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Economic Trends
for Over 20 Years"*
NOVEMBER 2005

WELLS CAPITAL MANAGEMENT



Economic and Market Perspective

Inside

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- All Negative Yield Curve?!?
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In the aftermath of Hurricane Katrina, pessimism is rising. The elevated level of energy prices has left at least four widespread impressions. First, the consumer surely will capitulate under the weight of higher gasoline, natural gas and heating oil prices—resulting not in a Merry, but rather a Scary Christmas. Second, energy costs and other commodity prices have now risen enough to negatively impact earnings reports. Third, the Federal Reserve seems bent on continuing to raise interest rates (seemingly more concerned with Katrina's inflationary fallout than its implications for weaker economic growth) just when many were beginning to believe the Fed was nearing the end of its tightening cycle. Finally, bad things seem to be happening with regularity so far in this new century. If it isn't an economic meltdown or a deflationary abyss, it is tsunamis, hurricanes, earthquakes, terrorism, war or Avian flu! The national obsession no longer considers it a question of if, just when. When will the next shoe drop and can the economy handle the "next big one?"

*Can the economy handle
the "next big one?"*

The erosion in confidence is reflected by an almost 5 percent decline in the U.S. stock market since Katrina. Even though the Fed seems confident about the recovery, most forecasters are significantly lowering economic growth projections for next year. Will this growing consensus view prove correct? Are the headwinds of surging oil prices and chronic Fed tightening simply too strong not to significantly slow this recovery and dent the stock market? Although we have moments of self-doubt, we continue to believe the undertow of the U.S. and global economic recovery remains quite impressive, as does the investment environment for equities.

This is a GLOBAL Recovery!!!

While there are questions about how much (if at all) U.S. economic growth may slow, foreign economic growth seems to be accelerating. One major and important difference between the contemporary recovery and economic growth during the 1990s is that the United States is no longer the sole economic engine. This recovery is truly global, synchronized and strong! In our view, this makes the current recovery much more sustainable and less vulnerable than it was in the recent past. A common adage during the 1990s was if the United States ever got a cold, the rest of the world would fall deathly ill. This may no longer hold true. The United States, while still a significant contributor to world growth, is no longer the sole or arguably even the most important source. China is the leader today. Japan, other Pacific Rim economies, Mexico and India are all growing faster than the United States this year. Indeed, while global economic growth has been dominated by the same old G7 economies since World War II, the contemporary recovery may be more diverse and widespread than any in several decades! While many currently worry about slower U.S. growth, it may be instructive to consider the increasingly positive economic outlooks emerging abroad.

China: No slowdown in sight! Recently reported growth shows real Gross Domestic Product is still growing close to an annualized pace of about 9.5 percent and Chinese officials seem less inclined to attempt slowing growth as they were earlier this year.

Japan: The dog of the 1990s is no longer a dog! Real GDP through the first half of 2005 was 4.6 percent—its fastest pace in 15 years. Most importantly, for the first time since 1991, the Japanese economy is being driven by consumer and capital spending rather than by net exports and government spending. Finally, the explosion in the Nikkei stock price index since mid-year may be suggesting Japan has finally emerged from its prolonged slumber! If it has, a 15-year-long liquidation of the world's

second largest economy is a wonderful launching pad for what would most likely prove a prolonged and robust Japanese recovery.

Europe: The dog of the current recovery may improve some next year?!? Eurozone real GDP growth has slowed to about 1 percent in the last year, but the European economic policies employed in the last year suggest faster growth during 2006. Eurozone long-term bond yields have declined by about 1 percent since mid-2004 to all-time record lows, the annual growth in the M3 money supply has accelerated in the last year, and the Euro currency has experienced its first period of weakness since at least 2001. Combined, these amount to a powerful package of policy stimulus, which should allow real GDP growth in the region to lift above 2 percent in the coming year. How unfortunate for the U.S. economy that the one area of the globe where the dollar has experienced its largest depreciation since mid-2002 (the dollar has cheapened by about 40 percent against the Euro) has been the one area with the weakest economic growth. About 16 percent of the current U.S. trade deficit is with Europe and its lack of improvement is primarily because Euro economic growth has been so pathetic. Imagine how much a stronger Europe could help the U.S. economy?

Developing Economies: Back when the Berlin Wall fell in the late 1980s and the world began to open up economically, the hope was someday the developing economies would advance into consuming economies. While this is still work in progress, it is also exciting to see how much fruit is already on the tree! We cannot remember another recovery in the postwar era when so many previously insignificant players (China, Pac Rim, India, Mexico) were such a large part of the global recovery. Perhaps rather than wringing our hands over whether the U.S. consumer is about to perish, we should be smelling the roses and relishing on just how far the world has come in diversifying contributions to global economic growth. Perhaps a U.S. economic slowdown is not nearly as important for investors and businesses in a global economic recovery that is no longer is so highly reliant on just U.S. growth???

We think people are currently underestimating how strong, diverse and sustainable the contemporary global economic recovery may prove to be. Not only are parts of the world currently exhibiting strong economic growth which will likely persist next year (China), but other parts (Europe and Japan) appear poised to experience even faster growth in the coming year. Perhaps, at some point in this recovery, ongoing global growth will be considered a cure for a U.S. economic cough???

The U.S. Slowdown Case...Fed & Oil!???

The consensus case for a significant U.S. economic slowdown is predicated on two things—Fed tightening and higher oil prices. While we agree both act as a restraint on economic growth, we also believe neither—whether alone or in combination—is substantial enough to significantly stall the U.S. economic recovery.

In 11 separate hikes, the Fed has lifted short-term interest rates by 2.75 percent in the last year. While this sounds ominous, overall monetary policy has remained remarkably accommodative compared to past recovery cycles. Even though it has been raised many times, the current funds rate is still very low by historical standards. Indeed, in our view, all the Fed has done thus far is remove a huge “crisis discount” in the funds rate which was introduced a few years ago in a panicky response to widespread fears the United States was headed toward depression. Simply eliminating an emergency crisis discount (something without precedent since the Great Depression) is not the same as

tightening. The lack of restrictiveness imposed by the funds rate is highlighted by the inability of the Fed to lift long-term yields from four-decade lows! It is also portrayed by a funds rate which is still below zero in real terms. Indeed, since the annual rate of consumer price inflation jumped to 4.7 percent in September, the entire Treasury yield curve from three months to 30 years has a negative real yield! Hardly a characterization of an overly restrictive monetary policy.

Not only has the Fed been unable to raise long-term yields, it also has left the economy flush with excess dollar liquidity. Although the growth in the U.S. money supply has slowed in the last year, the level of dollar liquidity remains uncommonly strong around the globe. Can anyone really argue there is a shortage of U.S. dollars? Global central bank vaults are stuffed with U.S. currency and U.S. corporate balance sheets have seldom been more bloated with cash. Finally, while the yield curve has flattened in the last year (how could it not, it was so steep?) there is still about one percent between the 30-year Treasury yield and Fed funds rate. Overall, we find monetary policy in the aggregate (short rates, long rates, yield curve and liquidity) at worst neutral and most likely still stimulative. Therefore, we believe most are overestimating the efficacy of Fed tightening in slowing the economy.

The rise in energy cost is certainly a restrictive force, but we believe it is not the “recovery killer” most seem to expect. Why? This oil price spike is different from the past in two major ways. First, as of mid-year, energy costs as a percent of the consumer budget was only about 5.5 percent compared to about 8.5 percent in the late 1970s. Indeed, prior to the mid-1980s, energy costs as a percent of disposable income was always higher than it is today! The contemporary oil crisis began from a near record low real oil price and energy budget share. Second, there are many deflationary offsets to rising oil prices today which did not exist previously. Today, mortgage yields remain very low, durable goods prices (e.g., new auto stickers) are chronically deflating, as are all consumer electronics prices. In past oil spikes it was not so much the rise in the price of oil which shut the recovery down, as it was the rise in the prices of everything else as oil prices rose. Certainly, rising energy costs will be a drag on the economy and will be very important for certain groups (e.g., low income households and airlines), but because of the significant differences from past oil crises, we believe this crisis will prove far less contractionary than feared.

U.S. Recovery Still Looks Solid!?!?

From an economic policy standpoint we fail to see why the economy should be expected to slow. Despite the numerous hikes in the Fed funds rate during the last year, it still remains very low in both nominal and real terms. Long-term yields remain locked in at four-decade lows, excess dollar liquidity remains prevalent, fiscal stimulus of about \$350 billion with more on the way (Katrina relief) is still remarkably robust, and the trade-weighted U.S. dollar exchange rate is still down about 25 percent from its 2002 highs. Until policy officials in the aggregate finally decide to step on the brake, why should the car slow?

Despite all of the angst surrounding the consumer, the household may well be in its strongest shape since the recovery began. True, real income growth may take a hit from higher energy costs for a period; however, household net worth (with or without real estate) is currently at an all-time record high, we have created about 2.5 million jobs in the last year (the most in several years), and have an unemployment rate close to five percent. The household net tax bite (taxes paid less subsidies received as a percent of income) is close to postwar lows. Housing and auto sales remain near cycle and record highs and overall retail

sales have recently been growing stronger than at any time in this recovery. Yes, consumer confidence indexes have declined. How could they not after the emotional 24/7 *CNN* coverage on New Orleans? Moreover, confidence measures have proven volatile and have shown little relationship to future spending patterns anyway.

