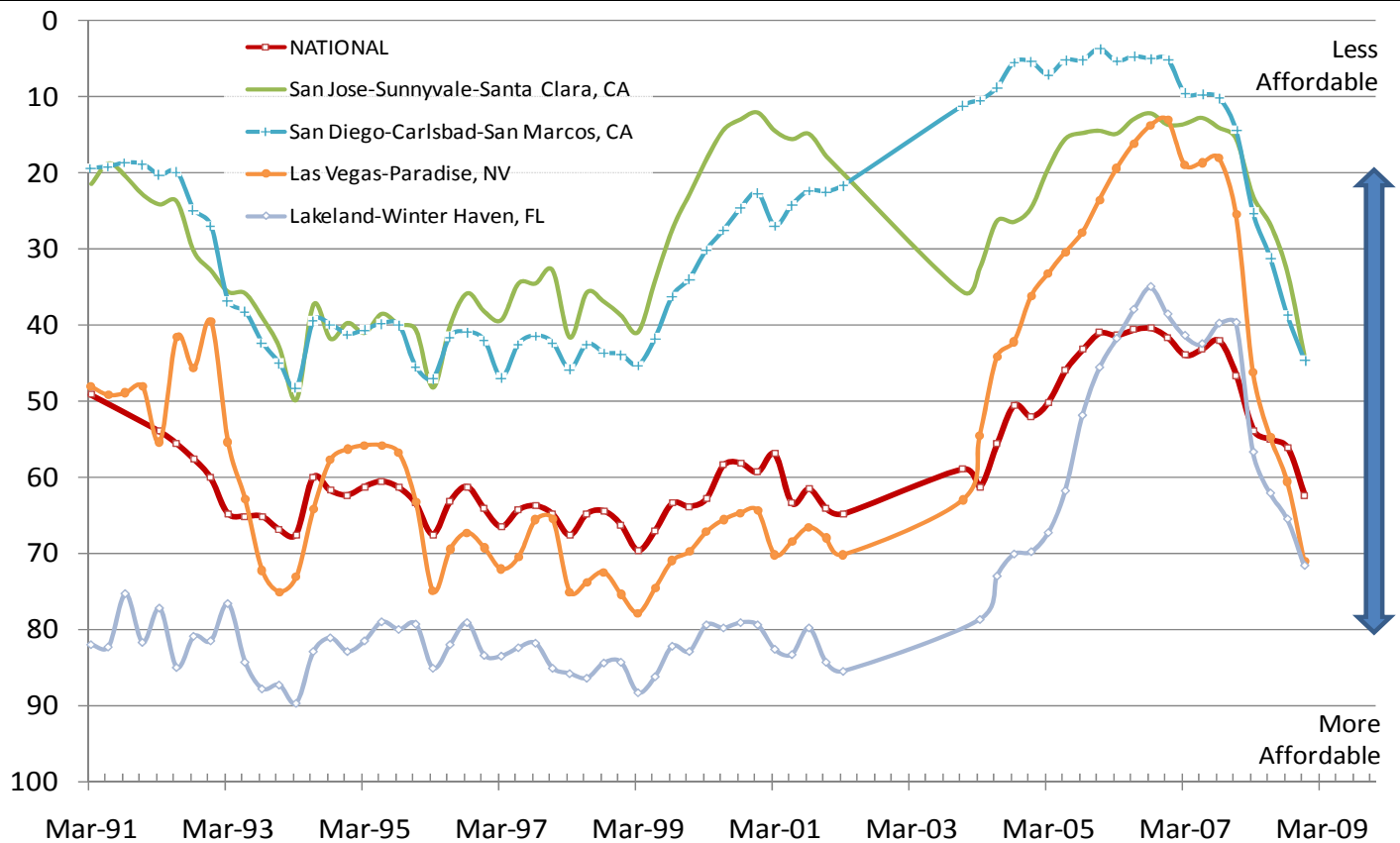


## Concern Builds Regarding the Timing and Strength of Recovery

- Market action since the start of 2009 has been disappointing, as investors seem very intent on drawing lines in the sand, trying to determine whether last November's lows for the popular averages will provide support. Looking beneath the surface of the averages, it is clear that the market is in a more discriminating phase than it was several months ago, when redemptions were forcing some investors to sell whatever they could to raise cash.
- So far, the Standard & Poor's 500 index has managed to stay above its low point seen in November near 740. But it has gotten very close, and it appears that some investors are reducing their equity exposure in preparation of what they believe will be a sign of much lower prices ahead. Some investors who are still focused on the Dow Jones Industrials index may have already made their decision, as that measure is already below its prior lows.
- The market is continuing to favor the "high-quality" theme (i.e. strong balance sheets, stable, diversified cash flows, defensive business models) that we have been highlighting. Meanwhile, companies without these characteristics have been less successful. Increasing concerns about the timing and strength of the recovery are responsible for this rotation toward quality "growth" — and away from what the market had previously seen as "value" among the large capitalization companies that appear most resilient in difficult economic times.
- To a very reasonable degree, the high quality growth theme that we have been espousing is represented by the S&P 500 Growth index (SGX, 411.64) of 286 companies. Its complement is the S&P 500 Value index (SVX, 352.40) of 374 stocks. While there is some overlap, these two indexes — when combined — comprise the entire S&P 500. The outperformance of growth over value is clearly evident in the fact that the SGX appears better positioned to successfully defend its November lows, while the SVX has already fallen below the mark.
- As previously mentioned, the S&P 500 index has thus far been able to stay above its November lows, though any index comprising hundreds of companies will have many that have already broken through and some that are comfortably above their own November lows. The SVX index has a higher exposure to stocks that have not been able to stay above their prior lows, while the SGX index is more heavily weighted in companies that are still above their lows. As we wrote earlier this month, "It Is Not Too Late to Upgrade the Quality of Your Stock Portfolio," and we still subscribe to that view.
- Looking more broadly at the economy, it seems likely that conditions are not likely to improve much until the decline in house prices is arrested. Nationwide, resale prices are nearly -30% below their highs of mid-2006, according to the Standard & Poor's Case Shiller index of 10 metropolitan markets.
