

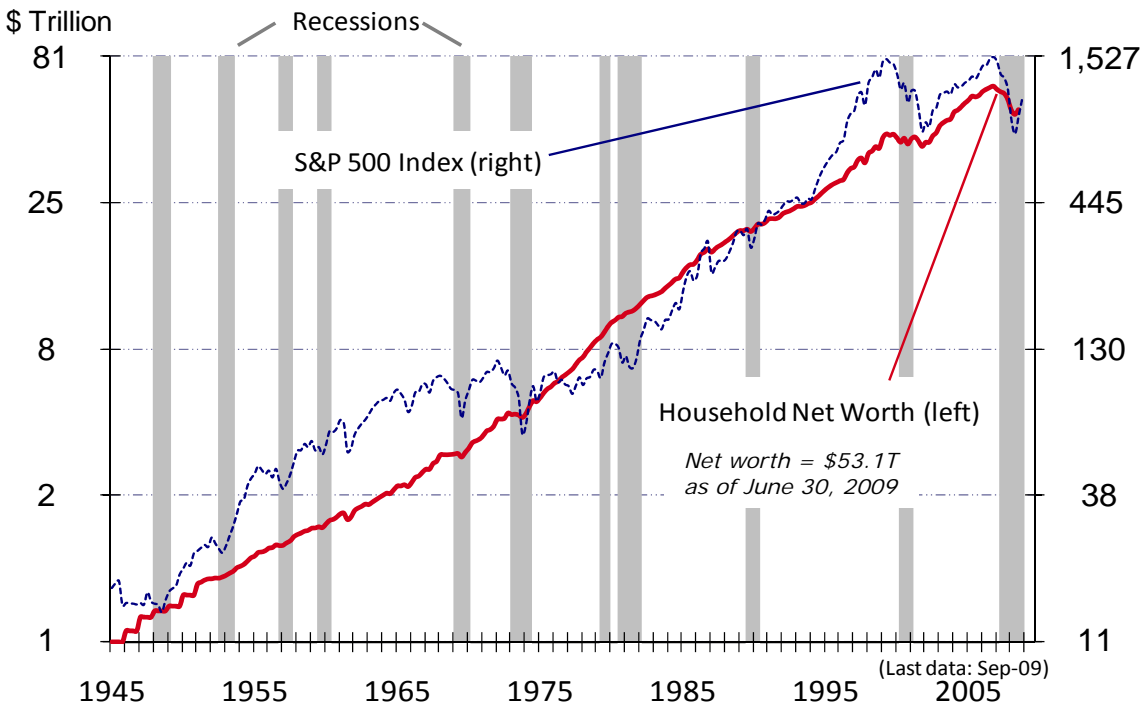
The Week

Tom McManus, Chief Investment Officer

Wealth in America: Under Repair

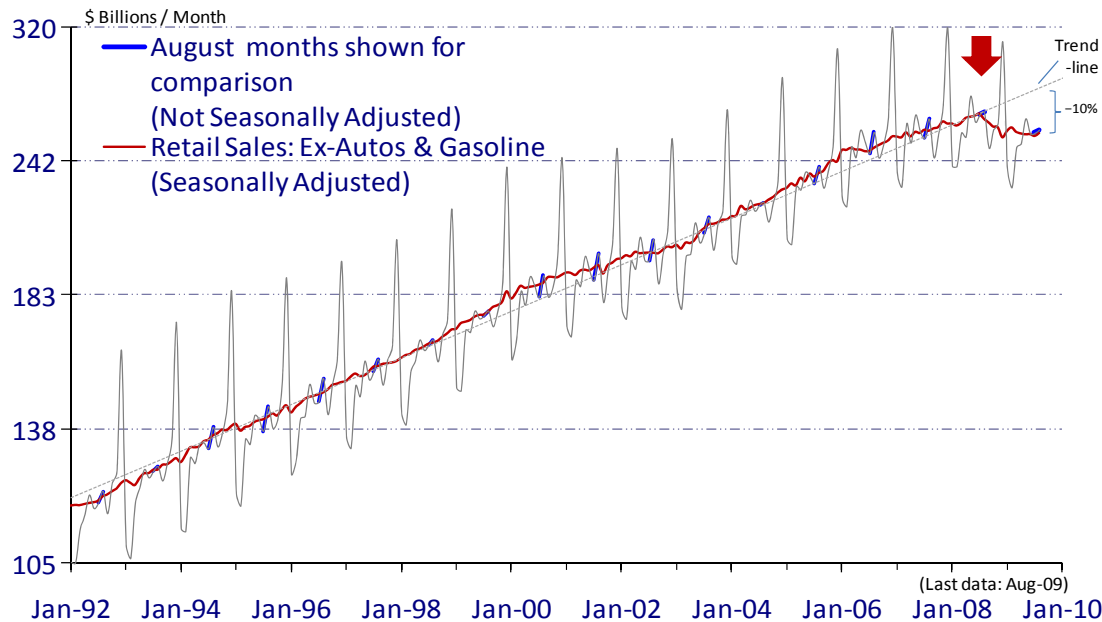
- After the stock market hit bottom late in the first quarter of this year, the cumulative net worth (total assets minus total liabilities) of American households also began to recover. Last week, the Federal Reserve reported that household wealth rebounded in the second quarter by +\$2 trillion, or about +4%, after falling about -\$13 trillion, or -20%, since the third quarter of 2007.
- With luck, the second quarter of 2009 will be the start of a long string of net gains for this measure, which includes all investment portfolios owned by individuals, combined with housing and other tangible assets. Perceptions of personal finances are an important dimension of consumer confidence, and capital market gains are very visible on personal balance sheets, providing a welcome boost to morale even while the other dimension — the employment outlook — is continuing to weaken.
- We also realize that confidence plays a critical role in the way our economy works. Consumers need confidence to spend — especially on big ticket items like appliances, autos and homes. These expenditures often require financing, and lenders need confidence to extend credit, too. Businesses need confidence that demand will recover so they can begin to crank up production and hopefully, employment. Wealth — and the pursuit of wealth — play an important role in a “virtuous cycle” of our economy. Markets rebound and wealth expands, boosting confidence and — ultimately — both production and employment.
- Our chart (overleaf) shows that the recent drop in household net worth (“HNW”) was significantly larger — both absolutely and in percentage terms — than any other decline on record (since 1945, when the Federal Reserve data series begins). The only other drop that comes close was -\$4 trillion, about -10%, from 1999-2002. Some of the previous bear markets of the prior half-century — even 1973-1974 — made barely-noticeable dents in HNW. The recent loss owes much of its severity to the contribution of housing market losses — these amounted to about -\$4 trillion from 2006 to 2009.
