



MONTHLY MARKET OUTLOOK OCTOBER 2005

THE INVESTMENT ENVIRONMENT: WHAT KIND OF ENERGY "SHOCK?"

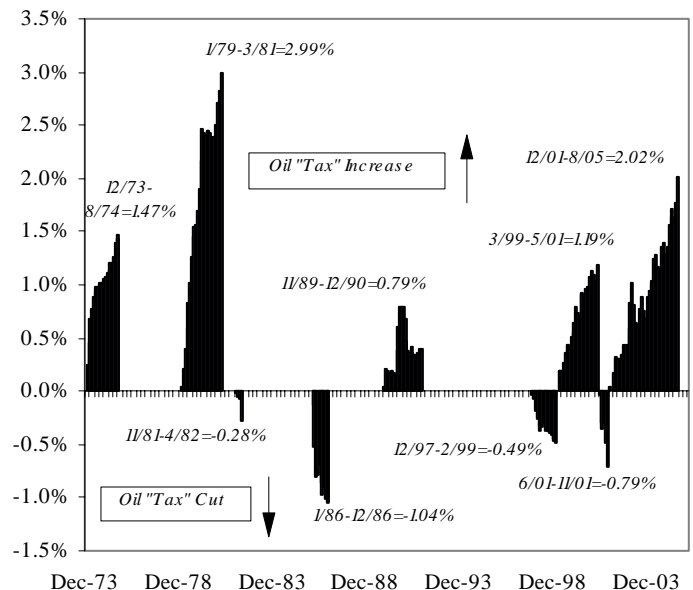
The economy has weathered the immediate impact of the energy and Gulf-Coast "shocks," but still faces a period of uncertainty in the months ahead. At issue is the ultimate effect of higher fuel costs and monetary tightening by the Federal Reserve on growth, inflation and investment performance. The importance to consumer spending of housing-related gains in net worth will be tested by a likely cooling of home sales and prices in coming months. The outlook for business "pricing power" also will provide a critical link between changes in interest rates and energy costs on the one hand, and economic and investment performance on the other. An inadequate pass-through of commodity and other costs as higher selling prices risks making those increases more "growth dampening" and bond "friendly." By contrast, a more complete pass-through by businesses risks the sort of inflation buildup feared by the Federal Reserve--aggravated, potentially, by a drift toward a "guns-and-butter" approach to fiscal policy and an energy-induced rise in the trade deficit that weighs on the dollar. Both would be more "unfriendly" to bonds than to stocks.

The Economy: So Far, So Good. Early post-hurricane returns, though mixed, show the economy largely resilient, thus far, to the devastation and to an associated rise in fuel and other commodity costs. Jobs and manufacturing output have been affected most, though even they appear to be holding up well after netting out the direct, local impact of the Gulf-Coast storms. For example, monthly job gains averaged a healthy 218,000 in the three months to September, after adjusting for the direct, hurricane-related loss of 200,000 jobs. Reports on manufacturing were mixed, with last month's decline in manufacturing output countered by a surprising jump in the purchasing managers' index of manufacturing to a thirteen-month high. Beyond consumer spending, manufacturing should get added support in coming months from double-digit growth in U.S. exports and, perhaps, from efforts to build inventories, which slipped from an already "lean" level relative to sales in August. Consumer confidence has been hurt materially by the run-up in fuel costs, though more of the weakness through early October centered on expectations than on current conditions. *Moreover, consumer spending continued to hold up reasonably well after the hurricane, adjusted for swings in volatile auto sales*

and hurricane-related distortions. One indication: a healthy gain last month in that component of retail sales, atop an equally impressive rise the month before.

However, the brunt of the latest energy "shock" may lie ahead. Household budgets, still digesting the recent jump in gasoline prices, soon will be hit by the second half of a "one-two" punch from rising heating oil and natural-gas costs with a seasonal increase in demand. As indicated in the chart below, all this is coming atop an energy "tax" that already was the second highest on record, before disruptions caused by this year's two Gulf-Coast storms.