- But how much of a decline is enough? One way to gauge the value of homes is to assess their affordability, given consumer incomes and the cost of financing. Of course, one important element — confidence — is missing from this analysis, so it cannot predict a turnaround. That probably will not happen until the employment picture brightens. The good news is that homes are more rationally priced now, given the declines we have seen.
- The Housing Opportunity Index (HOI) from the National Association of Home Builders (NAHB) and Wells Fargo is a measure of the percentage of homes sold in a given area that are affordable to families earning that area's median income during a specific quarter. Prices of new and existing homes sold are collected from actual court records by First American Real Estate Solutions, a marketing company. Mortgage financing conditions incorporate interest rates on fixed- and adjustable-rate loans reported by the Federal Housing Finance Board.
- The NAHB/Wells Fargo Housing Opportunity Index is strictly the product of NAHB Economics, and is not seen or influenced by any outside party prior to being released to the public.

## Home Prices Decline in Many Regions is Starting to Reestablish Reasonable Valuations (Regional Affordability Indexes Incorporate Recent Sales, Median Income Levels and Standardized Financing Terms)



Note: Affordability is shown on a reverse scale; the 2005-06 peak of housing prices is near the top of chart. Source: National Association of Home Builders.

The continuing weakness in home prices around the nation has one important positive aspect: house prices have become more affordable. The chart shows the affordability index for the nation as a whole, and for several representative regions. Note how the two California regions shown above have typically maintained a premium valuation to the average U.S. home (i.e. fewer homes considered affordable for those earning the median income), and that the premium began to expand in 1999. The effect of the technology boom-bust cycle is more evident in the index for San Juan — probably because of its proximity to the companies most affected.

Both California regions have returned to levels of affordability that approximate those seen throughout the prior decade and very close to the lows of 1994, when the entire state was suffering from a severe loss of jobs in the 1990-91 recession. The other two regions displayed in the chart — Las Vegas and central Florida — were considered “more affordable” than the national average for most of the 1990’s and the early part of the current decade, until the housing cycle accelerated. Each of these two regions went to a premium to the average U.S. home — a premium which has since evaporated. But unlike the California regions shown, the other two regions still have a way to fall before they get back to their prior lows.

Tom McManus

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### Additional Information Available Upon Request

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