Since the start of this decade, the death of the consumer has always been imminent. Remember the wealth effect of 2000, the terror attack in 2001, the actual recession thereafter, the jobless recovery of 2002–2003, the Iraqi war in March 2003, the deflationary scare in mid-2003, Fed tightening in the last year, the housing bubble and oil price spikes at various times. Each one of these events was expected to kill off the consumer, but none has thus far. We believe a single factor is paramount for the consumer sector—mortgage yields. Until mortgage yields rise and stay higher for a period, the consumer will likely stay healthy. Since mortgage yields have not yet begun to rise, rumors of the consumers imminent death are again probably premature.

The U.S. business sector looks very healthy. Balance sheets in corporate America are stronger than at any time since the 1960s. The corporate cash flow-to-capital spending ratio has seldom been higher in the postwar era. Quarterly profits reports have outpaced expectations in each of the last eight quarters. In real terms, the annualized growth in total U.S. corporate profits during this decade is faster than any other since at least the 1940s. Indeed, real corporate profits are growing faster in this decade than they did in the miracle 1990s! This profit story is not just a margin enhancement story, but is also a sales growth story. In the last year, sales growth for the median Standard & Poor's 500 Index company has risen close to 10 percent, which is almost 2 percent faster than sales grew during the booming latter part of the 1990s. This top-line story could improve even further if the U.S. trade deficit continues to show improvement allowing companies to gain greater pricing flexibility.

Excluding a temporary hit due to Katrina, we expect real GDP growth to remain remarkably strong in the coming year at about 4 percent. We think the restrictive forces of Fed tightening and higher energy costs are overstated, overall economic policies remain stimulative, overseas economies appear to be accelerating, and both the household and business sectors still appear healthy.

We Continue to Like Stocks!!!

Sentiment: Stock market sentiment has turned decidedly more bearish of late. Investors have a host of worries including slower economic growth, consumer capitulation, continued Fed tightening, signs of higher bond yields, rising inflationary trends and the ever present fear corporate profits are about to roll over. The escalation of fears is portrayed by the recent spike in the VIX index (the option volatility index), which has surged to levels comparable with the stock market lows of last spring and fall. Trading volumes have also increased during this sell off. We believe these are signs of a good cleansing for the stock market. If there was too much optimism and complacency prior to Katrina, there isn't anymore.

Profits: We are on the cusp of the earnings reporting season and it appears to be yet another good quarter. Consensus estimates are looking for about 15 percent profit gains this quarter—a number far greater than consensus expectations just a few months ago. It also represents a growth rate more than three times the current long-term bond yield! Given the solid growth character around the world, and our expectation for a continuation of strong U.S. growth, we believe most are underestimating the staying power of this profit cycle.

Valuation: Since profits have been rising all year while stock prices have not, the valuation of the stock market has become more and more compelling. The trailing price-to-earnings multiple on the S&P 500 index is about to break below 18 times earnings, its lowest level of this recovery cycle. Consensus estimates for 2006 earnings are about \$80 which implies a forward 1-year P/E multiple of only about 14.5 times! From a long-term historical perspective, 14 times trailing earnings is about average. If the stock market stays flat in the coming year and earnings achieve consensus levels, the stock market would be “average priced.” Is there anything average about the environment today? Annual real GDP growth, global economic growth, U.S. and global profit growth, interest rates, core inflation rates, excess financial liquidity, profit margins, productivity and the unemployment rate are all better than average. Why should the stock market valuation be only average when the environment is far above average? Finally, the valuation profile of the stock market is even more compelling when compared to alternative asset classes like bonds and cash.

We remain bullish on stocks even though we expect both higher inflation and rising bond yields. This may seem incompatible. A little inflation (e.g., a rise in core consumer inflation to about 3 percent to 3.5 percent) could be a good thing for many U.S. corporations. Improved pricing flexibility and greater consumer acceptance of price hikes may come at just the right time to keep the profit cycle going. Better pricing trends may boost top-line growth on already extremely high profit margins. Won't inflation reduce P/E multiples? There is an old rule from the 1970s called the “rule of 20.” This rule says the P/E multiple on the stock market should be approximately equal to 20 less the current rate of inflation. Currently, the S&P 500 is trading at about 14.5 times next year's earnings. If the core consumer inflation rate rose as high as 3.5 percent next year, the rule of 20 would imply a P/E of about 16.5 times, some two points higher than the current next year P/E. In essence, some rise in the inflation rate may already be imbedded in the stock market.

This Too Shall Pass??!

By early next year, Katrina will be largely forgotten by most stock investors. The media won't focus on oil forever—it will move on! We think attention will turn toward how resilient the consumer seems to be, how low the unemployment rate is, how strong corporations look, how amazingly good profitability remains and how synchronized and broad-based this global recovery has become. Many may also be awed by a renewed drop in crude oil prices back into the \$40s, perhaps uncovering the fact this whole oil cycle was more a speculative bubble than based on a fundamental shortage. There may also be an increased recognition of the U.S. trade deficit improving—especially if crude oil prices back off. Some may start to notice U.S. trade adding to quarterly real GDP growth rates rather than leaking growth abroad. Excitement may increase even more as improvement in the trade deficit starts to reinvigorate U.S. manufacturing employment.

Yes, there will still be horror stories—the housing bubble story won't fade, terrorism will remain a concern, inflation will be scary and bond yields may keep rising. But we also think many will be happily surprised by renewed strength in the stock market.



James W. Paulsen, Ph.D.

Chief Investment Strategist, Wells Capital Management

Chronic Fears !!??

One lasting impression from Katrina is simply a sense that bad things are happening with regularity in this century. For most people, it is no longer a question of if, just when. As this magazine cover illustrates, the media is no longer reporting the news as it is editorializing about the “next big one.” Evidently, the actual news is not bad enough, so now we are dreaming up even worse potential outcomes. This social trend is keeping pessimism and caution at high levels. Nervous sentiment has typically been a positive indicator for the stock market. When most expect the worst, a positive outcome is more likely. Reality is usually never as bad as feared. When everyone is hunkered down and prepared for the worst, it is probably a good time to become a more aggressive equity investor!??!

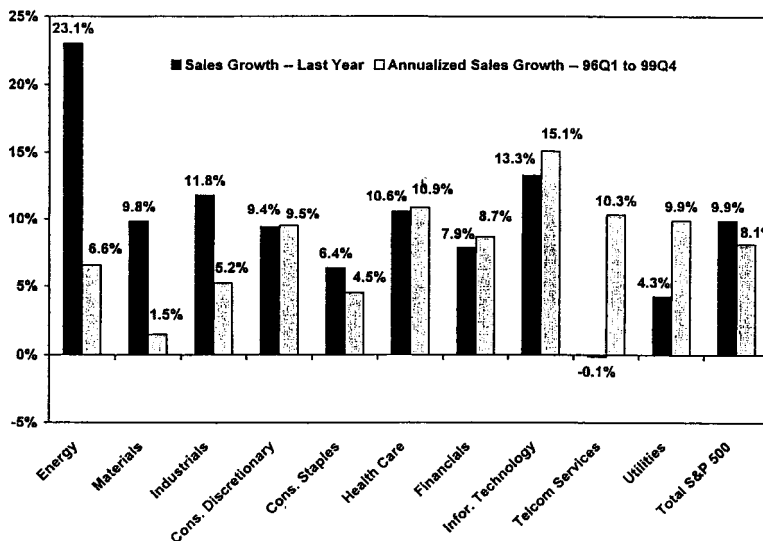


Top-Line Results...Better Than 90s Boom!!!!

Many people suggest the profit recovery in this cycle is primarily the result of improved profit margins and is not sustainable. As this chart shows, profits have also been driven by strong top-line results. Indeed, for the median S&P 500

company, sales growth in the last year is faster than it was during the late 1990s (1995–1999) dot-com boom period! Most of the strength is coming from the energy sector and the cyclical sectors (materials, industrials, consumer discretionary). Perhaps faster inflation has simply been adding to top-line growth in a manner we have not witnessed in 25 years! We continue to believe people are underestimating the strength and sustainability of corporate profits!?!?

S&P 500 Median Company Sales Growth By Sector
Last 4 Quarters vs. Annualized Growth Between 95Q1 & 99Q4

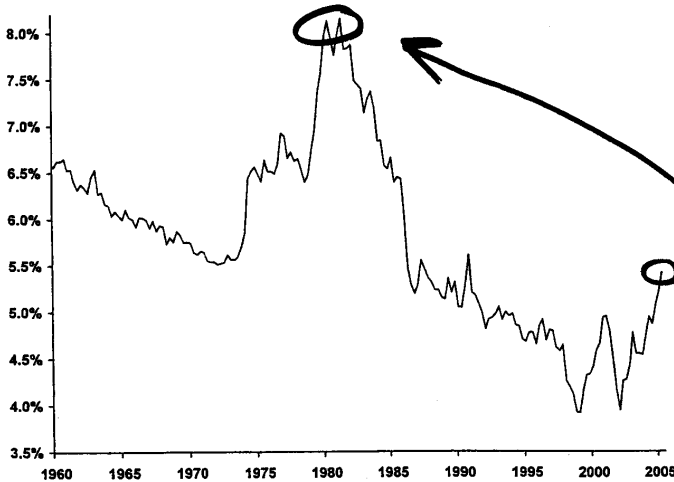


This Oil Crisis is Different!???