A WORRISOME ENERGY "TAX" EVEN BEFORE THE STORMS
Price-Related Changes In Consumers' Energy Spending; % Of Income



Dec-73 Dec-78 Dec-83 Dec-88 Dec-93 Dec-98 Dec-03

Source: U.S. Commerce Dept

Moreover, housing is becoming increasingly vulnerable, despite a reasonably strong volume of mortgage applications for home purchases in recent weeks. Scattered reports of a pullback by lenders from more aggressive "option ARMs" and "interest-only" mortgages have been accompanied by a marked slowing in the growth of home-equity lines amid rising short-term interest rates. That may make the so-called "affordability" index—keyed to more traditional, fixed-rate lending and now at a fifteen-year low—a more reliable gauge of potential housing demand. Double-digit gains in new and existing home inventories could add to the impact of any cooling of demand in undercutting home-price

increases that have been central to gains in household wealth and consumer spending in recent years.

The hurricanes' impact is likely to be greatest on fourth-quarter growth, which is expected to slow to a 2%-2.5% rate from a healthy 3%-4% pace in the third period. The good news is that massive reconstruction and, perhaps, fuel-price declines, should boost growth noticeably by the spring or summer of next year. The wild card in the outlook is the interplay between rising fuel prices and interest rates. The more rapid tempo of energy-price increases in the past year has removed one of the cushions against the kind of debilitating increases in fuel costs that helped sink the economy during previous energy-price "spikes" in the 1970s and early 1980s. The threat to housing and to housing-related gains in net worth could remove another. *The loss of these two buffers may leave the economy as exposed to a supply-induced rise in fuel costs as it was in the 1970s and early 1980s, when surging oil prices were followed by recessions.*

Interest Rates And The Federal Reserve: A Fine Line? Interest rates resumed their rise after stumbling in the aftermath of the hurricanes. Increases have been led by yields on more policy-sensitive, shorter-intermediate securities, propelled by an eleventh straight increase in the Fed funds target rate (to 3¾%) at the September 20 FOMC meeting and by "hawkish" comments on the policy outlook by Federal Reserve officials. Investors have signed onto that view, judging from the Fed funds futures market. *The futures market was "priced" in mid-October for a 4% target rate after the November 1 FOMC, a reasonably good chance for a 4½% rate as early as the January 31 meeting and a growing possibility of a 4¾% peak later in 2006.*

Elsewhere, the interest-rate difference between the policy-sensitive yield on two-year Treasury notes and the Fed funds target rate is widening, again, amid signs of extended rate hikes by the Federal Reserve. However, the gap between the two still is "lean" for this stage of the rate cycle, leaving the yield on two-year Treasury notes vulnerable to more rapid increases if the Fed continues to tighten credit. The Fed's overriding goal of removing excess "liquidity" built up during the period of aggressive "easing" in 2001-03, through "rapid-fire" interest-rate hikes, has been reinforced by "upstream" inflation pressures centered around commodity prices and extending to certain intermediate goods and tightening labor markets. *In fact, prospects for strengthening growth through much of 2006 could encourage the Fed to extend its rate hikes longer and push the Fed funds*

How Great A Threat From Inflation?

Central to the economic and interest-rate outlook is the future direction of inflation. Much of the price pressure, thus far, has been on commodities and on semi-processed materials. "Downstream" pressures on finished-goods prices have "percolated," particularly in energy-sensitive transportation costs, but generally have been more subdued. Second-quarter selling prices for all non-financial corporations posted their smallest increase in 2½ years. Rolling, three-month increases in "core" CPI inflation have averaged less than 1½% recently, down a full percentage point from the average during late 2004 and early 2005. A similar slowdown has been even more pronounced for wholesale, or producer prices for finished goods.

Among the reasons for subdued inflation: intense foreign competition, reflected in declining prices for an array of manufactured goods imports to the U.S. Moreover, less prevalent cost-of-living adjustments in the labor market are preventing the kind of pass-through of energy-led increases in overall inflation to wages that occurred during previous energy shocks. Bond investors apparently share the more sanguine view of the inflation outlook, judging from the fairly steady "breakeven" inflation rate for 10-year, inflation-protected securities, defined as the difference between the yield on those securities and that on a conventional, 10-year Treasury note.

A loose link between commodity prices and downstream inflation risks a replay of 1994, when the Fed chased soaring materials costs with aggressive rate hikes to guard against a buildup of price pressures that never developed fully. If so, then the Fed's interest-rate increases in this cycle could turn out to be a high-stakes gamble that risks a recession, by aggravating the debilitating effects of rising energy costs.

target rate to a higher level than it would have in the absence of the hurricanes' economic impact.

