

The Week

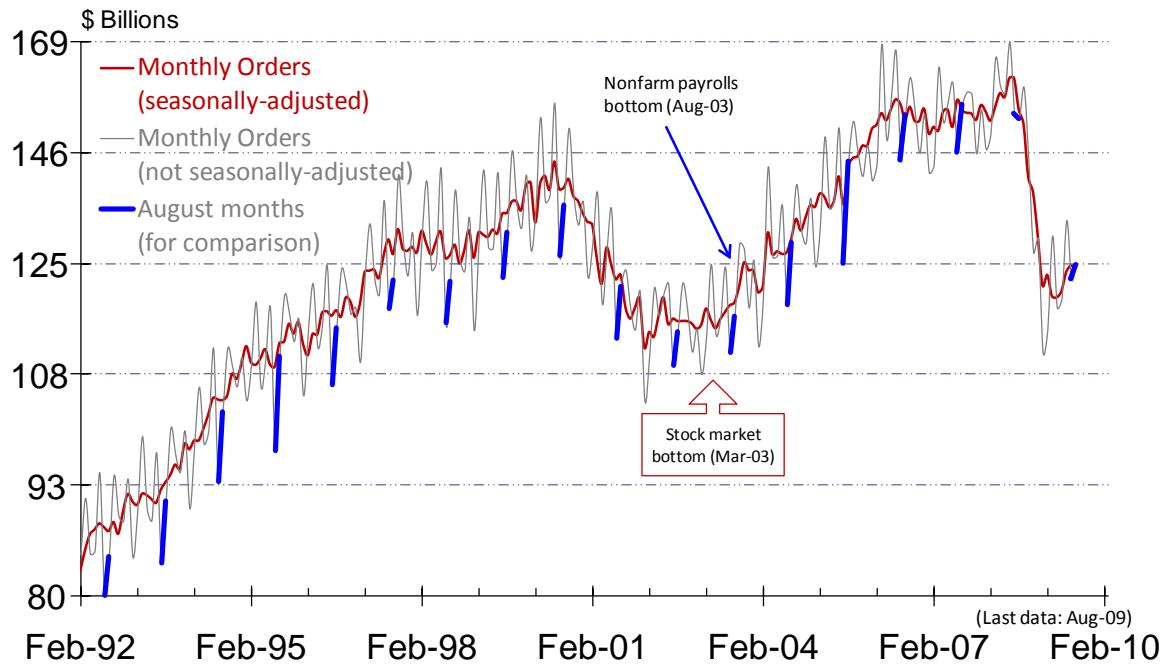
Tom McManus, Chief Investment Officer

Too Much, Too Soon, Too Fast?

- We participated in an investment conference last week where Nouriel Roubini was the featured speaker. A professor at New York University, Roubini operates an economic consultancy and is something of a celebrity, widely recognized for having been one of the few outspoken analysts who predicted that the eventual collapse of the housing bubble would ultimately result in a full-scale financial crisis.
- Prof. Roubini is less bearish currently, having acknowledged that extraordinary government actions — spending, lending, and forbearing — have been successful in stemming the sharp decline in economic activity seen in 2008.
- But unlike many other observers of the economy and markets, Roubini remains steadfastly cautious, convinced that the recovery that is now underway will be — in a word — “anemic.” Growth in US gross domestic product (GDP) will average +2.6%/yr. in the second half of 2009 and throughout 2010 (after adjusting for inflation), according to consensus forecasts. While these estimates are less optimistic than a so-called “normal” recovery, some naysayers like Roubini expect a bumpier path — one that may involve another quarter or two of negative growth. The path to recovery is likely to be longer and slower than the consensus expects, in Roubini’s view.
- After falling –25% from the peak in mid-2008, orders for manufactured items that are expected to last for 3 or more years (i.e. durable goods) remain under pressure, according to the first chart overleaf. (We have excluded transportation equipment to improve clarity). In the last recovery, GDP increased for 4 consecutive quarters — and durable goods orders increased some +10% — before growth stalled in the fourth quarter of 2002. Stocks pulled back, and didn’t mount a sustained advance until durable orders turned the corner in 2003.
- The connection between new orders and hiring is critical, as employers need confidence that business will continue to expand before they extend themselves. It is unlikely they will increase payrolls to meet demand they see as temporary, such as the Cash for Clunkers program, which moved manufacturers’ and dealers’ inventories into consumers’ driveways. By the time payrolls eventually bottomed in the last cycle (see annotations in both charts) new orders for durable goods had already recovered about one-third of their prior decline. So far in 2009, the rebound in durable goods orders has been less than half that much.
- Despite the struggling economy, corporate profit estimates have continued to improve. Over the past four weeks, 17 of the 30 companies in the Dow Jones Industrial index have seen an increase in their 2010 earnings forecast, according to the consensus of analysts tracked by First Call/Thomson Financial. Seven more have estimates that have held steady, and only 6 have suffered a decline in their estimates over the past month
- Perhaps the economy will surprise the naysayers like Roubini, stimulating both revenues and profits. Maybe companies will continue to expand their profit margins and generate good earnings even in a stubbornly weak economy like Roubini and others expect. But stock prices have increased much more than earnings forecasts, so they offer less protection against a possible resetting of expectations if the economy should stumble on the path to recovery.

