

MONTHLY MARKET OUTLOOK JANUARY 2006

THE INVESTMENT ENVIRONMENT: WHAT KIND OF TRANSITION YEAR? _____

The economy is early in its fifth straight year of economic growth, showing signs of middle age even as it continues to draw on unique strengths that have been the hallmark of this economic cycle. The building blocks for a rally in stocks look better than those for bonds, which face “head winds” from “rich” valuations and from firmer “core” (or underlying) inflation. The coming year may be remembered as much for transitions from themes shaping economic and investment performance in recent years as it is for the overall strength or weakness of the economy and the stock and bond markets. Investors are bracing for a new phase of the interest-rate cycle, now that monetary policy is approaching “neutrality.” Beyond the uncertain impact of an “inverted” yield curve on economic growth and the capital markets, investors will be eyeing a potential shift, or broadening, of risk taking from investors to “cash-rich” corporations, and a leadership change from high-flying energy stocks if, as expected, fuel costs stabilize. Investors also will be weighing the implications of any increased volatility in the stock and bond markets from an historically low level, along with the possibility of a more supportive role by overseas markets for U.S. earnings and, to a lesser extent, economic growth. Last, but certainly not least, the year also could witness an early “stress test” for more efficient, but highly charged global financial markets, as “liquidity” conditions are tightened by central-bank rate hikes here and abroad.

The Economy: “Shock” Proof! The economy shrugged off “body blows” from soaring energy costs and from the Federal Reserve’s latest interest-rate hikes to post solid, broad-based growth during the closing months of the year. *Housing’s slowdown and storm-related weakness at the start of the fourth quarter may have helped cut growth about a percentage point, or so, from the third quarter’s impressive, 4.1% pace.* However, auto-led gains in consumer spending bolstered confidence among businesses enough to support healthy job growth averaging more than 200,000 during the final two months of the year.

The economy is poised for another year of respectable, 3%-3½% growth, just short of 2005’s 3½%-4% pace. By the calendar, this expansion should be over, because the average length of growth cycles in the past sixty years has been three to four

TEN “SURPRISES” IN 2006

No forecast would be complete without a list of “surprises,” or unanticipated events that can change the outlook materially. Here are ten that could affect our economic and interest-rate forecast, or the outlook for stocks and bonds:

- * Plummeting oil prices, on surprisingly aggressive conservation efforts in major consuming countries.
- * An accelerated withdrawal from Iraq by the U.S., boosting the president’s popularity and jump-starting his policy agenda.
- * Passage of major tax reform, a by-product of the president’s improved standing in the polls.
- * A failure of crisis management by the new Fed Chairman during the next financial market upheaval, undermining the central bank’s credibility.
- * A quick housing rebound after the end of this credit tightening cycle, mirroring recent conditions in the U.K.
- * Russia’s expulsion from the “G-8” group of major developed countries, heightening tensions in Europe and roiling energy markets there.
- * Another dollar rally, fueled by an open-ended series of Fed rate hikes and weakening economies abroad.
- * A more aggressive revaluation of the Chinese yuan, designed to contain overheating, but raising fears about central-bank purchases of Treasury securities.
- * Economic disruptions from a “SARS” outbreak severe enough to trigger a global economic slump.
- * A management shake-up and major restructuring at GM and at Ford, boosting corporate bonds.