Bond yields rebounded to a two-month high during the early part of October, though some of the sell-off simply may have been a reaction to excessive yield declines in the wake of the two Gulf hurricanes. "Lean" yields compared to inflation are one indication that bond prices still are fairly "rich" and vulnerable to further declines. However, future yield increases should be limited by signs of a restrained rise in core inflation. The ever-present threat to bond yields from the "twin deficits" should be contained through 2006, as well. *The president's "guns and butter" approach to fiscal policy is more of a longer-term threat than a problem for next year, when the deficit should remain manageable for the financial market despite prospects for an unusual, mid-expansion widening. Moreover, the threat to the dollar and to U.S. interest rates from an oil-induced*

rise in the trade deficit should be contained by a continued influx of foreign private capital to the U.S., keyed to relatively high interest rates and to attractive returns on other investments.

Investors are bracing for a more inflation-prone economy in the coming year that threatens to send interest rates higher and to sink the bond market.

THE STOCK MARKET: HALF FULL OR HALF EMPTY?

Shrugging Off The Storms, The Fed...And The Calendar. Stocks retraced most of August's decline last month, with the S&P 500's moderate gain lifting the benchmark to its best quarterly showing since the powerful rally late last year. A setback during the first half of October wiped out that gain, however, leaving the benchmark in the "red" on the year. *Still, September's rally--in the face of rising fuel costs, rate increases by the Fed and devastating storms--was all the more impressive during a month in which the S&P 500 typically has fallen since 1960.*

EQUITY SCORECARD

Total Returns, In Percent

	Sep '05	3 Mos. To Sep	Yr-To-Date Sep	2004
S&P 500	0.8	3.6	2.8	10.9
Russell 1000	0.9	4.1	4.0	11.4
Russell 1000 Growth	0.5	4.0	2.2	6.3
Russell 1000 Value	1.4	3.9	5.7	16.5
Russell Mid-Cap	1.3	5.9	10.1	20.2
Russell Mid-Cap Growth	1.3	6.6	8.4	15.5
Russell Mid-Cap Value	1.4	5.4	11.2	23.7
Russell 2000	0.3	4.7	3.4	18.3
Russell 2000 Growth	0.8	6.3	2.5	14.3
Russell 2000 Value	-0.2	3.1	4.0	22.3
MSCI EAFE (\$ Terms)	4.5	10.4	9.1	20.2
(Loc. Curr. Terms)	6.2	11.4	20.4	12.7

Sources: S&P; Frank Russell Co.; MSCI

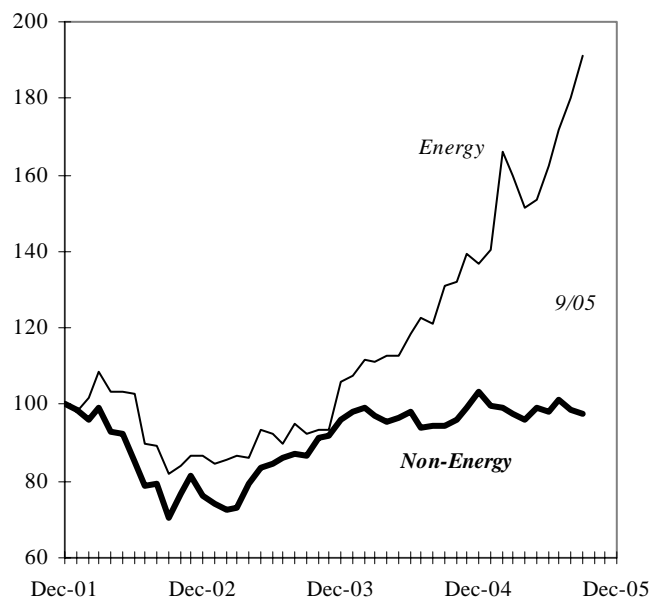
On balance, stock-market performance through September was keyed more to a reasonably strong economy than to the debilitating effects of rising fuel costs, similar to the pattern during past oil-price spikes. Seven of the S&P 500's ten broad sector groups did post gains during the period. *However, energy stocks led the way by a large margin in last month's performance rankings, pointing up the sector's extraordinary leadership role since oil prices bottomed out at the end of 2001.* (See the chart at right.) Overall, however, the rankings were mixed in September through mid-October between high "beta"