We believe the contemporary “energy crisis” will have far less economic impact compared to the 1970s oil crises. In real terms, the price of crude oil is still significantly below its peak levels of the late 1970s. More importantly, energy outlays as a percentage of consumer incomes are still far less than they have been historically. Through the second quarter, the income budget share of energy was about 5.5 percent. As the chart shows, prior to the mid-1980s, energy costs were

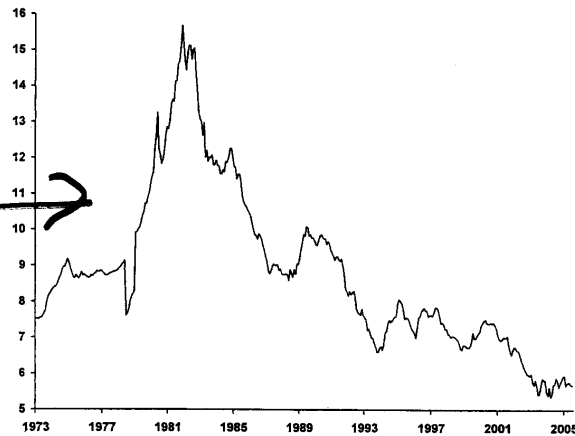
never this low! Yes, the budget impact of oil has risen significantly, but from all-time record lows earlier in this decade. The current surge in oil prices is more reflective of how “cheap” it was in the last couple of decades rather than how “expensive” it is now. The budgetary impact of oil has just recently increased to its lowest levels ever reached between 1960 and 1985. Moreover, unlike the 1970s, there are a lot of offsets to higher energy cost today. Mortgage rates have been declining in recent years and remain near four-decade lows! Durable goods prices (e.g., new sticker auto prices) continue to chronically decline. Finally, the entire spectrum of consumer electronics represents a persistent deflationary force. In the 1970s, it was not so much rising oil prices, which shut down the recovery; rather, it was the rise in almost all other prices (including mortgage yields) as oil prices rose, which ultimately slowed or recessed the economy. Today’s oil price cycle is very different. It is a negative force for the economy, but probably a much milder negative than it has been historically.

Personal Consumption of ENERGY Goods & Services as a Percent of Disposable Personal Income



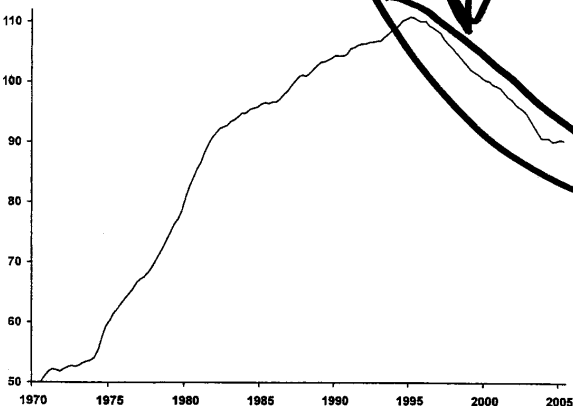
Still... A Far Lower Portion of Household Budgets...

Conventional New Home Fixed Mortgage Rate

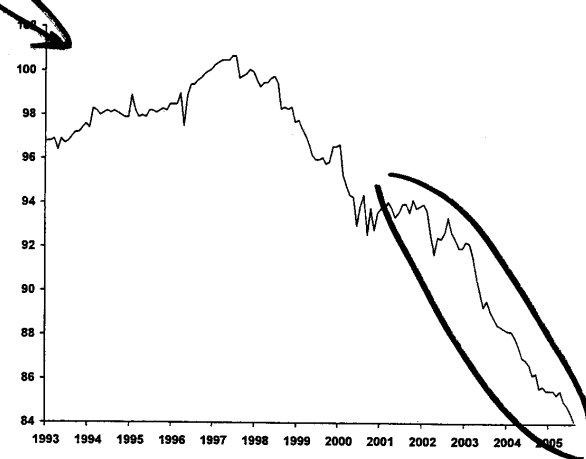


... And Enjoying Several Deflationary Offsets!!!

Price Index for Durable Goods Personal Consumption Expenditures



INFORMATION PROCESSING Consumer Price Index

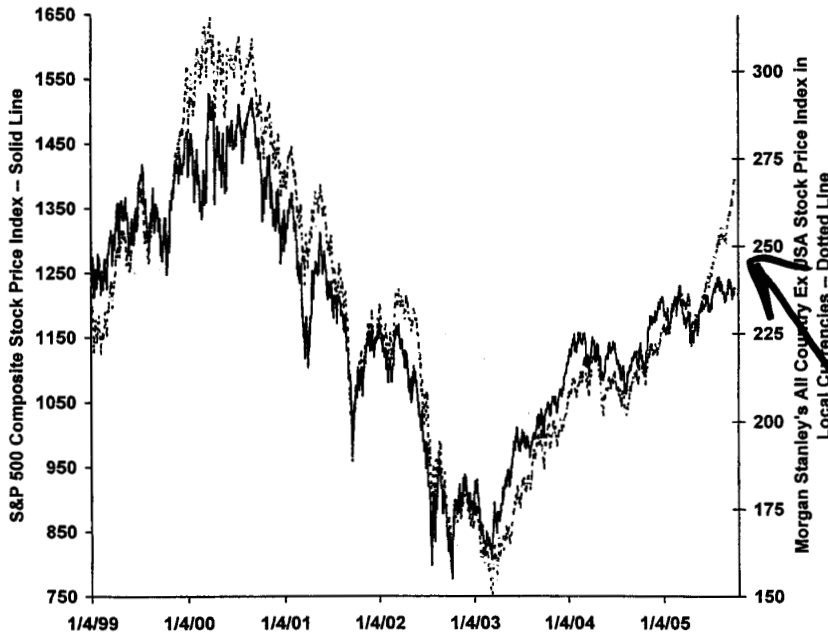


U.S. Stock Market is Global Laggard!?!?

Until very recently, the U.S. and global stock markets had been moving in tandem. Recently, the U.S. stock market has become the global laggard! We like that global stock markets are continuing to rise and we expect the U.S. stock market to eventually “catch up.” Katrina has been much more emo-

tionally disturbing for U.S. investors, whereas overseas markets have kept focused on the unfolding continued good economic fundamental story. As the United States moves further away from hurricane season, the positive fundamental undertow may take on more importance and hopefully allow the U.S. stock market to “catch up!!?”

USA Stock Market vs. Ex-USA Stock Market*



USA Stock Market vs. EX-USA Developed World Stock Market*

Solid – S&P 500 Composite Stock Price Index
 Dotted – Morgan Stanley's Developed World Ex-USA Stock Price Index (Local)
 *Note: MSCI Ex-USA is indexed equal to the S&P 500 on 1/2/2003.