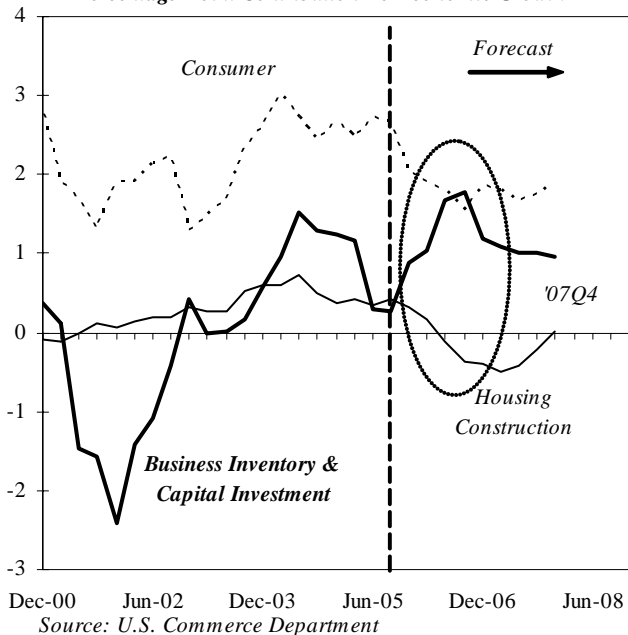
years. However, more recent business expansions have been considerably longer (and followed by milder recessions), due to an ongoing tilt toward more stable services industries, more effective economic policies, management innovations and improved “real time” information contributing to, among other things, a more competitive manufacturing sector. Equally important to that stability has been the secular decline in inflation and interest rates, along with the development of more “efficient” global financial markets that have dampened the wrenching adjustments to purchasing power, interest rates and credit availability contributing to the deep economic slumps of the past.

Many of those forces still are offering the same stable backdrop in this economic cycle as they have in the past. Additionally, consumer spending (70% of demand) should continue to provide the foundation for this growth cycle, supported both by increased

hiring, a modest acceleration of wage increases and by still-sizable windfall gains in housing-related wealth built up through mid-2005. Fiscal stimulus will provide a rare growth contribution in a maturing growth cycle, propelled mainly by Federal spending associated with Gulf Coast reconstruction. Foreign trade's support should continue to be limited, as relatively strong U.S. economic growth (and associated import demand) counters much of the boost to U.S. exports from modestly stronger, more investment-oriented growth abroad and from a reasonably competitive dollar.

Housing's slowdown—perhaps the biggest risk in this year's outlook—should be limited by modest increases in borrowing costs and by prospects for respectable economic and job growth. Moreover, increased business inventory and equipment investment should take up much of the slack from weaker housing activity. Investment's Business spending's full growth contribution has been delayed by cost cutting and, more recently, by energy-related and uncertainties. *As indicated in the chart below, however, business investment is expected to counter a diminishing growth contribution from consumer spending and a "drag" from residential construction activity later this year in supporting the expansion.*

BUSINESS SPENDING TO THE RESCUE IN 2006
Percentage-Point Contribution To Economic Growth



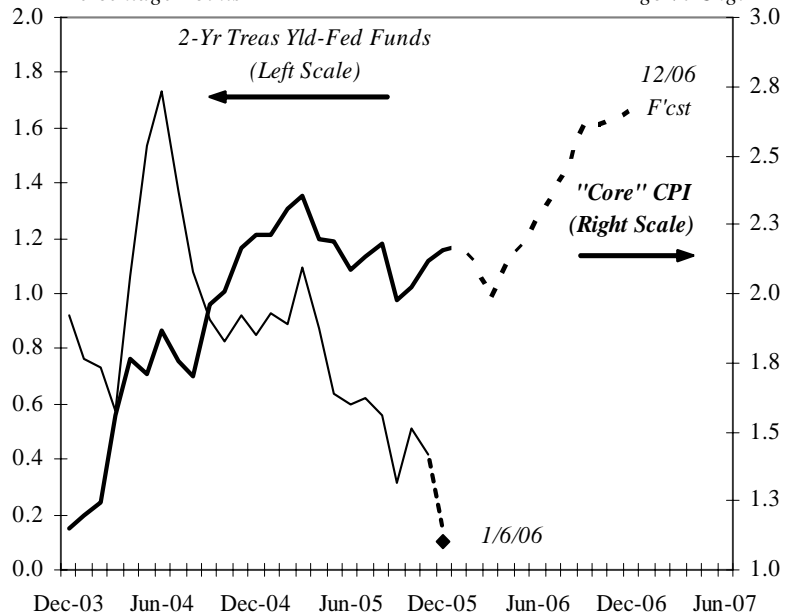
The Financial Market: An Early "Peak" In Interest Rates? Interest rates capped a remarkable year with a long-awaited, but temporary "inversion" of the Treasury yield curve, in which shorter-term rates were driven above yields on longer-term securities. Short-term and intermediate rates were driven higher by a thirteenth straight, quarter-point increase in the Federal funds target rate, to 4.25%, on December 13. *However, long-term bond yields were nudged below*

those on shorter-term interest rates last month by optimism over the inflation outlook, amid lower gasoline prices and signs that soaring fuel costs were having little, if any, impact on "core" CPI inflation (i.e., excluding the volatile food and energy costs).