Much like the last major interest-rate "up cycle" in 1999-2000, however, increases in longer-term yields could be contained by surprisingly subdued price pressures that are reinforced by the Fed's enhanced inflation-fighting credentials associated with hikes in short-term interest rates.

tech and "cyclicals" vs. the more "defensive" sectors of the market, reflecting cross currents from economic strength and worries over the effect of rising fuel costs and interest rates.

Elsewhere, leadership has continued to see-saw between the "growth" and "value" styles of investing right through early October. The Russell 1000 Value's lead over its Growth counterpart in September was reversed during first half of October, though it still maintained a year-to-date performance advantage of about 1¾ percentage points. *Growth out-performed Value in six of the eleven, identifiable sectors making up the two Russell 1000 benchmarks during the third quarter, allowing it to edge past Value despite oil's larger weighting in the Value index.* (See the Equity Scorecard table at left.)

A SIDeways MOVE BY S&P 500 STOCKS IN RECENT YEARS, OUTSIDE THE ENERGY SECTOR (INDEX: 12/01=100)

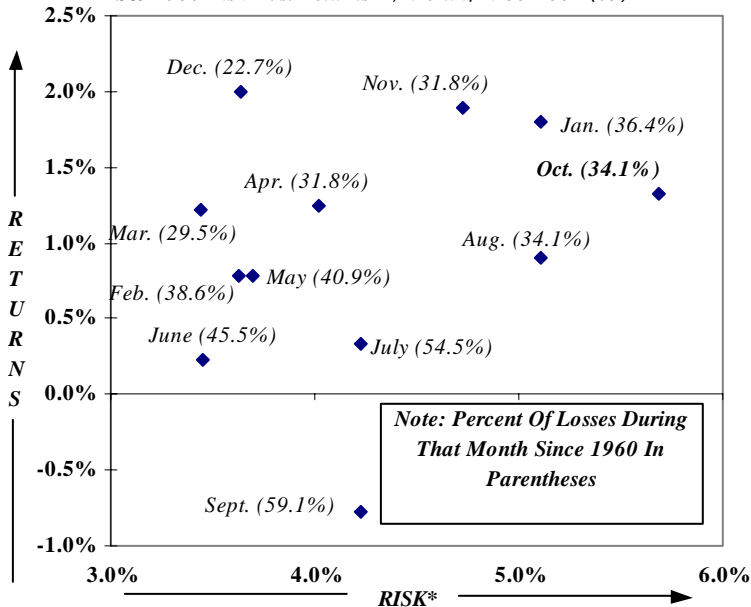


The Russell 2000 small-cap benchmark lagged the mid- and large-cap segments of the market for a second straight month in September and through the first half of this month. However, it did out-perform the Russell 200 Index of large caps for the third quarter as a whole. *Mid-caps remain the best performing of the three broad groups, despite the loss of much of the year's impressive gain during the*

early part of October. International stocks extended their strong rally for a fifth straight month in September, posting healthy gains both in dollars and in local currencies before suffering broad-based declines during the first half of this month. The September rally was led by the Japanese market and, to a lesser extent, Europe, amid signs of improvement in both economies and, in the case of Japan, by prospects for structural reforms in the wake of Prime Minister Koizumi's election victory.

What A Difference A Year Makes! The fourth quarter is shaping up as a different one from a year ago. Back then, a powerful rally, propelled by a combination of falling oil prices, a weaker dollar, remarkably steady interest rates and optimism after the president's clear-cut victory, turned a lackluster, 1.5% gain through the first nine months of the year into a double-digit return for 2005 as a whole. *This year's "wall of worry," associated with the threats to economic growth and the specter of higher interest rates, stand in the way of the sort of spectacular gains recorded during the closing months of 2004.* The calendar may not help much, either, at least for now. As indicated in the chart below, October returns historically have been healthy, on average, but market volatility has tended to be higher than in any other month of the year. That point was underscored by the decline during the first half of this month.

