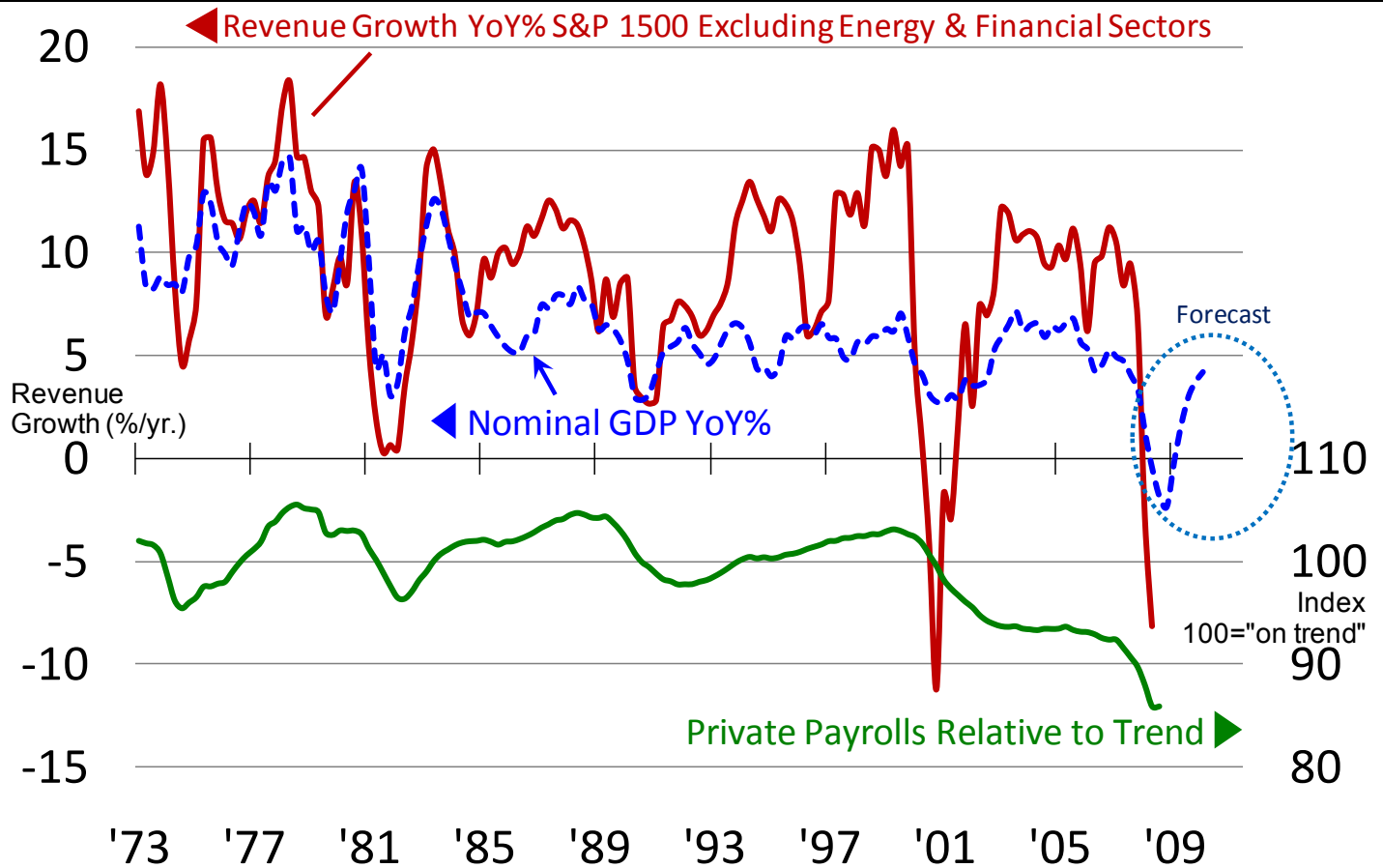


## Too Soon For Great Confidence in the Resumption of the Earnings Trend

- The U.S. economy shrank in 2009's first quarter, much as was expected, although consumer purchases — of durable goods especially — displayed a small uptick for the first time since rolling over in the summer of 2007. Production slowed more than purchases, so there was a sharp decline in inventories that made the headline report of gross domestic product — a contraction of -6.1% at an annual rate, after adjustment for inflation — to appear worse than it might have. Excluding the inventory decline, GDP fell -3.4%, a marked improvement from the prior quarter, when it declined at an annualized rate of -6.2%.
- Investors are hoping that the inventory decline is an example of a “clear the decks” approach on behalf of producers who have been reducing staff, too. Of course, the hope is that producers are underestimating the resilience of underlying demand, and that they may need to boost production and hiring in the near future.
- The bounce in consumer purchases of autos and other durable goods should not be a big surprise, given the sharp declines in the prior quarter — when the financial markets were tumbling — together with extraordinarily low borrowing costs, recent improvements in credit availability, and a brisk pace of mortgage refinancing activity.
- But Friday's reports of automakers' sales for April — among the first broad indicators for the current quarter — don't show continued strength of demand. The annualized sales rate fell to 9.3 million from 9.9 million in March, with imported vehicles suffering the biggest decline, despite heavy incentives. What is more, retail sales for the first quarter may have been helped by special factors — including less severe winter weather (except in North Dakota), larger tax refunds and a boost to Social Security and other indexed benefits. Various facets of the Obama economic stimulus act are likely to have an increasingly beneficial effect, but so far, these are hard to quantify.
- To some extent, wealth increases driven by the stock rally may be self-perpetuating. Markets have responded to increasing optimism that the worst of the economic downturn is over — that GDP itself is in a bottoming process — and that 2010 will be a year of positive growth. A boost in consumers' confidence should translate into more spending, potentially higher profits and eventually, production. But absent a real improvement, the rally may fizzle.
- What is the difference between a rally in a bear market and the first leg of a new bull market? Our experience and study of prior cycles indicates there is none. Both begin from an oversold and undervalued position, sparked by a positive surprise or rapid improvement in sentiment. The difference is that there is little real improvement beyond the sentiment shift to sustain the bear market rally, while the bull market gets its “second wind” from a rising earnings trend. As we suggested two weeks ago, investor sentiment and valuation are still positive for stocks, even after the rally, but not as strongly supportive as they were from November through March.