Bond yields also have been pressured lower in the past month, or so, by worries over the effect of an inverted yield curve on economic growth, and by signs of an early end to the credit-tightening cycle. That latter view seemed to be confirmed by minutes of the Fed's last policy meeting in mid-December, at which the Committee viewed the number of remaining rate hikes as "probably not large." The Fed funds futures curve is "priced" for only two more quarter-point rate increases, leaving the target rate at a 4¾% peak after the March 28 or May 10 FOMC meeting. *Moreover, an unusually narrow yield premium on the policy-sensitive, two-year Treasury note over the Fed funds rate is signaling an early end to the credit tightening cycle, as well.*

At this point, however, the greater risk is that the Federal Reserve is forced to raise interest rates further into 2006 than anticipated, in a more drawn out cycle interspersed with "pauses" at several of this year's meeting. It's clear that the Fed is at or near the end of "Phase I" of this interest-rate "up cycle"—a reversal of the policy stimulus provided during the aggressive "easing" between 2001 and 2003. *Still, policy "neutrality" may not be enough to contain inflation and inflation expectations, against a backdrop of slowly improving "pricing power" and growth strong enough to reduce excess capacity further.* As indicated in the accompanying chart, "core" inflation is expected to rise to a five-year high of 2.7% by the end of this year, enough to encourage a more open-ended series of rate increases that widen the gap between the yield on two-year notes and the Fed funds target rate materially.

ARE INVESTORS TOO OPTIMISTIC ON THE FED-POLICY OUTLOOK?
Percentage Points *Yr-Ago % Chg.*



An early end to this credit-tightening cycle could be accompanied by an initial decline in long-term rates, if the past is any guide. However, bond yields could become increasingly vulnerable to increases later in the year, if inflation expectations suffer from an early move by the Fed to the sidelines despite even a gradual buildup of underlying price pressures. Alternatively, ongoing increases in short-term rates through mid-year could nudge bond yields higher, but set the stage for declines later in the year as inflation expectations are better contained.

Either scenario is likely to lead to a renewed “inversion” of the Treasury yield curve in 2006, as shorter-term rates move above bond yields. That

could cloud the economic outlook, given the past link between inverted yield curves and recessions. As indicated in our last report, however, the greater impact of an inverted yield curve in this cycle should be less on the economy’s strength than on financial-market conditions, ranging from banks’ net interest margins to portfolio leveraging by hedge funds and other investors. That’s because interest rates still remain low by historic standards. More importantly, the yield curve’s inversion has been due as much to declining long-term rates, associated with a sanguine inflation outlook, as it has to worries over economic growth’s staying power amid rising short-term rates.

THE STOCK MARKET: A BETTER YEAR IN 2006?-----

Stumbling To The Finish Line. Stocks struggled during the final month of the year amid worries over the implications of an inverted yield curve for the economic outlook. The S&P 500 was virtually “flat” in December-- normally is, a strong time of the year for the market--following a strong showing in November that accounted for virtually all of the fourth quarter’s return of just over 2%. The indexes’ total return of less than 5% in 2005 was the weakest showing since its steep decline in 2002, and little better than the return on a risk-free Treasury bill. Still, last year’s modest rise did follow two straight double-digit increases that left the S&P 500 with its best three-year showing since 1999. Moreover, tepid gains in the more visible large-cap segment of the market masked pockets of strength, particularly in its more “peripheral” sectors.

Sluggishness within the S&P 500 last month was broad-based, with just two of its ten sectors posting material increases and just 63 of the 119 constituent industries in the black. The more highly charged tech and cyclically sensitive sectors of the market showed signs of relinquishing their leadership role in December, though they did occupy most of the top slots for the fourth quarter as a whole. As indicated in the table below, sector rankings were mixed in 2005, consistent with modest S&P 500 gains. Not surprisingly, energy stocks were the stand-out performer, with interest-sensitive utilities also buoyed by steady long-term interest rates.