OCTOBER A VOLATILE TIME OF THE YEAR FOR STOCKS
S&P 500 Risk Vs. Returns By Month, 1960-2004 (%)*



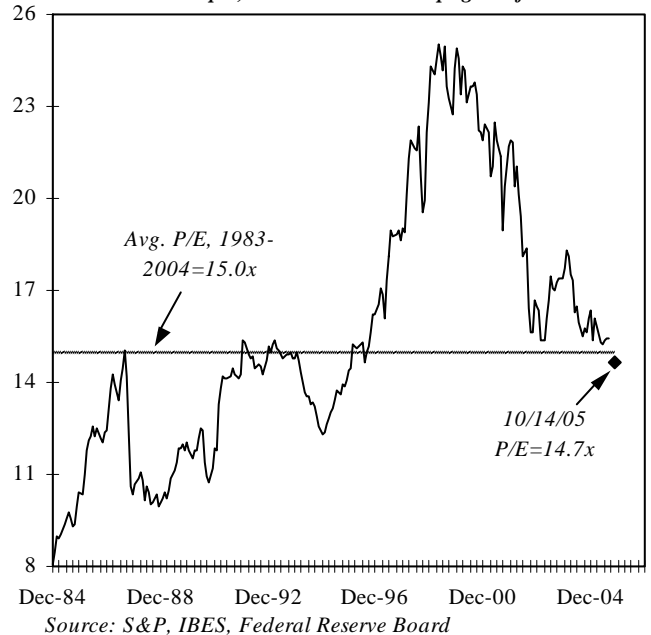
* As measured by the standard deviation of year-to-year returns.

The good news is that the "fundamentals" shaping overall market performance remain intact. Third-quarter earnings are expected to be up a healthy 15% from the same period last year, according to the First Call consensus, or a still-respectable 10%-11% excluding a projected surge of more than 70% in the

energy sector. The consensus estimate puts profits in the S&P 500's non-energy sector up at a double-digit pace through this year's fourth quarter, before slowing to the upper single digits during the early months of next year.

Moreover, strong profits growth and the market's "flat" performance this year have made valuations increasingly attractive. *The chart, below, shows that the S&P 500 forward price-earnings (or P/E) multiple is down to a nine-year low and less than its long-term average.* That decline in the P/E multiple has kept stocks unusually "cheap" compared to bonds, despite the bond market's sell-off associated with the rise in long-term interest rates. Moreover, next year's earnings growth could be stronger than expected, if the economy responds well to stepped-up reconstruction-related spending and to a possible decline in energy costs.

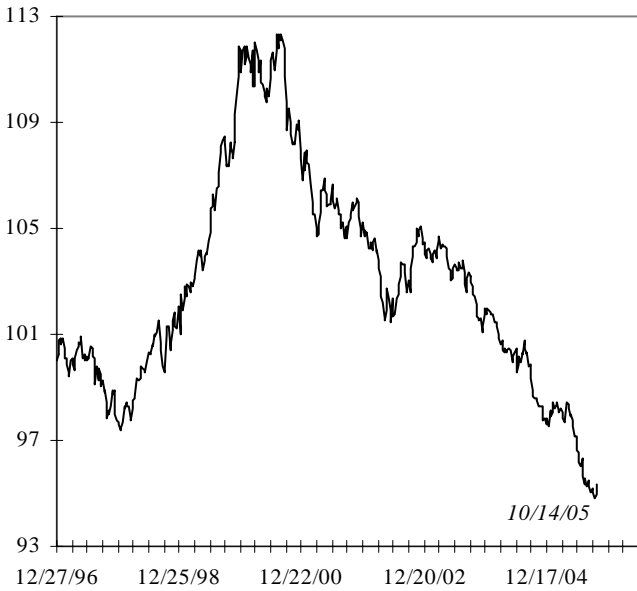
A NINE-YEAR LOW FOR THE S&P 500 P/E MULTIPLE
Forward P/E Multiple, Based On 12-Mo. Opng. Profits Forecast



A Starring Role, Again, For "Mega Cap" Stocks?

