

# The Week

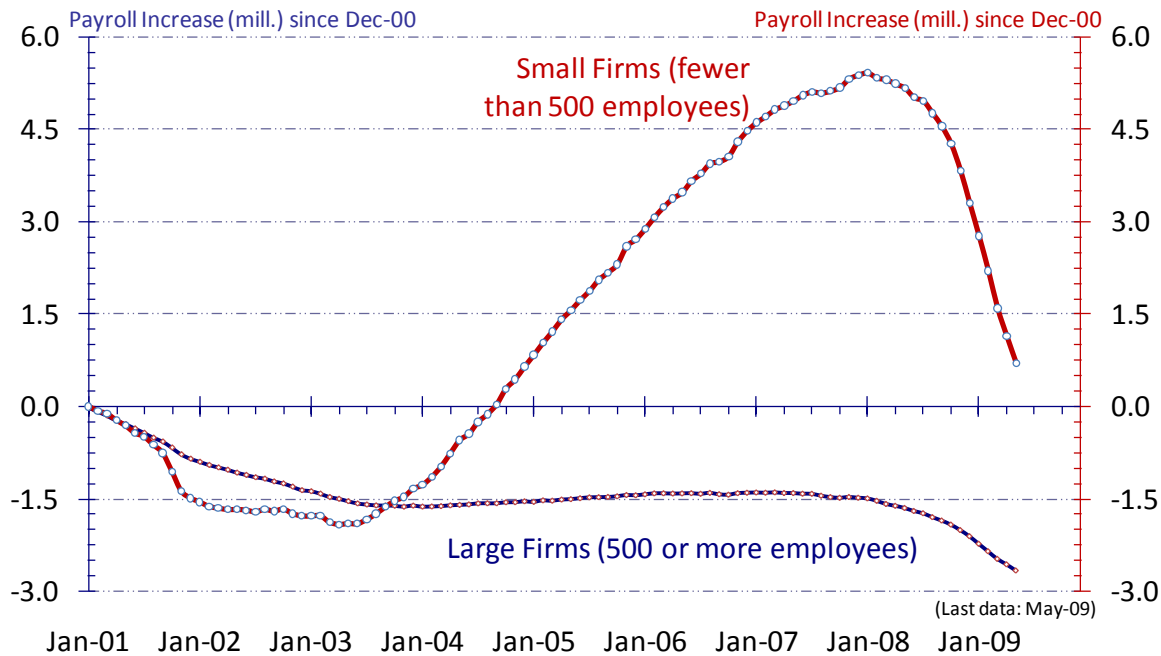
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*Tom McManus, Chief Investment Officer*

## **Reassembling Humpty Dumpty: Stocks Not Likely to be Straight Up From Here**

- Measured from the lows of early March, popular stock averages — and risky investments more generally — have made impressive gains, large enough for many to proclaim the dawn of a new, powerful bull market. We think that gains from here will be a much tougher road.
- Are we likely to see lower lows than early March? We do not believe so, because the fear and capitulation evident at that point matches anything we have experienced in the years we have been watching and analyzing markets. But could we suffer a significant retracement of recent gains? Yes, we believe that investors now should be wary of downside risks, even as they try to maintain the right exposure to potentially benefit from a possible recovery.
- Long term success in the markets — for most of us mere mortals, anyway — is not about how much you might have made if you had been lucky enough —or brave enough — to be a buyer during those scary days when pessimism was so widespread. After all, at the lowest point, the S&P 500 index had lost –55% of its maximum value from October 2007. Now, the loss has been trimmed to –37%. For every dollar invested at the lowest close, the gain has been \$0.40, or +40%. But for every dollar invested at the old highs — only \$0.18 (eighteen cents) of the prior “old high” value has been restored by the rally since the lows.
- We believe investment success depends less on what you make in the market, and more on what you keep. Remember that the long-term trend has been up for the US market, but that trend hinges on profit growth — which in turn depends on the fundamentals of economic growth — population, participation and productivity. Even if the economic trend continues upward as we expect, the pace of growth is likely to be slower than the rate to which we had become accustomed.
- The downshift in economic growth appears to have begun years ago, but it was disguised by an increase in debt — leverage — taken on by the household and business sectors. Now, to bail out the economy, the government sector has embarked on a huge increase in its own debt — on the balance sheets of both the Federal Reserve and the Treasury — to cushion the economy from an unwelcome “hard landing.”
- Credit markets have begun to thaw with the benefit of the special attention from the world’s central banks, whetting investors’ risk appetites. But putting Humpty Dumpty back together again — finding the path back to new highs for the market — will depend on a new formula for economic growth — one less reliant on increasing debt.
- Many investors — and some prognosticators, too — seem to rely on the durability of the long-term historical trend of value creation in the US market, without paying enough respect to the fundamentals that drove it. Looking at employment and retail sales trends, a jump in confidence about future growth is evident, and it may continue for awhile. But jobs are still being lost at a rate that would be alarming in any environment other than one where optimists can say they are “less worse” than before. Nonfarm employment is about even with 2001; about 5 million jobs have been lost in construction and manufacturing since then. Whatever growth has been seen has occurred in services like education, healthcare and leisure. Humpty Dumpty needs a new engine of job creation to perform as expected.

### Job Losses Among Smaller Companies Are Much Steeper in This Cycle



Source: ADP Employment Report.

Our chart underscores the importance of smaller companies to our national economy. Companies with 500 or more employees never regained the level of employment they represented at the peak of the prior economic cycle at the start of 2001. But smaller companies created +5.4 million jobs during the last cycle, even after making up the losses from the last recession. Since the current recession began 18 months ago, large company payrolls have fallen by -1.2 million to 18 million, while job losses at smaller companies total -4.6 million.

We recognize that part of the employment shift from larger companies to smaller ones is the trend toward outsourcing, where larger companies concentrate their employment pools on core activities, and contract with other firms to provide peripheral services like food service or benefits administration. Even so, this recession is already more serious in terms of total job losses than the prior one.

One reason cited for optimism is that the pace of job losses is slowing. This should be clear from our chart, which shows an average payroll decline of -444 thousand over the past two months for the smaller firms, as compared to an average of -492 thousand for the prior six months. If you want to get out from a hole, they say, the first thing you must do is stop digging. To this, we might add, before you stop digging, perhaps you should start digging more slowly.

Because markets depend on the cumulative psychology (i.e., greed and fear) of their participants, it helps to be able to identify the prevailing mood and to recognize extremes. Now that fear has dissipated and greed is returning, we believe markets will resume their role of "weighing" real profit results in the context of a slower underlying trend of economic growth. In the short term, we are cautious, but prepared to increase exposure on a significant pullback.

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