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WELLS FARGO ADVISORS

The Week

The Investment Strategy Committee

Markets recover on additional European support

Worth Noting

- The 13-month rally in U.S. equity markets was tested last week when stocks dropped sharply in response to anxiety over European debt problems and possible trading system problems. The swift pullback has helped remove much of the short-term excesses from the rally which lifted the S&P index more than 80% from the lows in March 2009 to its recent high in April.
- Much of the equity market weakness stemmed from a lack of confidence in the initial European efforts to contain the Greek debt problems from spreading to other countries. Fortunately, policymakers got the message, and over the weekend, they arranged an even bigger funding of loans and assistance, to support the euro and the European economies. As a result, the equity markets rebounded sharply.
- Our equity strategy team continues to hold a year-end target of 1175-1200 for the S&P 500, expecting only muted returns and increased volatility in the current year, after a strong first year recovery from the deep recession low.

The strong rally in the U.S. equity market since early last year has been a time of healing for many investors, with the recovery in the equity markets boosting the value of many portfolios. Unfortunately, just when investors were getting comfortable with the improving global economic outlook, doubts began to grow because of Greek debt problems. As Greek financing deadlines approached, the U.S. and many foreign equity markets began to consolidate and churn in late April and early May. Investors wanted to see what policymakers would do about the developing crisis. Last week's sharp drop in the market indexes came after equity prices dropped below a three-week trading range, causing more selling to come into the market. At one point, selling overwhelmed buying, and the Dow Jones Industrial Average briefly dropped nearly 1,000 points before bouncing back up.

Many investors appear to be worried that the inability of the Greek government to finance its debts could cascade into problems for other highly indebted countries. Memories of the housing crisis two years ago are still fresh in many investors' minds. However, there are important differences. The Greek problems are coming at a time when the global economy is expanding. The mortgage crisis happened when the global economy was contracting, eventually pushing the equity markets down sharply in 2008. We continue to believe that the global economy is likely to expand, but it may take time to work through these problems.

The International Monetary Fund (IMF) and the European Union initially agreed to provide loans to help Greece meet its financing needs into next year. But, we think it is likely that Greece will fail to restore economic growth before these funds run out. Therefore, European leaders still needed to find an alternative strategy to prevent Greek problems from spreading to the rest of Europe. Over the weekend, the finance ministers of the European countries along with the IMF and the European Central Bank (ECB) agreed to an even bigger assistance package designed to support the euro and other countries that may need help in the near future. The plan consists of 400 billion euros of loans from euro zone countries, 250 billion euros from the International Monetary Fund and 60 billion euros from an EU emergency fund.

Please see page 3 of this report for Important Information, Risk Factors and Disclaimers

The announcement of these bigger measures to contain the debt problems caused global equity markets to rally today and the euro is starting to recover. These latest measures show that European policymakers understand the need to contain the developing crisis and are doing much more than they initially thought was necessary. We do not see a significant threat to the unity of the euro zone, as we believe Europe will ultimately find a way to prevent contagion. The greatest risk is a loss of investor confidence, if policymakers make a mistake in dealing with the debt problems. So far, it looks like policymakers are taking appropriate measures, although they may be moving faster than they might have otherwise if the markets had not become destabilized.

As Europe deals with these problems, the financial markets are likely to be very volatile. We advise investors to think about how to position their portfolios. Long-term investors who can accept volatile European markets during the next couple of years, could benefit from the cyclical economic recovery in the broader euro zone. Investors who would like to avoid the volatility of possible future Greek-related problems may want to reduce positions and look at other international markets if European financials rally this summer, as we expect.

Our equity strategy team continues to expect a second leg of the equity bull market to form in 2011. In the meantime, investors should keep a cyclical bias to equity portfolios and spend this year getting prepared for the next move up. We continue to recommend an overweight position in the industrial and material sectors. History suggests that the equity market often maintains a cyclical personality for several years coming out of a recession. At this point, it looks like we are still early in the U.S. and global economic recovery and do not believe it is time to take a long-term defensive position.

During the recent market turmoil, investors sold risky assets and sought the relative safety in U.S. Treasuries, driving the 10-year Treasury note yield down to only 3.26% at one point last week. A month earlier, when investors were more optimistic and not overly concerned about Greek debt problems, the 10-year Treasury increased to 3.99%. When many investors were seeking the relative safety of U.S. Treasury debt, other investors sold more risky corporate, high-yield and preferred securities. Our fixed-income strategy team believes that the Treasury market is unlikely to hold its recent gains and yields are likely to rise again. Consequently, our fixed-income strategy team continues to look for the 10-year Treasury note to trade in a yield range between 3.25% and 4.25% for the year with a year-end target of 4.25%. Finally, our credit market strategists continue to overweight corporate and municipal bonds and see the current widening spread between more risky debt instruments and Treasuries as an attractive opportunity to add to or build positions in corporate and municipal bonds.

In summary, recent media coverage of the Greek debt crisis showed rioting and opposition to the new austere budget policies required in order to secure the loans needed to pay Greek government debts for the next year. These images increased investor anxiety, eventually leading to the sharp global equity market selloff last week. Many foreign equity markets have been weak since the Greek debt problems first surfaced late last year. However, U.S. equity markets were able to advance until sentiment began to erode in April. Investors are still worried about a possible contagion of Greek debt problems spreading to other countries. Fortunately, the larger assistance package announced over the weekend have dampened those concerns and boosted equity markets this morning. The important lesson from this crisis is high government debt can create severe problems when investors lose confidence. The high debt levels in the United States are a concern to investors, and the turmoil in Greece aggravates those concerns. It will take time to deal with all these problems. In the meantime, many of the global markets were oversold last week and volatility is high. Consequently, global equities are rebounding sharply this week because policymakers are expanding their support.

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