

remains intact. In fact, the latest purchasing managers' survey showed January export orders climbing to a thirteen-month high.

Consumers and exports will set the tone for business spending, as well. Companies will contribute to growth directly, through investment spending, and indirectly, through increased hiring's boost to consumer spending. Renewed inventory building late last year, after back-to-back declines, actually boosted businesses' contribution to growth in the fourth quarter despite the slower pace of capital spending. Inventories still are "lean" compared to sales, encouraging further increases in coming months. Moreover, rising operating rates should broaden investment beyond efficiency-enhancing high tech equipment to capacity-raising, low-tech machinery. In fact, double-digit growth in orders for a key component of capital equipment during the closing months of last year points toward stronger first-quarter investment, following a surprisingly modest rise in such spending reported with fourth-quarter GDP.

Growth prospects are clouded by the uncertain prospects for housing and energy prices. Home values in the nation's "hot spots" already are off their summer peak, amid rapid increases in unsold inventories and pressure on "affordability." Sharply lower home prices could undercut spending by eating into still-sizable "windfall" gains from the recent housing "boom," encouraging households to divert more of their income from spending to saving. The economy also is more sensitive now to rising fuel costs. Businesses and consumers still are adjusting to the "shock" of the past year's energy-price increases, and are doing so without the cushioning effect of declining long-term interest rates through much of 2005. In fact, recent increases in gasoline prices were largely responsible for the drop in January consumer sentiment.

However, declines in home values still are expected to be limited by only modest increases in interest rates, a reasonably strong economy and by favorable demographics in several of housing's recent "hot spots." What's more, the threat to consumer spending from lower home prices already is being countered by stronger income growth associated with a pickup of employment and wage gains. Job growth in the three months to January climbed to its highest reading since May 2004, with wage and salary increases picking up speed through the fourth quarter, too. Energy's threat to growth will be mitigated in the short-term by its reduced importance to the economy now compared to the 1970s and 1980s, and, in the longer term, by adjustments outlined in the previous page's inset.

On balance, the economy is taking on many of the characteristics of a middle-age expansion. The rotation is occurring later than normal, particularly for job growth and inventory rebuilding, but strength is set to shift increasingly this year from "early-cycle" housing and "big-ticket" consumer spending to "late-cycle" investment in heavy machinery and commercial construction. Oil-market uncertainties and adjustment to an unprecedented housing boom will create greater challenges now than in the past, but an array of strengths should sustain growth for a fifth straight year at a respectable 3%-3.5%.

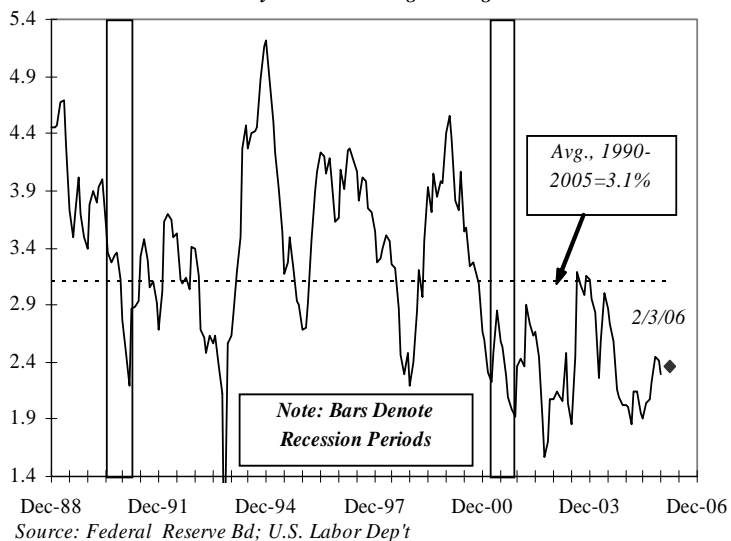
The Financial Market: Stirring The Pot. Interest rates moved broadly higher in late January and early February, responding to the latest signs of economic strength, a less sanguine inflation outlook and to a heavy calendar of new supply. Increases in short-term rates were fueled by a fourteenth straight quarter-point increase in the Federal funds target rate, to 4.5%, at Chairman Greenspan's final policy meeting. Investors shrugged off fresh geo-political tensions, news of tepid, fourth-quarter growth and a "friendly" inflation report for December in sending the yield on ten-year Treasury notes to its highest reading since mid-November and the two-year Treasury yield back to a level not seen since early in the Fed's last credit-easing cycle in February 2001.

The so-called Treasury "yield curve" (i.e., the path traced by interest rates at various maturities) has become increasingly "inverted" since early January, extending from the rate on six-month Treasury bills to the yield on ten-year Treasury notes. Worries over the threat to future economic growth from an inverted curve may increase, now that long-term yields have joined the rise in interest rates. However, relatively low yield levels still could cushion the blow to the economy if the yield curve continues to invert. Investors have become a bit less sanguine about prospects for an early end to the Fed's credit tightening cycle, judging from the Fed funds futures curve. Futures rates now are almost fully priced for another quarter-point hike in the target rate at the next policy meeting on March 28, to 4.75%, and have assigned a better-than-even chance for a 5% target rate by the summer.