Little has been heard of the "mega cap" segment of the stock market since the "bust" five years ago. Once the darlings of the S&P 500, the largest of the large-cap stocks were hit hardest by the sell-off and lagged the market during the subsequent recovery. *As indicated in the chart on the next page, the ratio of the S&P 100 "super cap" index to the S&P 500 has fallen more than 15% from its most recent peak in August 2000. That has left the super-caps "cheaper" against the S&P 500 now than they were prior to the late 1990s "boom" in the stock market.* However, the table on the right side of the next page shows that the largest of the large caps have more going for them

ARE "MEGA CAPS" POISED TO OUT-PERFORM SMALLER S&P 500 STOCKS? (INDEX RATIO, S&P 100/ S&P 500: 12/31/96=100)



Source: Standard & Poors, Inc.

than just attractive valuations. The group could become even more attractive if investor worries over the interest-rate and economic growth outlook encourage more of a shift toward quality. *The table*

	Top 25 "Mega Caps"	Top 50 "Super Caps"	Top 100 "Super Caps"	Smallest 400 Cos.
Forward P/E	15.7	15.6	15.6	16.2
Vs. 5-Yr. Avg.	66%	71%	74%	79%
Dividend Yield	2.0%	1.8%	1.6%	1.2%
% Chg Earnings*	14%	15%	17%	15%
5-Yr. Avg. Growth	12%	12%	12%	10%
L.T. Debt % Capital	22%	27%	28%	28%
ROE	23%	22%	20%	16%
Vs. 5-Yr. Avg.	117%	112%	106%	105%
Profit Margin	14%	15%	12%	9%

Source: Baseline, Inc.

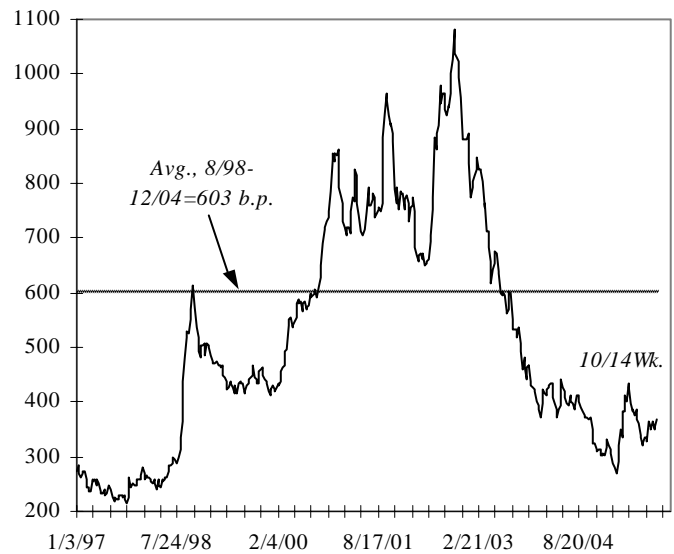
shows that median dividend yield, profit margin and ROE for the largest of the large caps currently is higher, and long-term debt as a percent of capital is lower, than it is for the smallest 400 S&P 500 companies. Mega caps may not provide the kind of explosive returns that they did during the late 1990s "boom," but their "liquidity" and relatively strong "fundamentals" could make them more resilient to any turbulence in coming months associated with rising interest rates and higher fuel costs.

THE BOND MARKET: SPOOKED BY RISING OIL PRICES

A Different Kind Of Oil "Shock." The Lehman Aggregate Index suffered its second decline in the past three months during September, leaving the benchmark for investment-grade, taxable bonds with a loss for the third quarter as a whole. *The bond market's sell-off extended through mid-October, amid inflation worries and hawkish comments by Fed officials. That left the Aggregate Index with a cumulative return of less than 1¼%, on track for its weakest performance since 1999.*

Quality is becoming increasingly important to investors, as concern over rising fuel costs, credit tightening by the Federal Reserve and hurricane-related disruptions begin to nudge up the risk premium on lower-rated issues. *Still, "quality spreads" between lower and higher-rated securities remain narrow by historic standards, a point underscored by the relatively small yield premium on non-investment-grade bonds, illustrated in the chart at right. That leaves lower-quality bonds vulnerable to bad news on the economy or on interest rates in coming months.*

HIGH-YIELD INTEREST SPREADS STILL QUITE "LEAN" COMPARED TO TREASURYS (BASIS-POINT SPREADS)



Source: Merrill Lynch, Inc.