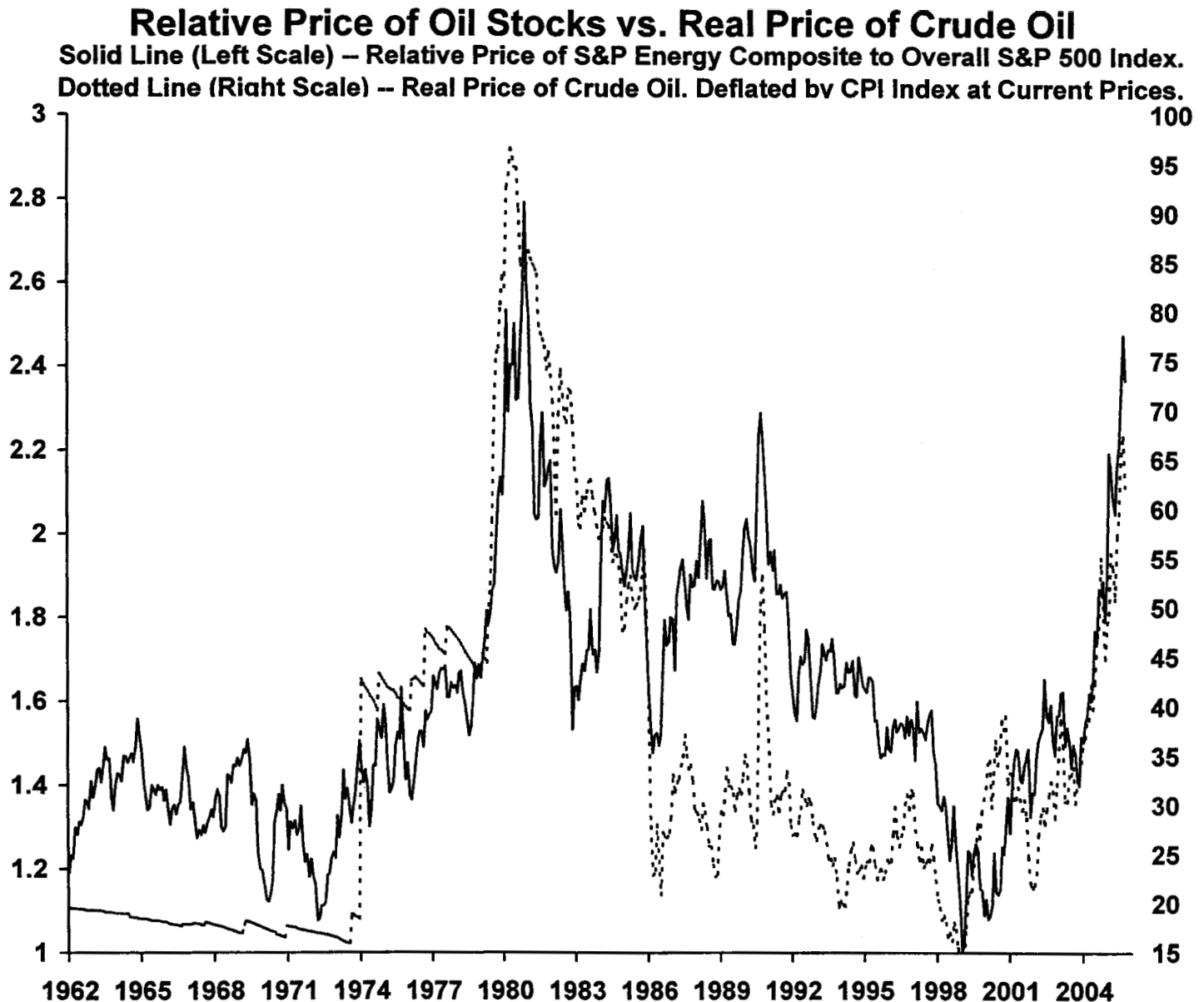


Will the U.S. Stock Market Soon Catch-up to Overseas Markets???

Oil...Secular Trend or "Bubblelicious"????

Why is it housing is always considered a bubble and oil is always portrayed as a fundamental supply shortage? This chart makes oil appear far more "bubblelicious." The solid line is the relative price of S&P 500 oil stocks and the dotted line is the real price of crude oil. In both cases, the rapid spike upward in real oil prices and relative oil stocks in the last year has less the character of a slow secular oil shortage than it does a feeling of "irrational exuberance." This hyperbola chart looks similar to tech stocks during the dot-com mania. We believe the price of crude oil is fundamentally based at around \$40, and thus believe speculation, political unrest and weather

has temporarily boosted crude oil prices by about \$20 to \$25. This chart gives us some confidence the price of oil is more likely to break below \$50 again rather than rise toward \$80. What goes up fast...? If crude oil prices do retrace some in the next few months, confidence in the consumer and in the economy will again improve. For those investors who are overweighted in energy stocks, do not delude yourself. You are not invested in oil stocks because they are a good value or because they pay a good dividend. Your oil stocks will trade lock-step with a barrel of crude oil. On a relative stock price basis, your oil stock bet is essentially a crude oil bet. And, at the moment, both bets appear highly speculative and risky.

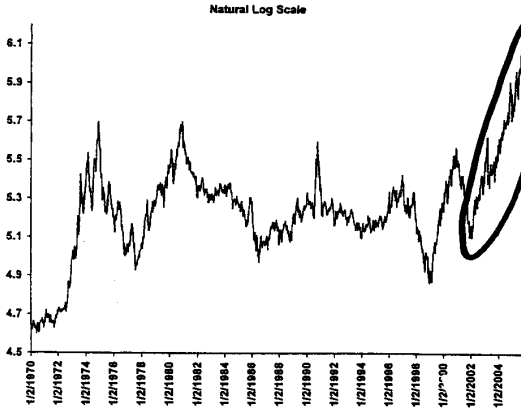


Inflationary Signs?!??

While core CPI has remained tame, we do believe inflationary pressures are evident in the system and still represent a risk. The annual rate of core CPI rose from about 1 percent in early 2004 to about 2.4 percent in early 2005 and has since fallen to 2 percent, calming fears. We think perhaps another "core" cycle is beginning. The JOC industrial commodity price index, which has very little energy exposure, has recently

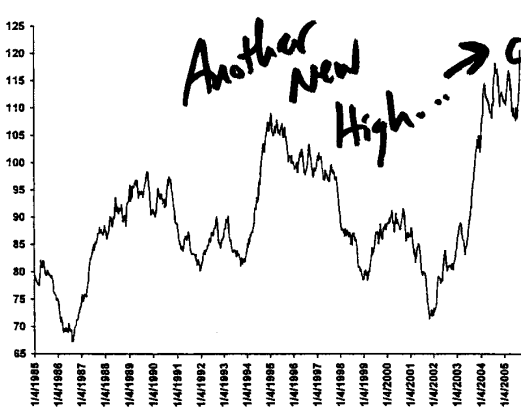
risen to new cycle highs. Goldman Sachs' non-energy commodity price index has also surged higher in the last month. Already the core crude goods producer price index has risen in each of the last two months. These pressures, just now emerging at the very low commodity price stage, may eventually feed through to producer and ultimately consumer prices sometime in 2006. Many of the indicators on this page suggest inflation risk may just be heating up?!?!

Goldman Sachs Commodity Price Index



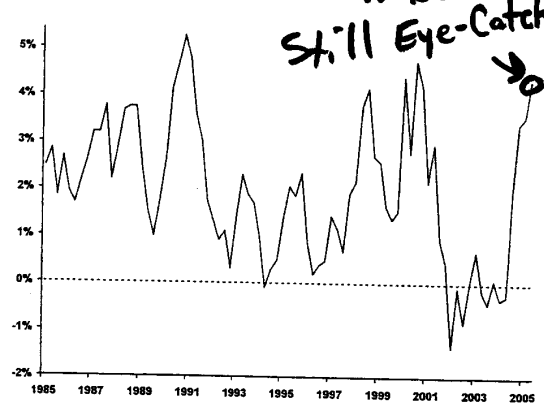
Biggest Recovery Cycle Surge Ever!!!

JOC Industrial Commodity Price Index



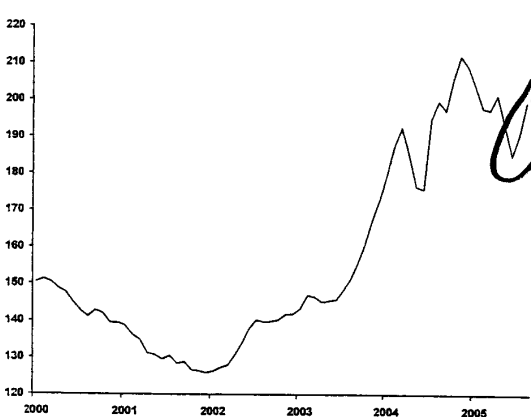
It's Not ALL Oil Prices Either!!!

Unit Labor Cost - Business Sector Annual Growth



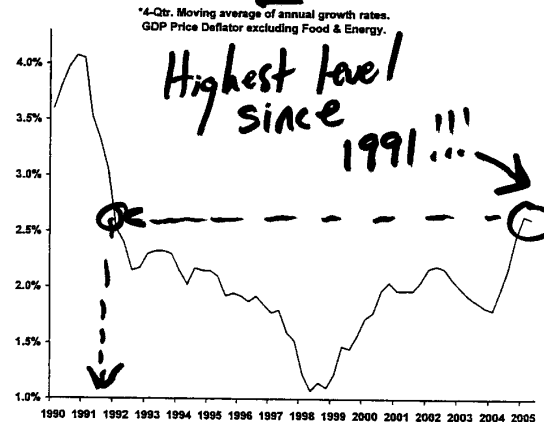
Perhaps Distorted... But Still Eye-Catching

CORE Crude Goods Producer Price Index



Restarting Another Core Pricing Cycle???

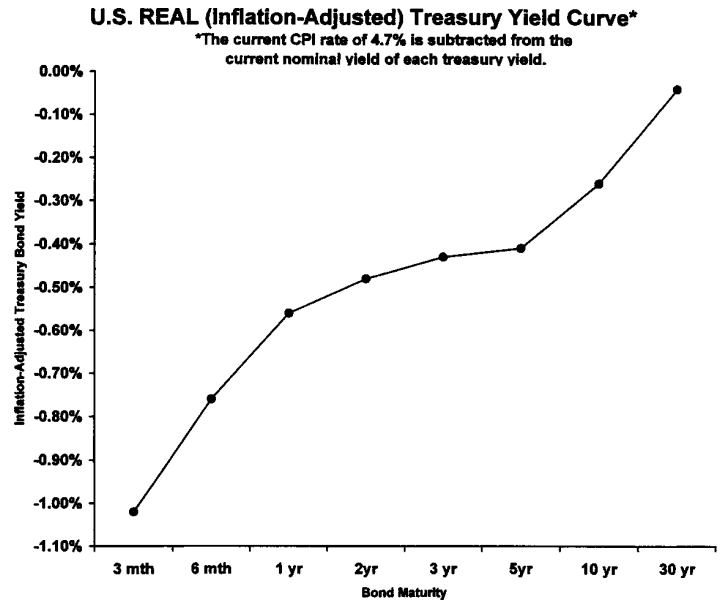
Annual Growth in the CORE GDP Price Deflator*



Highest level since 1991!!!