Orders for Durable Manufactured Goods* are Still Very Weak

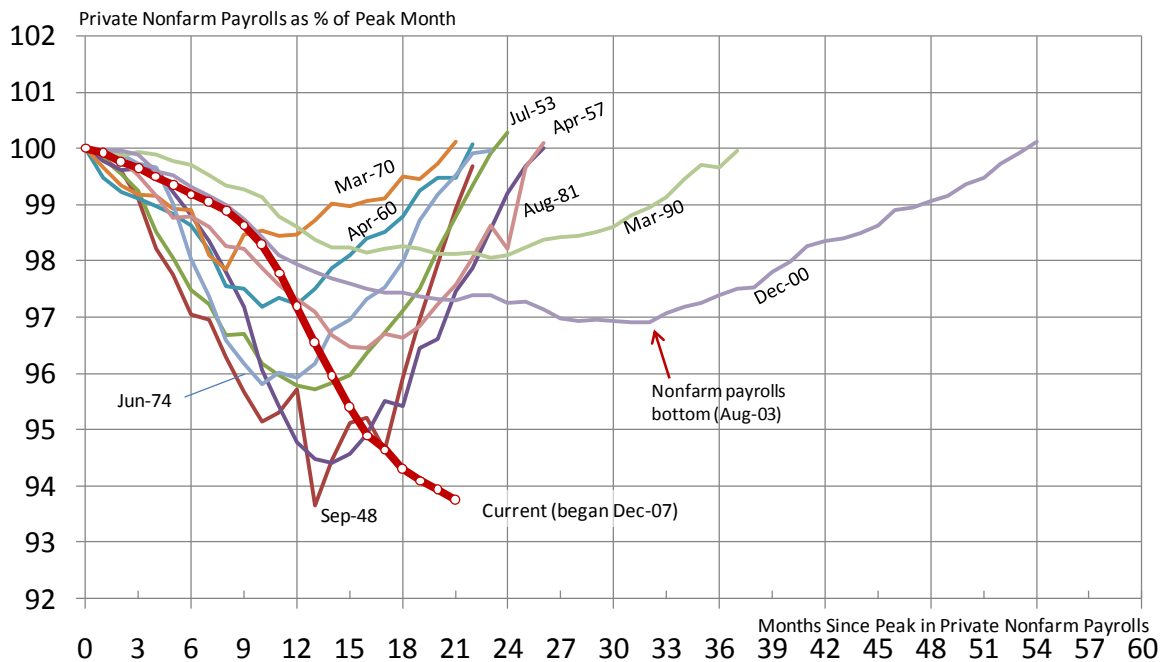
*Excluding Transportation Equipment, e.g. Autos, Trucks, Aircraft, Ships, Railroad Rolling Stock



*Note: Transportation equipment excluded to improve clarity of the trend. Source: Census Bureau.

Waiting For the Turn: Cumulative Job Losses are the Worst in 50 Years;

Job Growth in Recent Recoveries Has Been Noticeably Less Vibrant



Source: Bureau of Labor Statistics.

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