PROFILING THE S&P500 BY ECONOMIC SECTOR

	Price Return (% Change)			Fwd. P/E	
	2005	2005 Q4	Dec. 2005	2004	2005
Energy	29.1	-7.7	0.5	8.2	10.1
Utilities	12.8	-6.3	0.8	15.0	14.7
Health Care	4.9	1.0	3.4	18.9	18.1
Financials	3.7	7.5	0.1	12.5	12.1
Materials	2.2	10.6	2.8	15.5	14.9
Consumer Staples	1.3	-0.1	-0.4	18.1	17.5
Info Tech	0.4	0.9	-3.0	22.2	20.3
Industrials	0.4	4.5	0.1	17.9	16.0
Consumer Cyclicals	-7.4	0.8	-0.9	21.1	15.5
Telecom Svcs	-9.1	-1.1	-3.7	16.4	13.7
S&P 500	3.0	1.6	-0.1	15.8	14.9

Sources: Standard & Poors, Inc., Bloomberg Fin'l News, Inc.

Mid-cap stocks were among the best performing of the broad market sectors last month and throughout the year, among those “peripheral” sectors of the market whose double-digit gains on the year were overshadowed by the struggling domestic, large-cap sectors of the U.S. market. Another was the international sector, which posted even more impressive gains. In fact, the “EAFE” benchmark of

EQUITY SCORECARD

Total Returns, In Percent

	3 Mos. To			
	Dec '05	Dec	2005	2004
S&P 500	0.0	2.1	4.9	10.9
Russell 1000	0.1	2.1	6.3	11.4
Russell 1000 Growth	-0.3	3.0	5.3	6.3
Russell 1000 Value	0.6	1.3	7.1	16.5
Russell Mid-Cap	1.0	2.4	12.7	20.2
Russell Mid-Cap Growth	1.1	3.4	12.1	15.5
Russell Mid-Cap Value	1.0	1.3	12.7	23.7
Russell 2000	-0.5	1.1	4.6	18.3
Russell 2000 Growth	-0.2	1.6	4.2	14.3
Russell 2000 Value	-0.8	0.7	4.7	22.3
MSCI EAFE (\$ Terms)	4.7	4.1	13.5	20.2
(Loc. Curr. Terms)	4.5	7.1	29.0	12.7

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

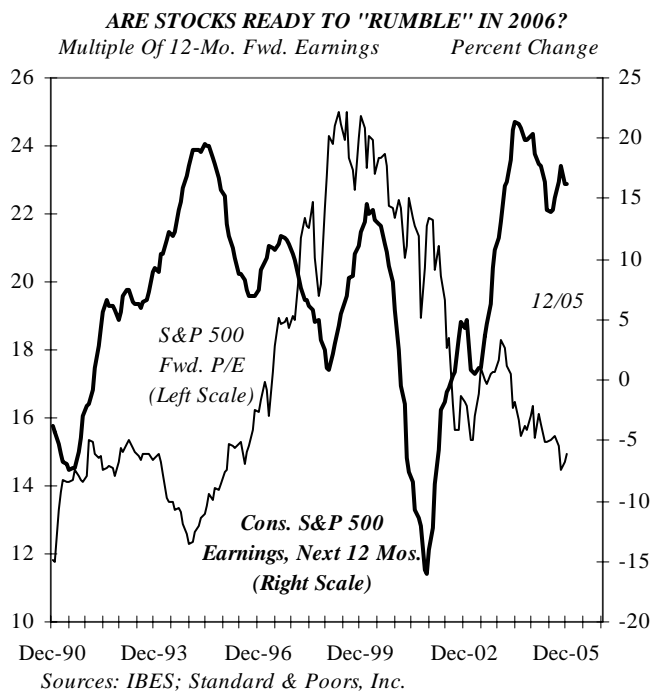
international equities bested the S&P 500 in December, during the fourth quarter and throughout 2005, despite a strengthening dollar during much of the period that sapped dollar-based returns. In local-currency terms, the EAFE's 29% return last year ranked among the best of the broad benchmarks. (See the accompanying Equity Scorecard.)