An "ALL-NEGATIVE" Yield Curve!?!?

Based on the latest CPI report, every yield along the Treasury curve is now "negative" after adjustment for inflation. This may prove a temporary phenomenon, but, nonetheless, is illustrative of just how low yields are in the current economy. For all of the angst surrounding the eventual impact of Fed tightenings, to have an entire yield curve with negative real yields hardly represents a contractionary monetary policy. Indeed, this chart implies the yield structure is still highly stimulative. Bond yields and the Fed may have much farther to go yet in raising yields???

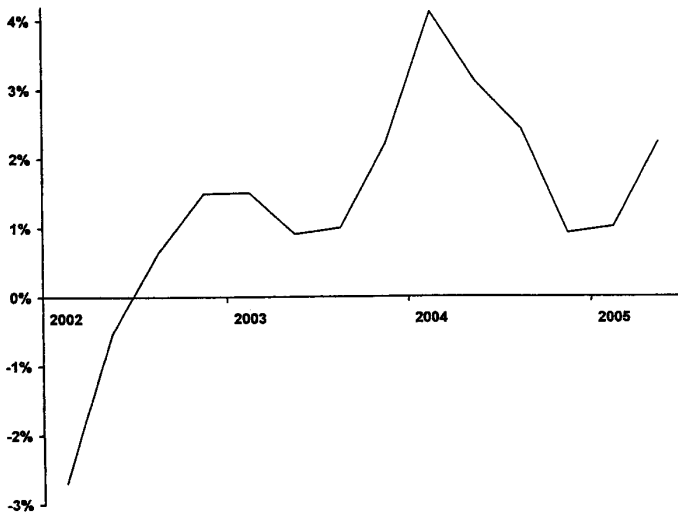


JAPAN is BACK!!!!

The dog of the 1990s is no longer a dog! Real GDP through the first half of 2005 was 4.6 percent—its fastest pace in 15 years. Most importantly, for the first time since 1991, Japanese growth is being driven by consumer and capital spending rather than by net exports and government spending. Has

Japan finally emerged from its prolonged funk? If a 15-year-long liquidation of the world's second largest economy is finally ending, it would speak volumes as to the robustness and sustainability of this global recovery!?!?

Japan Real GDP -- Annual Growth



By Lily Nonomiya

Sept. 12 (Bloomberg) -- Japan's economy grew at a 3.3 percent pace in the second quarter, triple the initial estimate, adding to investor confidence in the recovery after Prime Minister Junichiro Koizumi won a landslide election victory.

The estimate, released by the Cabinet Office today in Tokyo, compares with an Aug. 12 estimate for a 1.1 percent annualized pace of expansion. Spending by businesses increased 3.6 percent from the 2.2 percent initially estimated. Growth in the world's second-largest economy averaged 4.6 percent in the first half, the fastest in 15 years.

Sustained Growth

Capital expenditure accounted for about 50 percent of Japan's first-half expansion. Companies plan to keep spending for the rest of the year, according to the Bank of Japan's July Tankan survey. It showed manufacturers plan to increase spending 16.2 percent in the year ending March 31, 2006. The next survey is due Oct. 3.

It is the first time since 1991 that a recovery is being fueled by consumer and capital spending, not exports and government money. From the previous quarter, the economy expanded 0.8 percent. It grew 2.1 percent compared with the same quarter year ago.

Signs of Euro Recovery!???

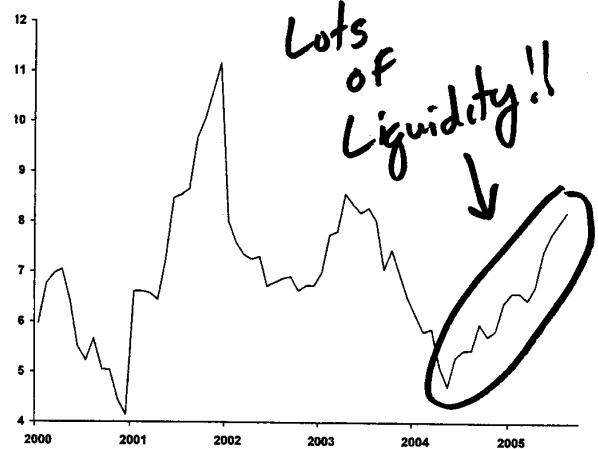
There are more and more signs the European economies are picking up speed. Economic policies suggest a better economy for 2006. In the last year, long-term bond yields have declined by about 1 percent to all-time record lows, the Eurozone money supply has accelerated, and the Euro currency has experienced its first period of weakness since 2001. Combined, these amount to a powerful package of policy stimulus, which should allow real GDP growth to surpass 2 percent again in the coming year. Already, economic sentiment indexes have been on the rise. In August, retail sales posted their strongest gain in 20 months and European manufacturing expanded at its fastest pace

in seven months! Moreover, the unemployment rate has been declining for the first time since this economic recovery began. Finally, most Euro stock markets have been rising solidly all year and are around 15 percent in local currency terms since year-end. How unfortunate for the U.S. economy that the one area of the globe where the U.S. dollar has weakened the most since 2002, has been the one area with the weakest economic growth. About 16 percent of the U.S. trade deficit is with Europe and it has not yet improved mostly because Euro-based economic growth has remained anemic. Imagine how much a stronger Europe could help lift the U.S. economy?!?!?

EUROZONE Economic Sentiment Index



Annual Growth in Eurozone M3 Money Supply



European Economies: Manufacturing Increases on Weaker Currency
Oct 3 2005 7:11

By Ben Sills
Oct. 3 (Bloomberg) -- European manufacturing expanded at its fastest pace in seven months in September as the euro's decline spurred exports, adding to signs that economic growth in the dozen nations sharing the euro is picking up.

New orders had their biggest increase since September 2004 and inventories declined for a ninth straight month, suggesting manufacturers may need to ramp up production.

Mfg Recovery

Retail Recovery

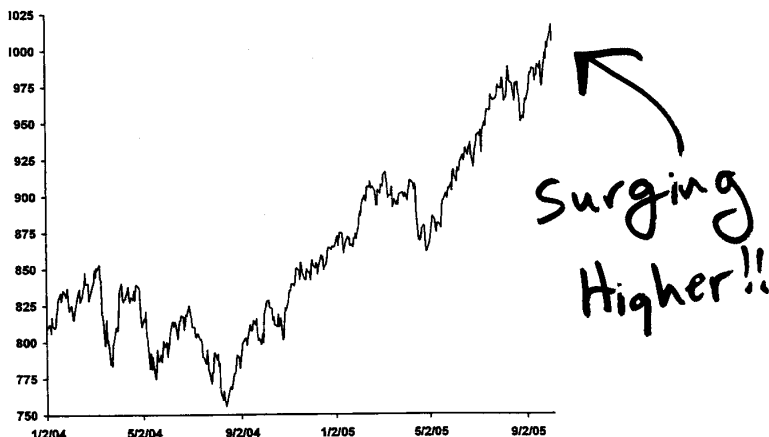
European Retail Sales Rise Most in at Least 20 Months
Sep 6 2005 6:49

(Adds German factory orders in fifth paragraph.)

By Ben Sills
Sept. 6 (Bloomberg) -- Retail sales in the dozen nations that share the euro rose the most in at least 20 months in August as retailers cut prices and unemployment declined.

August's number, the highest since the survey was introduced in January 2004, reinforced signs that euro-area economic growth may accelerate. The European Central Bank said Sept. 1 it expects growth to pick up in the second half. Unemployment fell to 8.6 percent in July, the lowest since February 2003, the European Union's statistics office said the same day.

MSCI EURO Stock Price Index



Eurozone Unemployment Rate

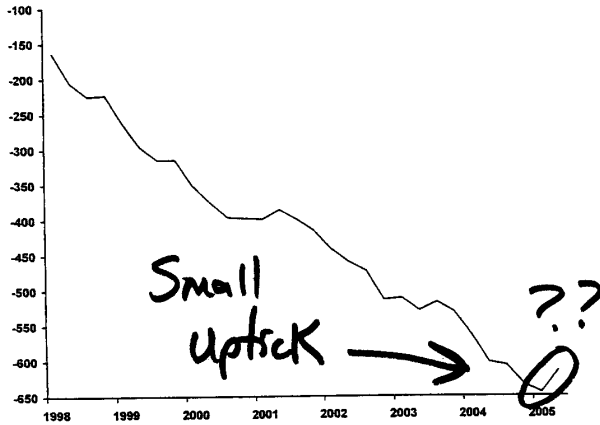


Is U.S. Trade Finally Turning???