Policy moves will be no easy chore for the new Bernanke Fed in the months ahead. The easy rate hikes are behind us, now that monetary policy generally is believed to be "neutral." The Fed must weigh fresh signs of economic strength and a less "friendly" inflation backdrop against still subdued "core" inflation (i.e., excluding the volatile food and energy components) and threats to growth from the housing slowdown and from rising energy costs in

determining the timing and extent of future rate increases. Also at issue is the role of still-ample “liquidity” in the financial market—which triggered the start of this credit-tightening cycle in June 2004—in policy deliberations.

YIELDS STILL QUITE “LEAN” COMPARED TO INFLATION
10-Yr Treasury Yield Less Yr-Ago % Chg. “Core” CPI



The betting is that the Federal Reserve will continue raising interest rates beyond the two increases anticipated by investors, before moving to the sidelines. Even without any further rise of inflation from its current level, a 5% “peak” target rate, anticipated by the financial market, would leave the inflation-adjusted Fed funds rate (a rough barometer of the “bite” to interest rates on economic growth) lower than it was at the end of any credit-tightening cycle since 1966. Low inflation gives policy makers the luxury of moving more slowly than in recent years, pausing, at times, to assess the impact of past rate increases and lessening the risk of “over shooting” that plagued past interest-rate “up cycles.”

Intermediate and longer-term rates are vulnerable to a moderate “snap back,” if, as expected, investors begin to anticipate a more extended tightening cycle by the Fed. The policy-sensitive yield on the two-year Treasury note still is only slightly above the Fed funds target rate. That, plus an inverted yield curve are consistent with expectations of an early end to the Fed’s rate hikes. Moreover, long-term rates still are “rich” compared to such benchmarks as earnings

HELLO “LONG BOND!”

Back by popular demand after an absence of over four years, the upcoming, \$14 billion sale of thirty-year Treasury bonds at the Treasury’s mid-quarter refunding seemingly is a “win-win” situation for the government and for investors. “Liquidity” will be restored to a part of the bond market deemed increasingly important to pension funds and other investors seeking to match long-term liabilities with long-term assets, amid new pension-fund regulations and uncertainties over the outlook for stock-market returns. (In fact, that same demand by overseas investors helped prompt the sale last year of fifty-year government bonds by the U.K., France and Poland, with the U.K. mulling the sale of a forty-year issue in 2006.) Trading desks like the long bond both for its added volatility (and profit potential amid fluctuating interest rates) and for its role as a “raw material” in creating “zero-coupon” bonds from “stripped” interest payments on the securities. For the government, the reintroduction of thirty-year bonds provides a broader array of maturities to maximize the investor base, at a time when Treasury financing needs are on the rise. The sale of the long-dated security also allows the government to reverse a 20% decline in the average maturity of outstanding debt (to four years, ten months) since the last thirty-year bond was issued in October 2001, locking in borrowing costs at a time when interest rates are poised for a sustained rise. The fear is that those same interest-rate expectations could discourage participation by a large enough portion of investors to undermine future long-bond auctions.

yields on stocks and inflation. Note the unusually “lean” yield premium on 10-year Treasury notes over inflation in the chart at left. Intermediate rates, “repricing” for more open-ended increases in the Fed funds target rate, likely will continue leading a more broad-based rise in yields, deepening the yield curve’s inversion in much the same way that they have in recent weeks.

The burden of proof is on the economy to ease worries over the inflation outlook by slowing sufficiently, if credit tightening is to end soon. That could come quickly, if growth succumbs to rising oil prices, housing’s slowdown or to an inverted yield curve. With underlying inflation still low, in fact, signs of slowing growth could conceivably trigger early cuts in interest rates by the Federal Reserve. At the moment, however, the economic backdrop shaping inflation and interest rates points toward more sizable rate increases than those currently priced into the financial market.

THE STOCK MARKET: WEIGHING THE STRENGTHS & WEAKNESSES

A Good Start. Stocks regained momentum in January after December's "flat" performance. The near-2.7% gain by the S&P 500 benchmark was its strongest January since 2001—significant because the month often serves as a bellwether of full-year strength. However, a strong start early in the month has since given way to a see-saw pattern of performance, amid worries over the outlook for energy prices, inflation and interest rates, along with cautious earnings outlooks by several high-profile companies.

Strength last month was broad but shallow. Eight of the 10 S&P 500 sectors were up, but just 76 of the 119 constituent industry groups finished higher. Rising oil and other commodity prices kept energy stocks at the top of the performance rankings, posting a double-digit gain that was well ahead of the return by second-ranked materials producers. Elsewhere, rankings were interspersed between "high beta" tech and "cyclicals" on the one hand, and the market's "defensive," more stable sectors on the other. The increased appetite for risk was more apparent across the various size segments of the market. Investors shrugged off fairly "rich" valuations in propelling the Russell 2000 small-cap benchmark to a leading role in the rally, followed by the market's mid- and large-cap segments.