Higher-quality and shorter "duration" asset-backed securities have been among the best-performing sectors of the Lehman Aggregate universe since the start of the third quarter, benefiting from their relatively high quality and low price sensitivity to rising interest rates. Mortgage-backed securities have been cushioned during the period, too, by reduced "refinancing" activity and associated "pre-payment

risk” as interest rates moved higher. (See the Bond Market Scorecard table below.)

Corporate bonds have suffered most since mid-year from investors’ tilt toward quality, with utilities’ bucking the relatively strong performance in the stock market by leading the way lower through September. Long-term Treasury bonds were hit even harder during the July-September period, though their sizable, 3.9% drop still left them with a respectable, year-to-date return of nearly 5.3% through mid-October. Elsewhere, a strong start to the third quarter allowed high-yield securities to post a gain for the period as a whole, despite a second straight monthly decline in September (that picked up speed during the first half of October). *Recent declines in the high-yield sector have been spurred by worries over the effect of rising fuel costs and higher interest rates on asset quality.* The sell-off in the bond market’s non investment-grade sector since the end of July has left its year-to-date return below that of the Lehman Aggregate, after running ahead of that benchmark during most of 2005.

BOND MARKET SCORECARD

	Total Returns, In Percent			
	3 Mos. To		Yr-To-Date	
	Sep '05	Sep	Sep	2004
Leh'm Aggregate	-1.0	-0.7	1.8	4.3
Treasurys	-1.3	-1.1	2.0	3.5
Agencys	-0.8	-0.5	1.8	3.3
Mortgage-Bkds.	-0.5	-0.2	2.0	4.7
U.S. Credit	-1.5	-1.0	1.5	5.2
Asset-Bkds.	-0.5	-0.1	1.5	3.0
Municipals	-0.7	-0.1	2.8	4.5
High-Yield	-1.0	0.9	2.0	11.1
Non-U.S. Gov'ts*	-0.1	0.3	4.8	5.2

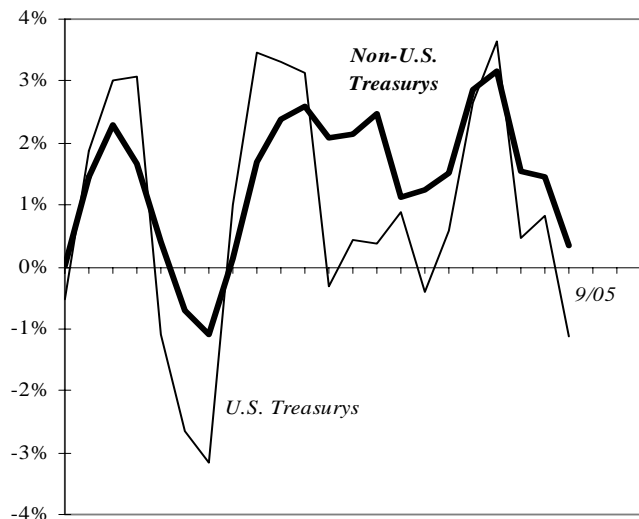
* Denominated in dollars, fully hedged.

Sources: Lehman Bros., Citigroup, Inc.

Municipal bonds also out-performed the taxable, investment-grade sector through September and during the first half of October. *Tax-exempt issues are benefiting both from light supply and from fairly broad-based demand that has extended to hard-pressed property and casualty insurers facing a jump in hurricane-related claims.* Non-U.S. Treasury issues also out-performed the U.S. sector last month and during the third quarter as a whole, despite a relatively modest, September decline that was cushioned by gains in Continental Europe. As indicated in the chart above right, in fact, U.S. Treasurys have out-performed non-U.S. Treasurys only once in the past eleven months on a rolling

three-month basis. The group’s 4.3% return was more than 2¾ percentage points higher than that of U.S. Treasurys through mid-October.