The Russell 1000 Growth Index stumbled in December. However, it still ended the fourth quarter with a performance advantage of more than 1½% over its Value counterpart, extending across eight of the twelve identifiable sectors making up the two indexes. Growth could out-perform Value for the first time in six years during 2006, buoyed by relatively attractive valuations and the strong earnings growth prospects for several of its key sectors and for the market as a whole. Growth's overall recovery could raise the "bar" for active managers, who have done well against their benchmark in recent years. In 2005, for example, 60% of actively managed "growth" funds out-performed the Russell 1000 Growth benchmark compared to a similar success rate of less than 30% for "value" managers against their benchmark.

Building Blocks For A Better 2006. The S&P 500's near-5% return last year, though gratifying after two impressive years, still was less than half its long-term, 10%-11% average. *The market's strong start to January—a bellwether of market performance for the year—bodes well for 2006.* By one estimate, a January gain in the Dow Jones Industrial Average has led to above-average gains for the year 61% of the time since 1900 compared to just 34% of the time when the market declined at the start of the year. "Bears" expecting another lackluster year for stocks base their outlook on moderating economic and earnings growth—typical of a maturing economic expansion—and on the threats from the Fed's credit tightening and the housing slowdown. Any future rally also could be short-circuited by another oil-price "spike," terrorism, weather or some other surprise, in much the same way as the market's gains were disrupted in 2005.

However, a closer look at the "building blocks" of market performance—earnings growth, interest rates along with absolute and relative valuations—point toward a more upbeat outlook for the market in the coming year, particularly if future economic shocks are less numerous or more muted than they were in 2005. Corporate earnings are firing on all cylinders, in a remarkable spurt that is expected to be capped by a tenth straight quarter of double-digit growth when all the reports are in for last year's fourth quarter. *Reasonably strong growth in domestic spending should fuel above-average growth in unit sales for*

yet another year, particularly if businesses opt for greater investment spending and other risk-taking. Furthermore, historically high margins may not expand as rapidly as they have in recent years, but businesses still could get some mileage from improved pricing power and from productivity-led reductions in costs. Overseas earnings of U.S. multinationals—more important now than they were just a few years ago—will be providing added support if, as expected, domestic spending picks up in Japan, Europe and in other major industrialized economies. And aggressive share buy backs and takeover activity could boost per share earnings as they did in 2005, when they added an estimated 2-2½ percentage points to growth by reducing the number of shares outstanding.



Valuations have become more compelling in the past year, too, as strong earnings growth has been accompanied by only modest gains in stock prices. The S&P 500 price-earnings (or P/E) multiple has been hovering around its long-term average of fifteen times forward, twelve-month earnings, based on a consensus forecast, leaving its relative valuation against long-term Treasury securities more than 30% below its long-term average. That valuation "discount" should be enough to allow stocks to weather the modest rise in long-term interest rates expected this year and to strengthen against bonds.

Sector strategy likely will be as important to the market's performance this year as it was in 2005. Energy stocks' dominant, 30% gain accounted for more than half the total return by the S&P 500 benchmark. However, this year's performance rankings likely will depend more on more on relative

valuations and economic performance than on a single event, like last year's oil-price "spike."

The more highly charged tech and cyclically-sensitive sectors of the market (including materials, industrials and, to a lesser extent, "big-ticket" consumer goods) should do well if, as expected, the economy enjoys solid, manufacturing-led growth in the coming year. *These high "beta" stocks experienced some of the biggest declines in P/E multiples last year, making them all the more attractive if the economy performs as well as expected.* High tech's upbeat prospects, buoyed by strong business and consumer-related demand, bodes well for "growth" stocks in 2006. In fact, "mega-cap" growth stocks are a leading candidate to replace the energy sector on the edge of any future rally, based on earnings growth prospects, valuations, liquidity, restructuring potential and available "cash" for profit-enhancing investments.