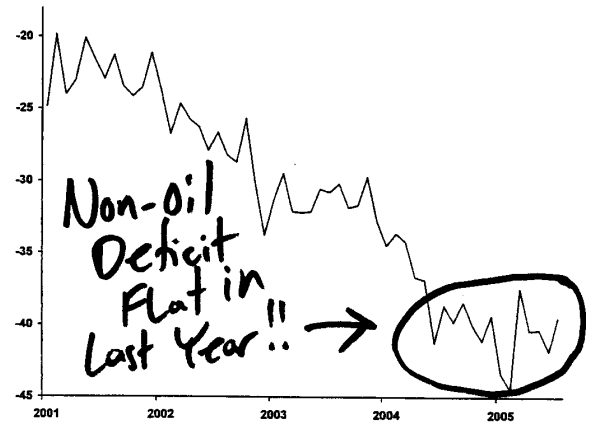
Increasingly, it appears the U.S. trade deficit may finally be improving. Overall, the trade deficit has improved marginally in recent months, but much greater improvement is noticeable in the non-energy deficit. The non-oil deficit has been flat for the last year. If oil prices do decline in the coming months, the overall trade numbers may improve rapidly. Other indicators shown on this page also suggest that trade is finally improving. The ratio of exports to imports has been flat in the last year. For the

first time in several years, annual export growth has caught up to annual import growth. In the second quarter real GDP report, imports did not subtract from growth, while exports added to growth for the first time since the early 1990s! Finally, in the last three months, the Institute for Supply Management's manufacturing survey suggests that export orders exceed import orders. We think the trade sector could "add to overall real GDP growth" in 2006 for the first time in many years!!!

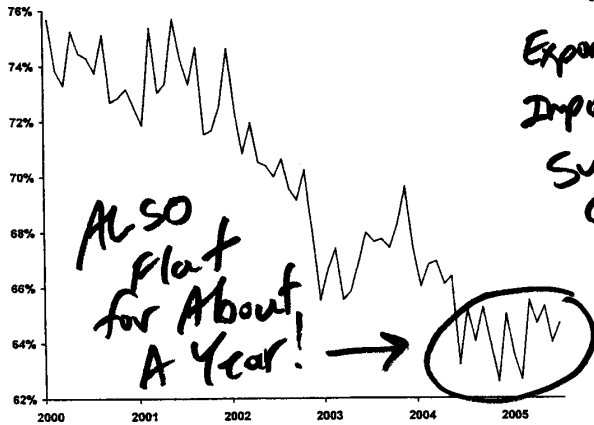
U.S. REAL Net Exports -- in 2000 Dollars



U.S. Trade Balance Excluding Petroleum

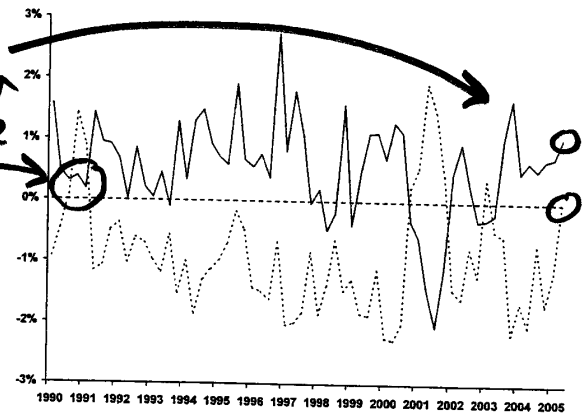


U.S. Exports as a Percent of U.S. Imports



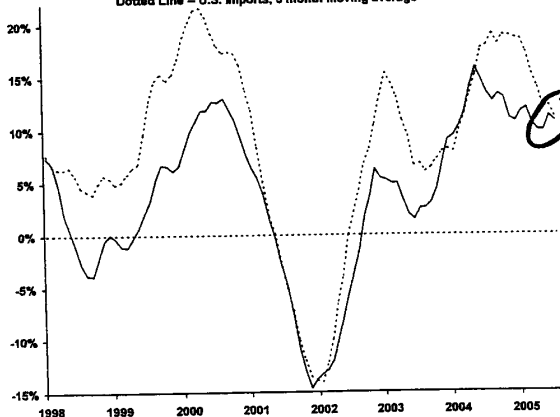
First Time... Exports Added & Imports Didn't Subtract from Growth since 1990!!!

Contribution To Quarterly Real GDP Growth Exports (Solid) and Imports (Dotted)



U.S. Exports & Imports -- Annual Growth

Solid Line -- U.S. Exports, 3 month moving average
Dotted Line -- U.S. Imports, 3 month moving average



Institute for Supply Management Manufacturing Survey -- Export & Import Orders

Solid Line -- Manufacturing Survey Export Orders, 3 month average
Dotted Line -- Manufacturing Survey Import Orders, 3 month average



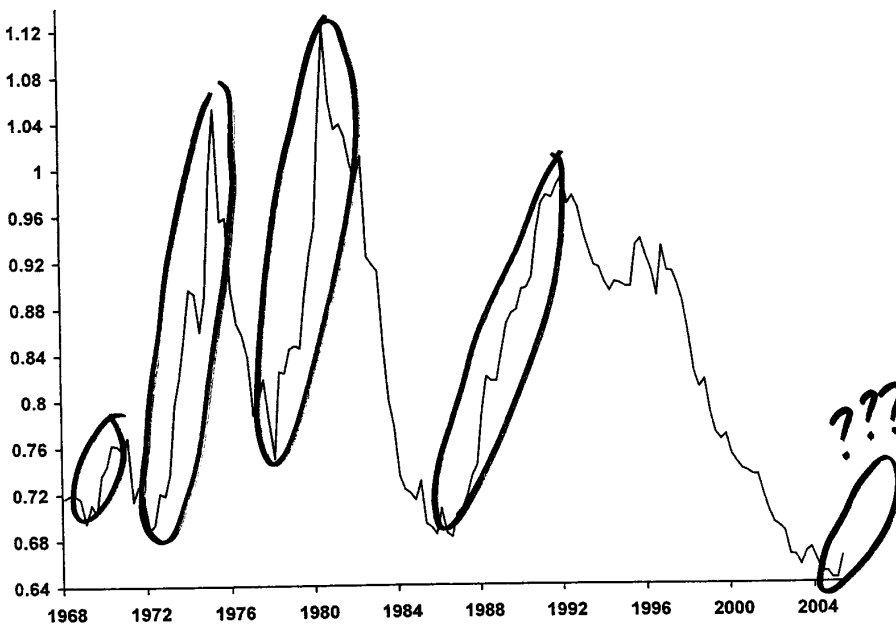
If Trade Improves...Inflation Will Likely Rise!?!

If the trade deficit does begin to improve in the coming year, much about the character of the economy will change. Perhaps the biggest change is that the economy will have a more inflationary undertone. The top chart shows the ratio of U.S. real exports divided by real imports. When this ratio rises, the trade deficit improves and when it declines the trade position worsens. This ratio is related to the annual core CPI rate in the lower chart. Since the late 1960s, whenever the United

States has experienced a period of trade improvement, the core inflation rate has risen. Indeed, the primary reason we believe inflation has remained dormant for so long is because trade has chronically worsened for so long. If the trade deficit improves, more demand will fall on the U.S. resource base, stretching an already low labor unemployment rate of only about 5 percent and a factory utilization rate of close to 80 percent. If trade flows turn more positive, inflation news will likely turn more negative!??

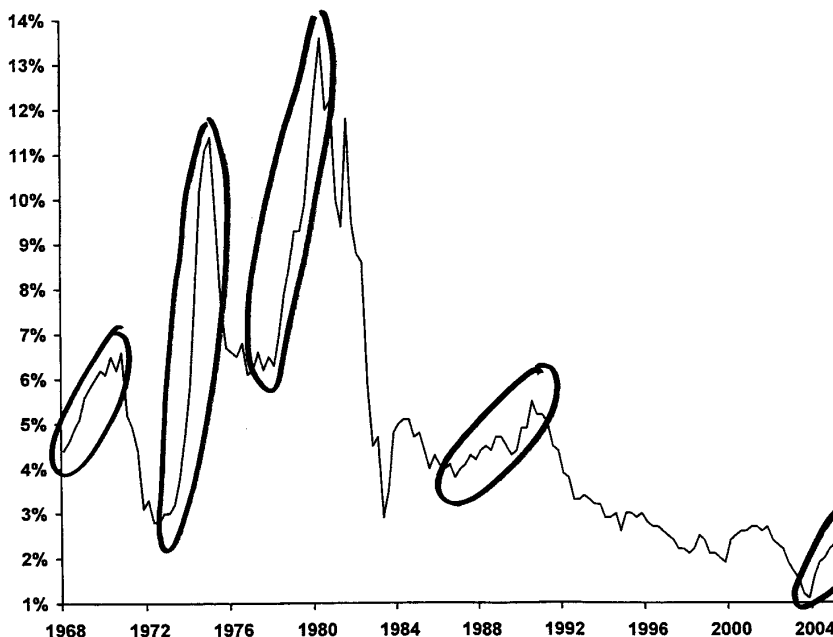
U.S. Trade Ratio*

*U.S. Real Exports divided by U.S. Real Imports



*Trade Improvement
Implies Greater
Demands on
Existing Capacity...*

Annual CORE Consumer Price Inflation Rate



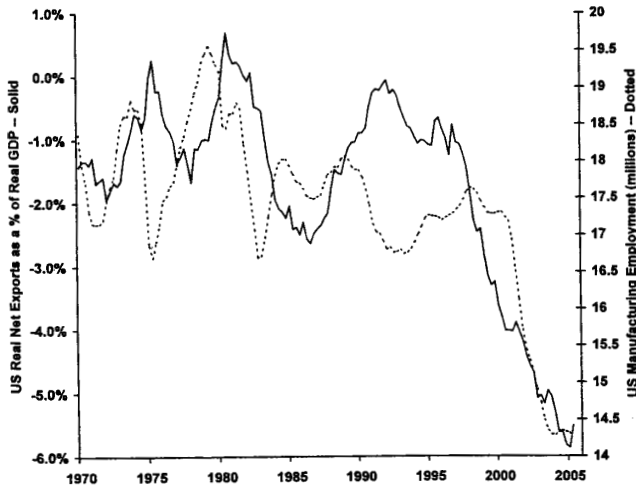
*... which tends
to worsen Core
Inflationary
Trends!!!*

If Trade Improves...MUCH Will Change!!!?

