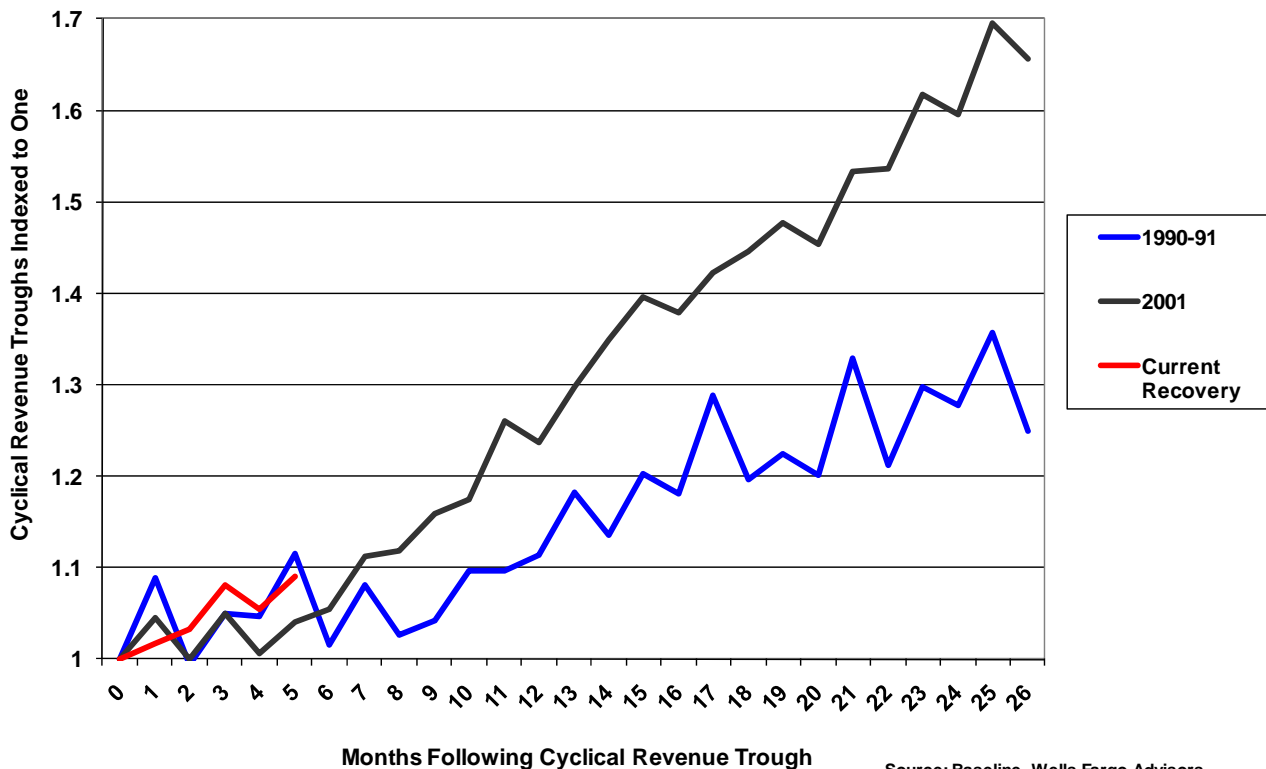
Revenue Growth in the S&P Composite Index – Cyclical Drivers and Laggards

As we have noted in the past, the S&P operating earnings expansion has been much greater than the revenue expansion due to a very rapid rise in margins. The companies within the S&P Composite Index were quick to reduce costs and slow spending programs during and after the recession.

S&P operating earnings for the second quarter were up 28.9% following a year-to-year increase in the first quarter of 51.8% and one in the fourth quarter of 2009 of 47.4%. Operating earnings increased by 9.6% between the first and second quarter, and they are up 74.3% from the weakest quarter of the recession (Q4-2008). S&P revenues are now up 9.1% from their lows, they were up

5.4% (year-to-year) in the first quarter and 7.2% in the second quarter (from recession lows). Although the revenue decline in the most recent recession was particularly deep, the revenue recovery from the bottom has been roughly in step with the early 2000s recovery and ahead of the early 1990s recovery (Figure #1).