- The increase in the second quarter was driven mostly by an increase in financial assets, and the gains in that category were mostly due to the rally in stocks. But tangible assets also increased modestly, and liabilities continued to decline as well.
- Of course, the continued rally for the markets since the effective date of the Fed’s report has generated additional gains. So far, it appears as if we are on track for an even larger gain in HNW for the third quarter (probably +\$2.5 trillion, or more, if stocks manage to hold or extend their gains over the final eight sessions of the quarter). The Fed’s next report on HNW is due on December 10.
- Despite the gains in HNW, retail sales continue at a disappointing pace (see second chart). Some households may see potential tax increases as higher liabilities in the future, thereby limiting the benefits of the wealth increase so far. Our retail sales analysis excludes autos and gasoline sales to help smooth month-to-month volatility. Government sales reports are on a sequential (i.e. month over month) basis, in contrast to industry practice, which focuses on year over year comparisons. Even these can be misleading now, as the extraordinary weakness in retail sales began more than one year ago.

Household Net Worth: About 1/3 of the Damage Has Been Repaired So Far



Note: Log scales. Performance does not include dividends. Past performance is not an indication of future results. An index is not managed and is unavailable for direct investment. Source: Federal Reserve, Standard & Poor's.

Despite Recent Wealth Gains, Retail Sales Remain Under Pressure



Note: Log scale. Source: Commerce Dept.

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