Russell 2000 small-cap stocks could move up in the performance rankings, too, after lagging the S&P 500 last year for the first time since 1998. Propelling smaller-sized stocks: economic growth strong enough to overcome fairly "rich" valuations and any "head winds" from modest interest-rate increases. A close correlation between the performance of small cap and high beta, larger cap stocks points up the importance of strong economic growth to both sectors of the market. Overseas, international stocks aren't likely to repeat their explosive gains in 2005, as the European and Japanese central banks remove some of the stimulus provided to both economies in recent years. *Still, international stocks are positioned to outperform the S&P 500 for a fourth straight year despite "richer" valuations, buoyed by still-ample restructuring opportunities, improved economic growth prospects and relatively attractive dividend yields. U.S. investors could enjoy an added boost to dollar-based returns if, as expected, the dollar weakens amid an interest-rate narrowing gap as credit conditions are tightened abroad.*

THE BOND MARKET: SHIFTING GEARS?

A "Tail Wind" Into 2006. The bond rally gathered momentum in December and into early January, but not by enough to prevent the smallest fourth-quarter return by the Lehman Aggregate Index of investment-grade, taxable bonds in five years. *The full-year gain, though the weakest since the bond market's last setback in 1999, was impressive in the face of Fed tightening, the latest energy-price spike and inflation uncertainties associated with soaring gold and other commodity prices.*

Treasury securities benefited most from the decline in longer-term rates during the closing months of the year, touched off first by worries over the impact of an inverted yield curve on economic growth and, more recently, by optimism over the interest-rate outlook in the wake of "dovish" comments in the minutes to the Fed's last policy meeting. Another solid gain by long-term Treasury bonds lifted their full-year return to an impressive 8.6%, according to estimates by Lehman Brothers. Corporate Bonds also did well last month, though that strength was due as much to their relatively long "duration" (or price sensitivity to a given change in interest rates) as it was to the inherent strength of that sector of the market. In fact, investment-grade corporate issues under-performed the Aggregate benchmark during the fourth quarter and for the year as a whole, despite

last year's relatively strong finish. *Non investment-grade corporate bonds did better than the investment-grade benchmark during the fourth quarter and on the year, benefiting from strong*

BOND MARKET SCORECARD

	Total Returns, In Percent			
	Dec '05	3 Mos. To		
		Dec	2005	2004
Leh'm Aggregate	1.0	0.6	2.4	4.3
Treasurys	1.0	0.7	2.8	3.5
Agencys	0.7	0.5	2.3	3.3
Mortgage-Bkds.	1.0	0.6	2.6	4.7
U.S. Credit	1.0	0.5	2.0	5.2
Asset-Bkds.	0.5	0.6	2.1	3.0
Municipals	0.9	0.7	3.5	4.5
High-Yield	0.9	0.7	2.7	11.1
Non-U.S. Gov'ts*	0.9	0.9	5.7	5.2

* Denominated in dollars, fully hedged.

Sources: Lehman Bros., Citigroup, Inc.

balance sheets, ample liquidity in the market, low default rates and a rising stock market. The same decline in long-term rates that worked in favor of long-term "corporates" left shorter-dated asset-backed securities well short of the benchmark gain in December and, to a lesser extent, for the entire year.

Elsewhere, municipal securities also out-performed the taxable sector during the fourth quarter and for the year as a whole, despite a relatively weak finish to 2005. *Tax-exempts continue to be buoyed by relatively attractive yields on longer-dated issues,*

improving state and local budget positions and by a prospective easing of supply pressures. Demand by individual investors continues to be supported by ample cash positions. Property and casualty insurers have remained active in the market, as well, despite the more than doubling of insured catastrophe losses in 2005, to nearly \$56 billion.