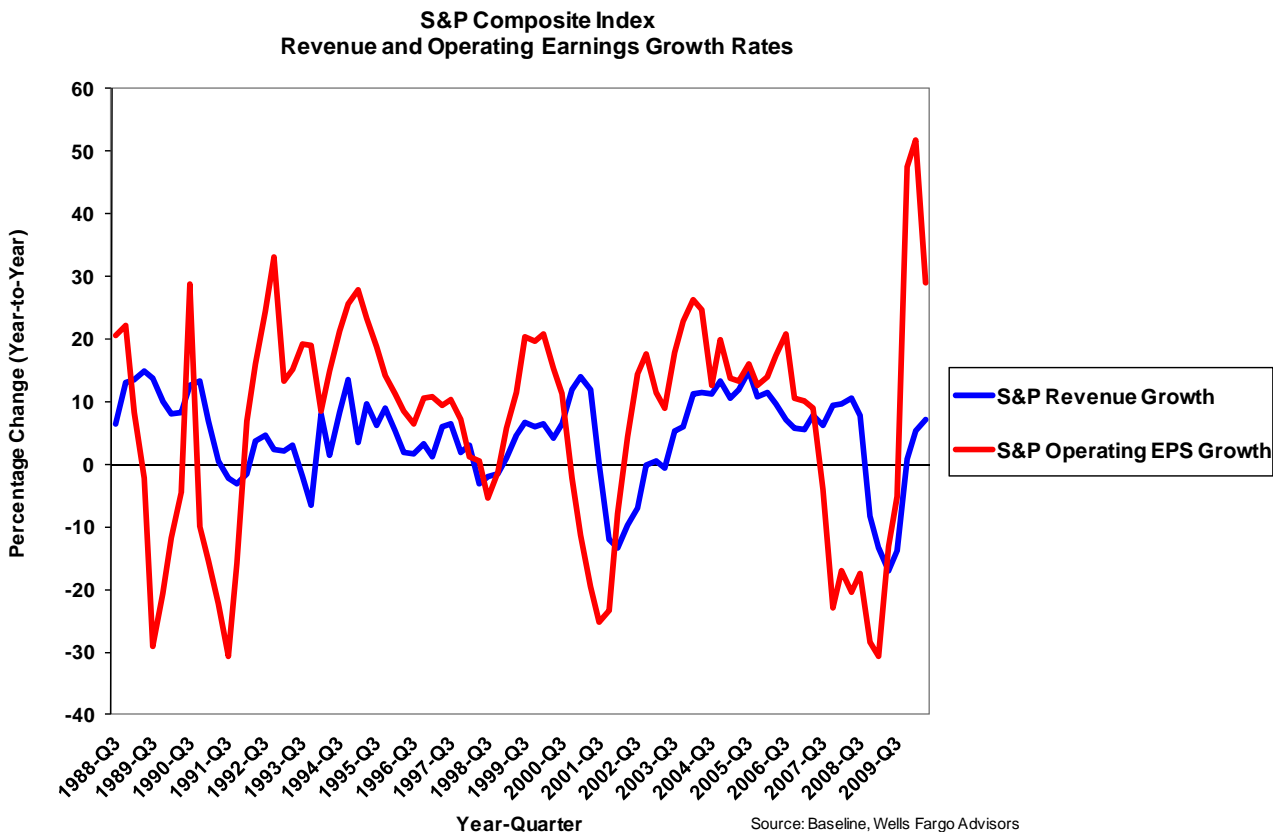
S&P Composite Index Revenue Progress from Cyclical Troughs



Source: Baseline, Wells Fargo Advisors

As we have noted in the past, the S&P operating earnings expansion has been much greater than the revenue expansion due to a very rapid rise in margins. The companies within the S&P Composite Index were quick to reduce costs and slow spending programs during and after the recession. The 74.3% increase in earnings on a 9.1% increase in revenues has been supported by an increase in net margins from 5.1% (Q4-2008) to 8.7% (Q2-2010), or 70.6%. We have plotted

the year-to-year growth rates of the S&P Composite's revenue and operating earnings back to late 1988 in Figure #2. In that chart, the reader can see the dramatic difference in the growth of earnings versus revenues as well as the beginning of the trend toward slower growth earnings in the second quarter. We expect S&P Composite earnings growth will be roughly 12-13% in the last half of this year.