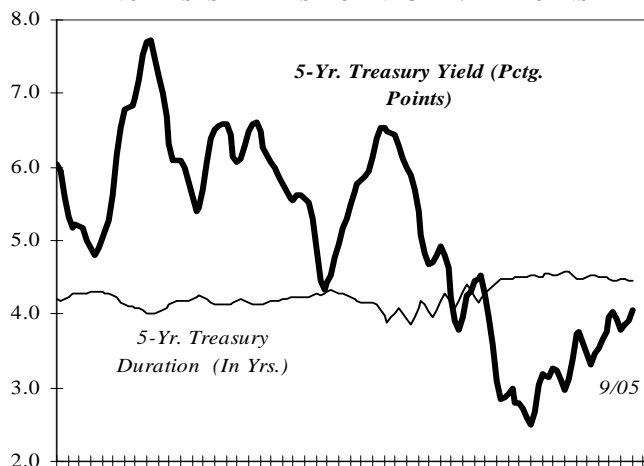
NON-U.S. TREASURY SECURITIES LEAD THE WAY
Rolling 3-Mo. Returns, Hedged For Exchange-Rate Changes, In %



Sources: Lehman Bros., Inc; Citigroup, Inc.

A Potentially Challenging Fourth Quarter. Rising long-term interest rates and the bond market’s setback through the closing weeks of the third quarter and into October were like a warning shot for investors planning strategy for the closing months of the year. *Inflation worries, stoked by the Fed’s “hawkishness” on the outlook, have raised the stakes for investors positioning for lower yields by tilting toward long-term securities.* Adding to that risk, at these historically low interest rates, is the thin yield cushion against bond-price declines associated with rising rates. Note in the chart, below, for example, that, despite recent interest-rate increases, the yield on five-year Treasury notes remains below its “duration,” or the percent change in its price for a one percentage-point change in interest rates.

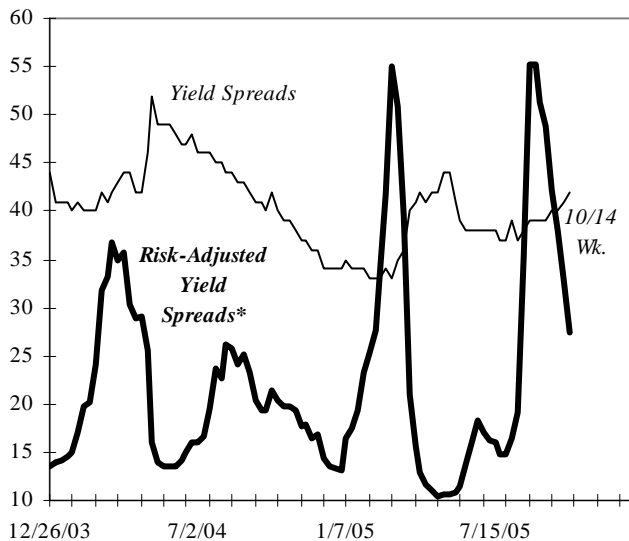
A LOW YIELD “CUSHION” AGAINST PRICE DECLINES
INCREASES THE RISK OF NEGATIVE RETURNS



Source: Merrill Lynch, Inc.

Some investors may be lured to potential gains on longer-term bonds by the chance that rates could move unexpectedly lower. With inflation still subdued at the finished goods level and the economy facing “head winds” from rising fuel costs and credit tightening by the Federal Reserve, there is the possibility of an unexpectedly limited rise or, perhaps, a decline in bond yields if the economy falters, that would allow these long-term securities to lead performance. Still, heightened bond volatility already has sent risk-adjusted yield premiums down materially since early September, despite an increase in nominal yield differences. (See the chart below.)

RISK-ADJUSTED YIELD SPREADS LOWER DUE TO HEIGHTENED BOND VOLATILITY (YIELD SPREADS,* IN BASIS POINTS)



* Against comparable Treasuries for the Domestic Master Index; risk adjusted returns based on returns adjusted for their standard deviation. Source: Merrill Lynch, Inc.

Effective positioning of two other “engines” of fixed-income performance—sector and “yield-curve” strategy—seemingly is more clear-cut by comparison. A likely combination of slowing growth and credit tightening could reinforce the shift toward higher-quality issues in the bond market. *And despite uncertainties about the future direction of longer-term interest rates, odds still favor a further “flattening,” and, perhaps, “inversion” of the Treasury yield curve (i.e., the path traced by interest rates at various maturities).* That pattern of rate changes in the past year has allowed investors to boost returns through a so-called “barbell” approach that splits investments between short- and long-term securities to achieve a given maturity target.

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