- While we are monitoring economic data closely to determine whether a real improvement is at hand, it is not too soon to consider what longer-term changes are in store for the economy after the “great recession” of 2008-09. President Obama's interview in *The New York Times Magazine* is a good place to start. Obama would like to see the nation's educational horsepower devoted to developing more engineers, with the ability to help construct a more efficient national energy network, a so-called “smart grid.” Meanwhile, the financial sector is likely to have fewer derivative traders and more regulators, if Obama has his way.
- Given his high approval rating after 100 days in office and the Democrats' advantage in Congress, we cannot overlook Obama's desire to seek significant change on many fronts, even while dealing with the financial crisis. Even if one is inclined to favor such changes, it may well be a better time to “sow” new investments, rather than to “reap” the benefits of prior commitments.

Growth in Gross Domestic Product (Before Adjustment for Inflation) Drives Corporate Sales ... (& Profits)



Note: YoY % is year-over-year. Sources: Company Reports, Bureau of Labor Statistics, Commerce Dept., S&P.

Our chart shows the sharp decline in corporate revenue over the past several months — even when we exclude the energy and financial sectors, sales fell -3% in the last quarter of 2008 and around -8% in the first quarter of this year. We haven't experienced such a sharp fall since the period immediately following the 9/11 terrorist attacks.

Overall growth in the U.S. economy has been similarly affected — to a lesser degree, the chart should make clear — but even so, the drop into negative territory for “nominal GDP” (i.e. before adjustment for inflation) is quite startling, as it is the first instance of such a decline in the post-War period. It is also clear that sales have been climbing faster than GDP since the 1980's, perhaps because of consumers' increasing tendency to spend above their means. Correcting this overreliance on unsustainable levels of consumption will take several years, in our view. So, we see steadily growing companies as more attractive than those that depend on consumer borrowing power and spending patterns of the past 25 years.

The markets are getting increasingly comfortable that GDP will bounce back smartly beginning later this year, and, while this has been (and remains) our base case, we are concerned about the implications of a relapse. *Tom McManus*

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