The unidirectional path of the U.S. trade deficit for much of the last decade has been responsible for much of the economy's character. If trade is about to change trends, many things in the economy will also change. In addition to inflationary pressures, this page highlights a few other potential changes. First, the biggest loser of a chronically worsening trade deficit has been the manufacturing sector and, particularly, manufacturing jobs. The top chart shows a close relationship between the trade deficit as a percentage of GDP and the level of manufacturing jobs. Should trade improve, so should the news on manufacturing jobs! The middle chart shows the median annualized growth in total U.S.

corporate profits has been noticeably stronger during the 60 quarters since 1960 when the trade balanced improved compared to the 102 quarters when the trade balance worsened. Even though corporate profits have been very strong in this recovery, perhaps they will stay much stronger for longer than most anticipate if the trade deficit improves? Finally, the lower chart suggests the Fed may have a hard time shutting down the recovery cycle. The rate of growth in the money supply velocity (the rate at which growth in the money supply is converted into nominal GDP growth) has traditionally been much stronger during periods of trade improvement compared to eras of trade worsening. Overall, if trade does begin to improve, anticipate a lot of unexpected outcomes in the economy and the financial markets!!!?

Trade Deficit vs. Manufacturing Jobs

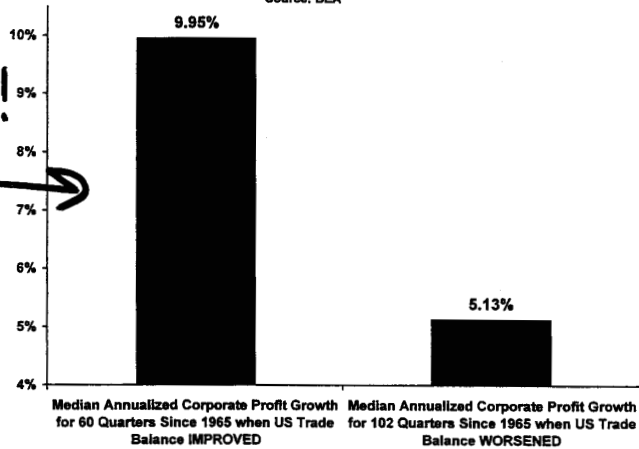


Mfg Jobs Should Improve!!!

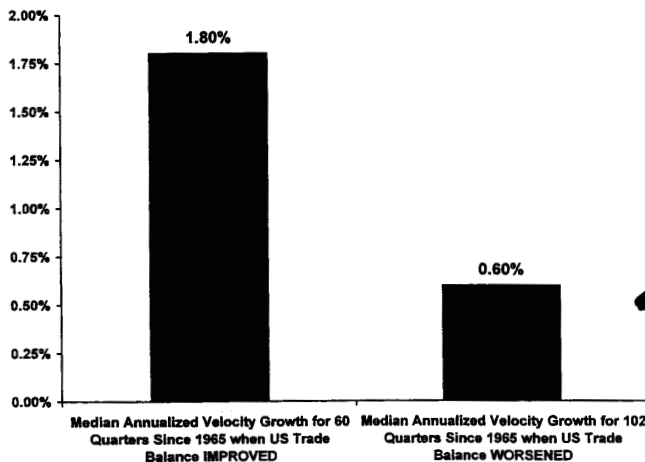
Profits May Stay Impressive!!!

Total U.S. Corporate Profit* Growth and the U.S. Trade Balance Since 1965

*Total U.S. Corporate Profits with IVA & CCA Adjustments
Source: BEA



M2 Money Supply - GDP Velocity Growth and the U.S. Trade Balance Since 1965

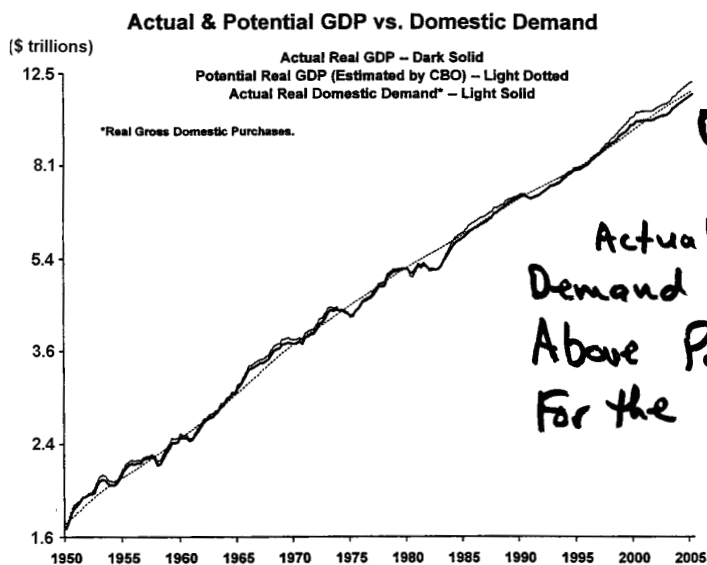


And... the Fed May Have Trouble Getting Inflation Under Control!?!

Potential GDP and U.S. Trade??!

This chart compares potential GDP (dotted line) with actual GDP (dark solid line) and actual domestic demand (light solid line). Actual GDP has been below potential GDP throughout this recovery and is perhaps why inflation has not yet risen much. However, actual domestic demand has been above potential GDP for much of the last decade. Why hasn't this

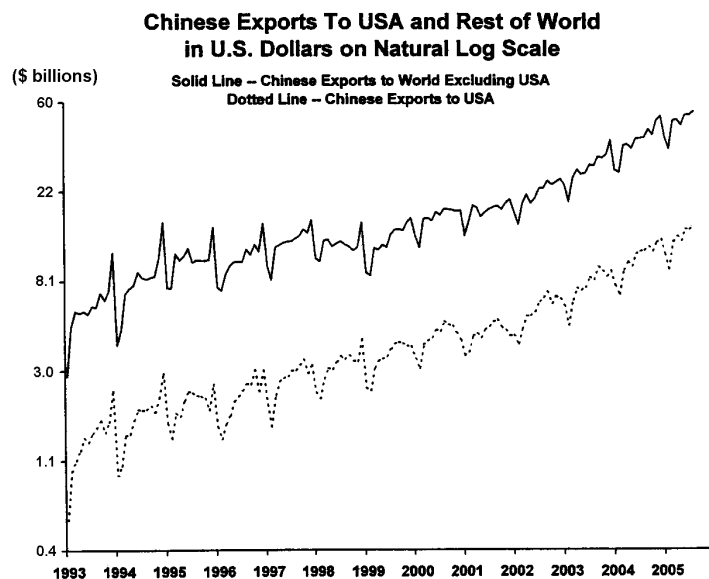
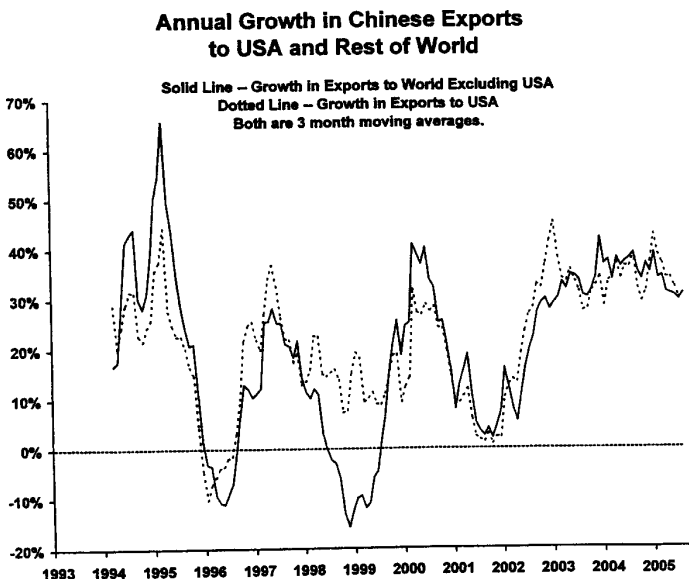
been inflationary? Because a large chunk (currently about 6 percent annually) has been leaked abroad via a worsening trade deficit. Why is this chart important now? If the trade deficit begins to improve, then actual GDP would tend to grow in line with or even faster than domestic demand, which has been chronically growing faster than potential GDP. Bottom line...trade improvement may rapidly cause actual GDP to surpass potential GDP aggravating inflationary pressures???



China Exports to Everyone!!!