Past performance is not an indication of future results. An index is not managed and is unavailable for direct investment.

Overall, margins are running above their longer term averages for all of the more cyclically sensitive sectors except for the Financial Sector. Financial Sector margins were running 12.5% in the second quarter versus a longer term average in the upper-teens. Also, the sector's revenues were lower in the first and second quarters versus one year ago by 6.5% and 9.5%, respectively, (although margins were higher in the second quarter than the first). A lack of material loan growth thus far in the cycle is playing an important part in the retrenchment of revenues, here. Deleveraging throughout the economy continues to have an impact upon the sector's revenue and earnings expansion. For the sake of comparison,

we have listed the last two quarters of revenue growth for the other cyclical sectors below:

- Consumer Discretionary - Q1: -1.6%, Q2: 6.1%
- Energy - Q1: 34.8%, Q2: 25.7%
- Industrial - Q1: 0.3%, Q2: 5.9%
- Materials - Q1: 17.9%, Q2: 17.6%
- Technology - Q1: 14.4%, Q2: 17.6%

Generally, the Financial Sector is an outperforming sector within the S&P Composite Index in the early and mid-phases of a new cyclical bull market. As the sector has underperformed the S&P over the course of the last year (and performed roughly in line with the S&P since the beginning of the year by outperforming into April but underperforming

since), we believe the financials will need to be a more important factor in the second up-leg of the cyclical market recovery. Although we recently published a near term tilt that puts the Financial Sector in an underweighted position for perhaps the next one or two quarters, we anticipate our weighting will move more toward an evenweight or overweight stance as we see initial signs that will lead to acceleration in financial revenue trends. In our opinion, those signs are likely to signal the initial stages of the second upward move for equities. From our perspective, those fundamental signals are likely to show up later this year or early next year.

Specific Recommendations:

The Consumer Staples sector makes up roughly 11.7% of the total market capitalization of the S&P 500. This sector's index has risen nearly 8% over the last 12 months versus a roughly 3.3% increase 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. While this sector substantially underperformed the market from the early March 2009 lows through mid-April 2010, increased uncertainty and fears of a double-dip recession has pushed relative performance ahead of the overall market on a 12 month basis. We do not believe this period of outperformance will last and are recommending an underweight (8%) allocation to this defensive sector for clients with average risk tolerance. "Buy" rated Consumer Staples stocks among our correspondent research providers total 58 companies. The companies listed below appear attractive based on our Equity Strategy team's industry group work as well as the analysis performed by our Consumer Staples sector analyst:

- J.M. Smucker Co. (SJM-NYSE-\$59.00)
- Procter & Gamble Co. (PG-NYSE-\$59.50)
- Walgreen Co. (WAG-NYSE-\$27.45)

Weekly wrap and look ahead:

Despite the intraday volatility, the three major indices finished little changed once again in last week's trading. The S&P 500 fell 0.7% (Year-to-Date down 4.5%), the Dow Industrials lost 0.6% (YTD down 2.7%) and the NASDAQ Composite fell 1.2% (YTD down 5.1%). Looking at the S&P sectors, seven of 10 outperformed the Index but only three of 10 managed to finished higher on the week. The best performing sectors were Utilities (up 2.0%), Telecom Services (up 1.2%) and

Energy (up 0.2%). The worst performing sectors were Information Technology (down 2.1%), Industrials (down 1.5%) and Consumer Discretionary (down 0.8%).

While not trying to sound like a broker record, most of the economic news reported last week was disappointing. The economy clearly is slowing down. For many Wall Street pundits, this in all likelihood means lowering earnings estimates, GDP projections and equity index targets as we move into the Fall. We mentioned last week that many analysts had been expecting a second half slowdown but their targets for the stock market and economic growth seemed too optimistic. The downward revisions we expect to see over the next few weeks will create further headwinds for the market over the next few months in our opinion.

