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WELLS FARGO ADVISORS

The Week

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Worth noting

- We reiterate our Equity Strategy team's year-end S&P 500 target range of 1,175 – 1,200 and expect more volatility around this range during the second half of the year.
- The market has already surpassed the 1,200 mark and could push higher. At this time, we do not anticipate tactically overweighting stocks if the market continues higher.
- We believe the market could be vulnerable to a pullback if it moves meaningfully higher in the near term, perhaps toward potential technical resistance in the 1,250 – 1,275 range.

Where do we go from here?

The S&P 500 has now traded through our Equity Strategy team's year-end target range, which is 1,175 – 1,200. We have been expecting the market to reach this target and perhaps move modestly higher to a 2010 high by mid-year. The question is, What should investors do from here?

We expect some periods of consolidation as we move through the balance of the year. The market is behaving much as we have been expecting during the first half and has pushed past the target range. Over the last 15 months, we have been recommending that clients average into the equity market for participation in a multi-year economic recovery. However, a variety of headwinds exist for the back half of the year:

- Market complacency: Some measures signal complacency in the market. For example, the VIX, the Chicago Board Options Exchange implied option volatility index for the S&P 500 index, has fallen to its lowest level in nearly two years. The low level on the VIX suggests that S&P 500 investors are not expecting large price swings in the near term. In other words, the market does not see much risk. Complacency tends to give way to pullbacks when and if bad news returns and surprises investors.
- Election uncertainty: As the summer approaches, more attention will focus on the upcoming mid-term Congressional elections. Uncertainty is typical ahead of elections, but this coming election may bring more changes than usual.
- Significant economic obstacles: Finally, important challenges persist in the economic data. Unemployment remains close to 10 percent, and we expect little change before the end of the year. Households are still cautious about spending. In addition, in the second half of the year, we also expect the market to become more anxious about predicting the Federal Reserve's ongoing removal of monetary stimulus and its potential first interest rate hike. Rates may begin to rise late in 2010, or possibly early in 2011.

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We regard the economic recovery as still young, but these sources of uncertainty have to be worked through. Taken together, these headwinds suggest to us that the market will likely trade near current levels at year-end. We expect far more muted and volatile returns this year than last and reiterate our Equity Strategy team's year-end S&P 500 target range of 1,175 – 1,200. If the S&P 500 were to move meaningfully higher than our year-end target range, we would likely take a somewhat less cyclical (and more cautious) stance for a period of time. On market pullbacks, however, we would continue to pursue our strategy of accumulating stocks in favored cyclical sectors.

Clients should keep a cyclical portfolio bias to prepare for the next leg up in this bull market. We believe the second leg should begin to form next year. Different sectors tend to outperform in each stage of the economic cycle. At this stage of a recovery, cyclical sectors have typically driven market returns. Such has been the performance of the market since last year's market trough, and we anticipate the equity market will keep its cyclical personality for several years past the recession. Our current cyclical overweights include the Industrials and Materials sectors.

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