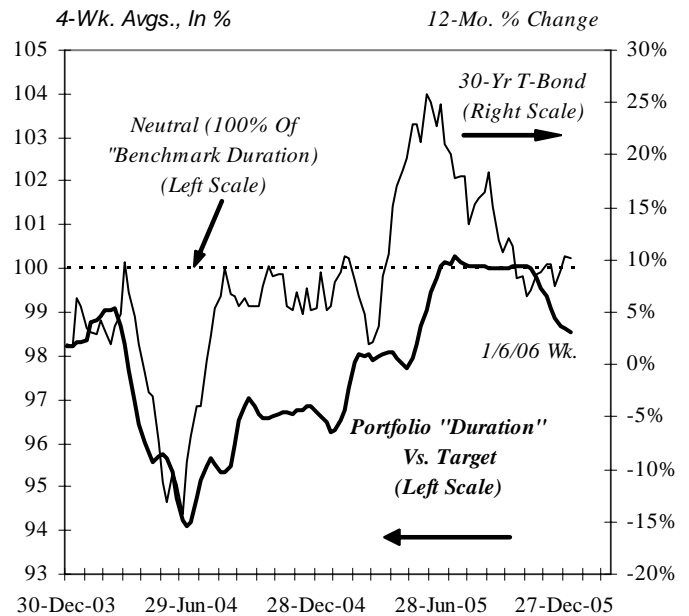
Much the same performance pattern last year was apparent overseas, with non-U.S. “Treasury” lagging their U.S. counterpart in December but outperforming during the fourth quarter and, particularly, for the year as a whole. Much of the strength during the early part of the fourth quarter came from Australia, Canada and the U.K., amid signs of slowing growth in several of these markets. The euro area provided added support in December, as fears of rapid rate increases by the European Central Bank began to fade. However, strength in several overseas markets was largely offset by rising yields and price declines in the important Japanese market, amid signs of economic strength and an approaching end to the Bank of Japan’s “zero-interest” monetary policy.

What Kind Of Strategy Changes In 2006? Investors are likely to follow the broad contours of last year’s fixed-income strategy, until the outlook for interest rates becomes clearer. Prospects for a relatively “flat” yield curve—featuring fairly uniform interest rates across the maturity spectrum—will give investors little incentive to tilt portfolios toward long-term securities, particularly amid worries over the possibility of higher-than-expected inflation and a more extended credit-tightening cycle. Partly for that reason, perhaps, portfolios remained slightly “short” their benchmarks through the end of last year, according to one survey of managers, despite still-respectable gains by long-term bonds. (See the chart at right.) “Barbell” strategies of splitting investments between short and long-term securities, to benefit from a “flat” or “inverting” yield curve, could remain popular in the immediate aftermath of the Fed’s last rate hike, if long-term interest rates lead the subsequent decline in rates, initially, as they have done in recent interest-rate cycles.

Reasonably strong, broad-based growth and healthy corporate balance sheets may continue to encourage a tilt toward the bond market’s lower-quality segments in coming months. However, investors aren’t being paid adequately to move into riskier assets because of historically lean yield premiums, tempering future moves out of higher quality securities. Security selection also will be more cautious, because of “event risk” associated with increased corporate restructuring and buy back activity that can boost debt abruptly. For now, the risk-reward trade-off for municipal securities will remain more attractive, even

for certain “crossover” investors in the taxable sector. Yield ratios to comparable Treasury issues still are high by historic standards, particularly for longer-term issues. Another kind of crossover strategy could become increasingly popular, too: a shift toward high-dividend stocks, with the potential for further yield increases as corporate cash hoards continue to be deployed. Risk-tolerant investors could shrug off the greater “price” risk inherent in stocks, if, as expected, the market’s rally continues this year.

CAUTIOUS “DURATION” STRATEGY AMONG MANAGERS, DESPITE ATTRACTIVE BOND RETURNS



Still, 2006 could be marked by fundamental strategy changes over the course of the year, if an inverted yield curve or other strains on the economy foreshadow an early decline in interest rates. Investors likely will respond to signs of an approaching decline in yields and a return to a more upward-sloping yield curve in two ways: by shifting into longer-term bonds, and by targeting a relatively narrow range of maturities in a more “bulleted” strategy that tends to do best when the yield curve is “steepening.”

Higher-rated bond issues also are likely to become increasingly popular, if the decline in yields is accompanied by heightened credit-quality concerns associated with a slowing economy. High-quality, “yield-advantaged” securities could be particularly attractive if the next decline in rates is moderate. Mortgage-backed issues are one candidate, benefiting from reduced supply (as housing cools) and from a limited increase in pre-payment activity. Added support will come from the strong credit backing by issuing agencies and from a diversified mix of supporting loans to cushion the impact of any housing slump. Municipal securities should remain attractive, too, as Treasury interest rates lead the decline and keep muni yield premiums relatively

high, despite a likely decline in new-issue activity in the tax-exempt sector. Added support will come from dimming prospects for fundamental tax reform that might make competing investments more attractive.

Gary Schlossberg

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