The United States is often portrayed as the sole consumption engine driving the globe. In particular, it is often suggested the only reason China is growing is because of U.S. imports. While U.S. imports are certainly important to China, they are not the only source of growth. As illustrated, Chinese exports to both the United States and other countries have been grow-

ing equally strong between 30 percent and 40 percent since 2003. China is enjoying strong "non" USA demand as well as strong U.S. consumer demand. This simply illustrates that neither China nor the globe is as highly dependent on continued U.S. growth as is widely perceived!?!?

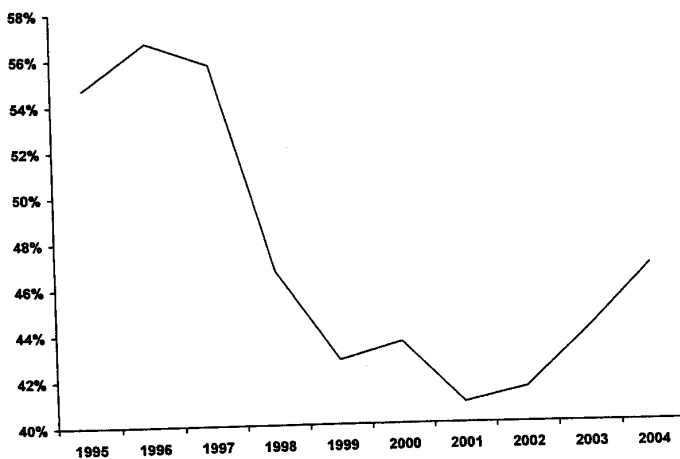


Developing World is...Developing!!!?

Back when the Berlin wall fell in the late 1980s and the globe began to open up economically, the hope was that someday the developing economies would advance into full-fledged consumer economies. While this is still a work in progress, as this page illustrates, it is already exciting to see how much previously called "third world countries" are contributing to the contemporary global recovery! There has not been another recovery in the postwar era when so many previously insignificant players (e.g., China, Pac Rim, India, Mexico) were

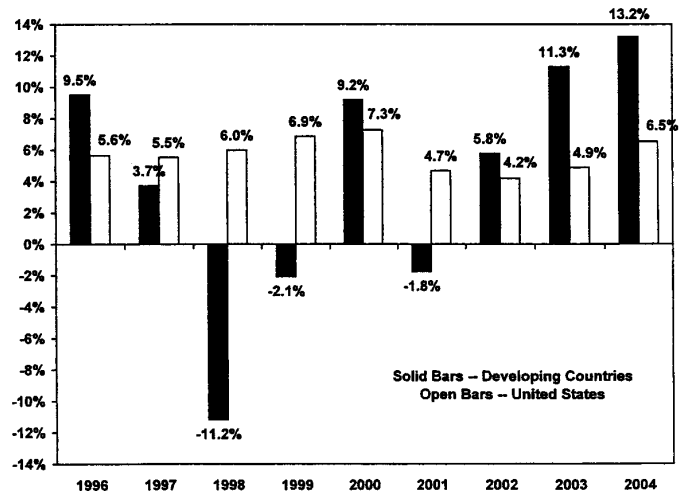
such a large part of the global recovery. Perhaps rather than worrying about whether the U.S. consumer is about to capitulate, the focus should be on just how far the world has come in diversifying contributions to economic growth. Because of the advancement in the role played by developing economies, perhaps a slowdown in the U.S. economy is not nearly as important as it once was to the overall global economy or financial markets???

**Total Consumption Expenditures -- in U.S. Dollars
Developing Economies as a Percent of United States**



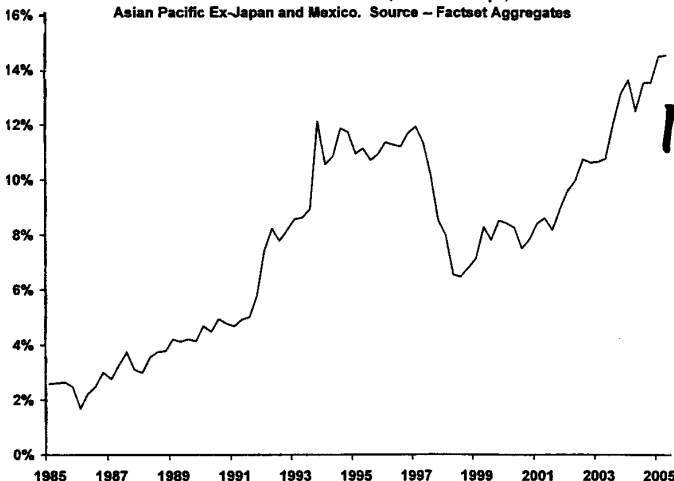
*Developing Country Consumers
Now Trump the U.S.
Consumer!!!*

**Annual Growth in Total Consumption -- U.S. Dollars
Developing Countries vs. United States**



**Developing Economies* as a Percent of
World Stock Market Capitalization**

* Includes Middle East & Africa, Eastern Europe, Asian Pacific Ex-Japan and Mexico. Source - Factset Aggregates



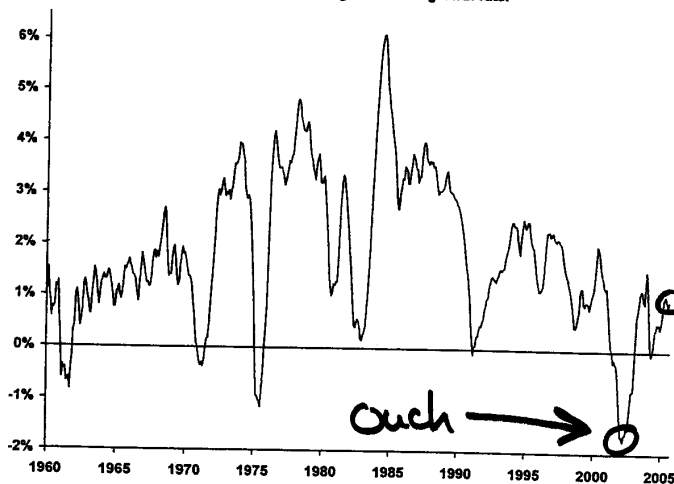
*Stock Markets
Also Reflect the
Growing trend of
Developing Economies!??*

"Meat Consumption" Job Market Remains Weak??!

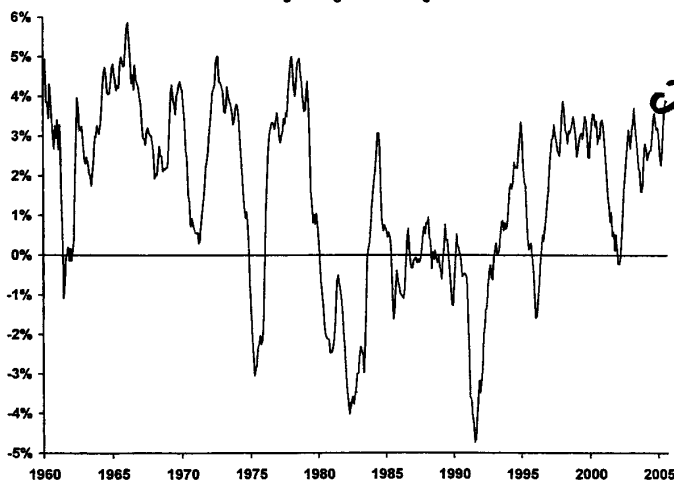
To the extent this job recovery cycle has been weaker than most, it has been the weakest among the "Meat" Consumption Year Workers. As these charts show, job growth among the 25-54-year-olds (age when consumption is the highest) fell by a record amount in the last recession and has thus far recovered by the weakest amount of any recovery since at least the early 1960s. By contrast, Tail worker (the young and old tails) job growth remained impressive throughout the

recession and since. Part of what is happening here is demographics. Demographic trends are simply slowing the growth of the middle (meat consumption) population. However, the other reason for this trend has to do with corporate mentalities. The strong cost-cutting mentality, which swept through the corporate culture in the 1990s, is contributing to greater reliance on less expensive tail workers to the detriment of typically higher paid meat workers. Demographic patterns suggest this trend will worsen even more for the next several years. Unless the emphasis on cost-cutting eases in the next few years, the "tail" may continue to wag the labor dog!?!?

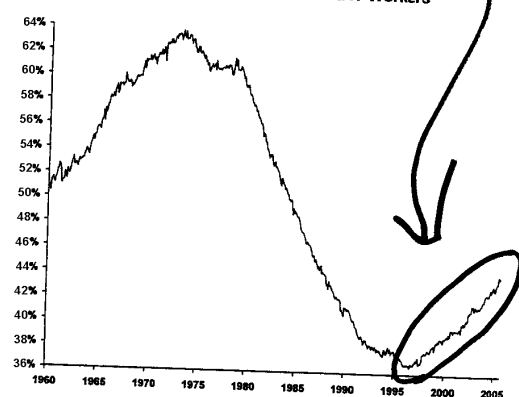
MEAT Consumption Year Workers
Annual Job Growth -- Age 25 to 54 Years*
*3-month moving average of annual growth rate.



TAIL (Low Spending) Workers
Annual Job Growth -- Below 25 & Above 54 Years*
*3-month moving average of annual growth rate.



TAIL Workers as a Percent of MEAT Workers



Written by
James W. Paulsen, Ph.D.
Phone: 612.667.5489

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