Housing reports last week were perhaps the most gloomy of all data. New home sales in July fell to a record low 276,000 annualized pace. Existing home sales, which make up more than 90% of all sales, fell more than 27% in July and are down more than 25% over the year-ago period. Investors are beginning to find out just how much the government's tax credits drove the housing market earlier this year. Indeed, it appears the credit pulled in buyers who would have been looking to purchase homes throughout much of the Fall period at least. A weak housing market does nothing but dampen confidence and cause consumers to hesitate before spending money. Without a doubt, this is one of the reasons why the University of Michigan's measure of consumer sentiment fell in August. In most parts of the country, many neighborhoods are littered with "For Sale" signs. As consumers drive around town, they are constantly reminded of the housing market weakness and the fact that their homes are likely worth considerably less than they were three or four years ago. This results in large scale consumer caution.

Other items on the schedule last week included July orders for durable goods and the government's revised "guesstimate" of second quarter GDP (Gross Domestic Product). Both reflected the slowdown we have been expecting. We prefer to look at a segment of the durable goods orders report called "capital goods orders excluding aircraft and defense". This segment is a good gauge of business investment/spending and has shown more growth than we expected for most of this year. In July, this critical segment fell 8%, far more than the average economist was expecting. Companies have been upgrading equipment on an as needed basis but this segment hit a wall in July. We only look for modest growth

in business investment and capital spending for the rest of this year. We were looking for second quarter GDP to be revised down to the 1.5% area from the initial estimate of 2.4% last month. The “whisper number” on the Street was calling for a revision of just 1%. Second quarter GDP came in at a better than expected 1.6%. Stocks traded higher on the day as investors have been looking for any positive surprises. None-the-less, GDP has slowed significantly since the fourth quarter of last year (5% growth in 4Q 2009). We look for full year GDP to be in the 2.8% area, well below historical recovery levels. Our early analysis for 2011 indicates that economic growth next year may only be in the 2.3% area. It will be hard for the labor market to improve significantly given that level of growth.

This week, all eyes will be focused on Friday’s employment report for August. While it is likely private sector jobs increased by approximately 50,000, the loss of temporary Census workers still means that overall non-farm payroll jobs probably fell by around 100,000. Remember that non-farm payroll jobs need to increase 125,000 each month just to absorb the new entrants into the labor market. More than 8 million jobs were lost in the last recession. The labor market will take years to recover these lost jobs and will weigh on economic growth and consumer spending for an extended period of time. The unemployment rate in August

may have ticked up a notch or two from the 9.5% rate in July.

There are several other important economic reports this week that will be closely watched by market participants. The ISM (Institute for Supply Management) will release both the manufacturing (Wednesday) and services (Friday) sector surveys during the second half of the week. Analysts are expecting both to fall from the prior month’s readings but still stay above the 50 expansion/contraction line. Readings closer to 50 would correlate to a slower economy but not one ready to fall back into recession. At this point, we see the probability of a double-dip recession at 20% or less.

Other news includes reports on construction spending, auto sales, consumer confidence and factory orders. We look for these reports to further confirm that the economy has hit a soft spot. All in all it will be a very busy week for economic reports.

The recent volatility in the market is not going to go away any time soon. While we look for the S&P 500 Index to trade to the 1200-1220 range by the middle of next year (from the current approximate 1050 level), it will not do so in a linear, one-way fashion. Our year end target range remains 1100-1140.

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

<u>Sector</u>	<u>S&P Weighting*</u>	<u>Wells Fargo Advisors Guidance</u>	
Industrials	10.6%	Overweight	14.0%
Materials	3.6%	Overweight	7.0%
Telecom Services	3.2%	Overweight	5.0%
Consumer Discretionary	10.3%	Evenweight	11.0%
Energy	10.9%	Evenweight	11.0%
Financials	15.9%	Evenweight	16.0%
Information Technology	18.3%	Evenweight	17.0%
Utilities	3.9%	Evenweight	3.0%
Consumer Staples	11.7%	Underweight	8.0%
Health Care	11.7%	Underweight	8.0%
S&P 500 Earnings Estimates:		2010 = \$79, 2011 = \$89	
S&P 500 Year End 2010 target:		1100-1140	

Sources: Bloomberg, Wells Fargo Advisors

*Sector Weightings May Not Add To 100% Due To Rounding

Pricing: based on August 27, 2010 close

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