WELLS FARGO ADVISORS

The Week

Tom McManus, Chief Investment Officer

Updating Our S&P 500 Market Cap to US Gross Domestic Product Analysis

- The 14% advance this year for the Standard & Poor's 500 index reflects a similar increase in the aggregate market value of the component companies, now $9 trillion (T). By contrast, the comparable level of capitalization at the end of February was only $6.5T. The arrest and partial reversal of last year's steep setback has recreated a portion of the wealth lost, and is contributing to a sense of relief and increasing confidence.

- We should not forget that our economy and financial system required a rescue, however. For some time to come, we will collectively wear the scars of the downturn and bear the costs of the Federal government's extraordinary actions to avert disaster.

- At the outset of this year, we were looking for a break in the clouds, but for some time now, we have been enjoying brightening skies. US Gross Domestic Product (nominal — i.e., before inflation adjustment) has been stalled for the past few quarters near $14.3T/yr., but the consensus of economists figures that this key measure has already begun to increase again, and that it will continue to expand for the foreseeable future.

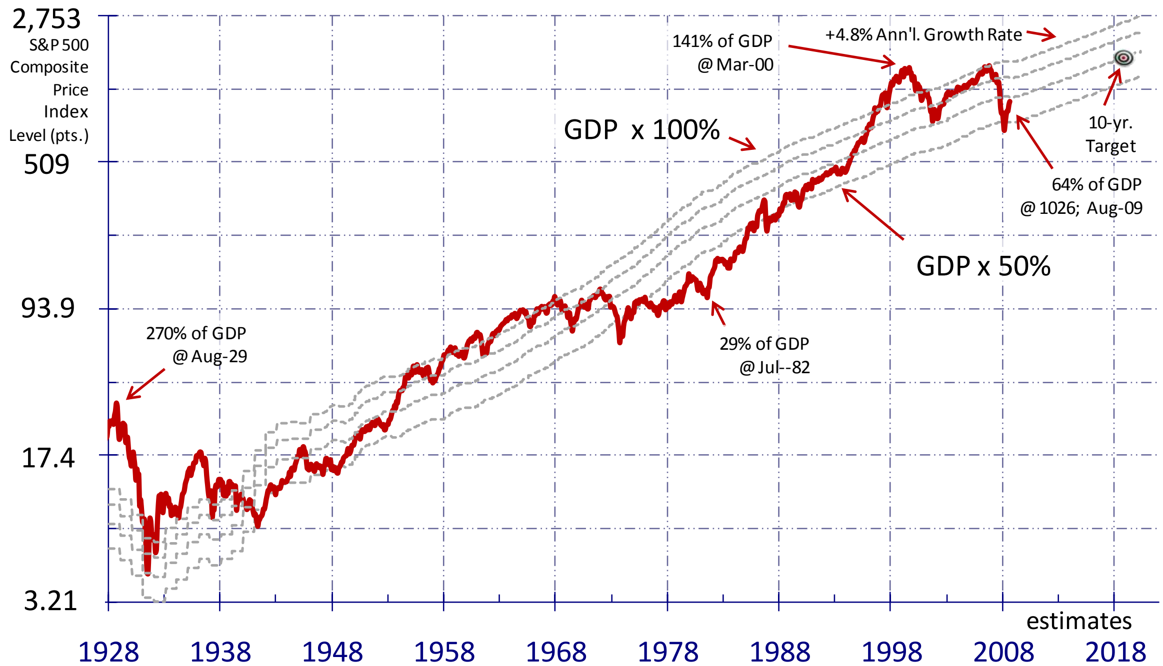
- Most economists and casual observers are focused on "real" — i.e. inflation-adjusted — GDP, because they are primarily interested in tracking the <u>quantity</u> of production. By contrast, we are interested in both <u>quantity and price</u>, because both are important contributors to earnings growth. In the stock market, companies are routinely rewarded for displaying "pricing power" — i.e., the ability to pass along cost increases directly to customers in the form of higher prices.

- Nominal GDP growth is an important contributor to nominal earnings growth, which should drive stock prices higher over time. Our assumptions for the growth potential and risk of various asset classes —our so-called "Capital Market Assumptions," or CMAs — are all based on nominal (i.e. before adjustment for inflation) prices.

- For the balance of 2009, growth is expected to be slow, but then pick up speed in 2010. Some economists are already predicting a significant stumble next year, as many seem to doubt the ability of the US consumer to reengage vigorously enough to offset the eventual decline in the pace of Federal stimulus spending.

- Typically, a surge of consumer spending fueled by pent-up demand and sparked by improving confidence lends some real pizzazz to the early stages of economic recovery. But in the current cycle, we see housing and portfolio losses that are much more severe, and sense that both lending and spending will be more restrained than what markets have become accustomed to in the "normal" recovery.

Trend Growth in US Nominal GDP* Has Tended to Drive US Stock Prices
(Dashed lines Display 50%, 67%, 83% and 100% Multiples of Nominal GDP)



**Nominal Gross Domestic Product measures the annualized value of all goods and services produced in the US, expressed in current (i.e. not adjusted for the effect of inflation) prices. S&P index series excludes dividends. Base date for S&P index is 1941-43, when the average index level was equal to 10. There is no assurance that these movements or trends can or will be duplicated in the future. An index is not managed and is unavailable for direct investment. Source: Commerce Dept., Standard & Poor's.*

Our chart shows the ratio of S&P 500 market capitalization to GDP is now 64%, up from 45% at the end of February. Back in March 2000, the reading was an inflated 141%, while in July 1982, it was as low as 29%. The current reading of 64% is very close to the median ratio (since 1940) of 67%. If the S&P 500 were to rise an additional +4% to 1076, the ratio would match the long-term median. Our long-term target price for the S&P 500 is based on several assumptions: trend GDP growth over the next ten years will be slower than the past 25, S&P 500 earnings will grow a little faster than US GDP, and the S&P 500/GDP ratio will be near its historical median.

The S&P 500/GDP ratio is an admittedly oversimplified yardstick of market valuation, but it enables us to use a very long time series comparing market levels with a key economic measure that reflects a substantial portion of the revenue opportunity for US companies. There are a number of adjustments one could adopt to improve the analysis, e.g. to broaden the equity portfolio to include public (and private) companies that are not part of the S&P 500. One must also recognize that a substantial portion of the value of S&P 500 companies is due to business conducted outside the purview of US GDP.

Despite its shortcomings, the market cap/GDP ratio is often used to make international comparisons. One should be careful not to attribute all of the variance in these figures to valuation differences alone. We believe the best usage of the ratio is to try to identify those occasions when prices seem very far removed from the typical range. Billionaire investor Warren Buffett has used a similar measure to highlight the apparent overvaluation of stocks in 1999-2000, and once again late last year and early this year to support his contention that US stocks had become bargain-priced for the first time in years.