EQUITY SCORECARD

Total Returns, In Percent

	3 Mos. To			
	Jan '06	Jan	2005	2004
S&P 500	2.6	6.6	4.9	10.9
Russell 1000	2.8	6.9	6.3	11.4
Russell 1000 Growth	1.8	5.8	5.3	6.3
Russell 1000 Value	3.9	7.9	7.1	16.5
Russell Mid-Cap	5.1	10.9	12.7	20.2
Russell Mid-Cap Growth	6.0	13.0	12.1	15.5
Russell Mid-Cap Value	4.3	9.1	12.7	23.7
Russell 2000	9.0	13.7	4.6	18.3
Russell 2000 Growth	9.7	15.7	4.2	14.3
Russell 2000 Value	8.3	11.8	4.7	22.3
MSCI EAFE (\$ Terms)	6.1	13.8	13.5	20.2
(Loc. Curr. Terms)	3.5	13.1	29.0	12.7

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

Russell 1000 Value outperformed its Growth counterpart for a second straight month in January.

Value's advantage extended across seven of the 12 constituent sectors making up the two benchmarks, with the big difference being the double-digit gain in Value's relatively important, large-company energy sector. Relatively strong gains in international stocks (measured by the MSCI "EAFE" benchmark) were led by the commodity-driven Canadian market and by such "core" European centers as Germany and France, with added support to dollar-denominated returns from a weaker U.S. currency.

Something Less Than A Rising Tide? Looking ahead, seasonal forces will provide less support to the market in February than they did in December and January. February returns have averaged 0.8% since 1960, well short of the 1.95% and 1.71% in December and January, respectively. If the past is any guide, investors also can expect a more volatile stock market as Ben Bernanke settles into his new role as Fed Chairman. As indicated in the table below, the last five Fed Chairmen have been greeted with heightened S&P 500 volatility during their first three months in office. The transition's impact on S&P 500 returns is less clear, deteriorating in three of those five instances.

Beyond these near-term forces, the building blocks for another year of moderate S&P 500 returns still are

GETTING TO KNOW YOU

Stocks Often Unsettled By Incoming Fed Chairman

Chairman	Start Date	Returns (%)		Volatility* (%)	
		3 Mos. Before	3 Mos. After	3 Mos. Before	3 Mos. After
T.B. McCabe	4/15/48	0.0	10.3	2.3	1.2
W.M. Martin	4/2/51	4.7	-0.1	1.9	2.0
A.F. Burns	2/1/70	-10.4	-8.4	1.7	1.9
G.W. Miller	3/8/78	-8.1	14.8	1.7	2.0
P.A. Volcker	8/6/79	2.4	-4.1	1.4	1.9
A. Greenspan	8/11/87	7.8	-24.0	2.3	5.5

* As measured by the standard deviation of weekly returns.

Source: Based on data from Standard & Poors, Inc.

in place. Stocks in the index chalked up a tenth straight quarter of double-digit earnings growth during the closing months of 2005. Analysts still expect full-year growth of just over 12.5% in 2006, off only modestly from the estimated 13.5% gain last

year. The index's price-earnings (P/E) multiple is slightly below its long-term average of 15 times forward operating earnings, and stocks remain unusually "cheap" compared to longer-term Treasury securities at current interest rates.

Still, heightened volatility, amid uncertainties over oil prices, interest rates and, perhaps, a new Fed Chairman could foster greater performance disparities across broad sectors of the market. In fact, fresh opportunities to enhance returns through sector strategy soon may be created if recent increases in performance disparities across the ten broad groups making up the S&P 500 continue. Looking ahead, investors' risk appetite likely will remain high if, as expected, economic growth continues to hold up well. That should work in favor of high beta technology and cyclically sensitive sectors keyed to manufacturing. Materials producers still are well-positioned, for now, amid rising oil and other commodity prices. And in a marked reversal of the historic norm, firms more actively engaged in takeover activity could continue to do well, too, much as they did in 2005.

International stocks are expected to continue doing well, on their way to a fifth straight year of relatively strong performance compared to the U.S. market. Overseas "fundamentals" may be less compelling after the group's strong performance of recent years,

but they still are attractive. As indicated in the table at right, P/E valuations in several regions still are

"cheaper" than in the United States, and dividend yields are higher. And while long-term earnings

**INTERNATIONAL STOCK "FUNDAMENTALS"
STILL REASONABLY INTACT**

	Market Cap (\$ Trlns)	Fwd. P/E	L.T/ Earnings Growth	Div. Yield
U.S.	11.9	15.3	12.4	1.8
EAFE*	10.5	14.4	10.6	2.3
Europe	7.1	13.2	9.1	2.7
Japan	2.6	19.1	15.3	1.0
Pacific, Ex, Japan	0.8	14.8	10.0	3.5
Australia	0.6	14.5	10.9	2.3

Memo:

Canada	0.8	14.6	14.7	1.6
Emerging Mkts.	1.8	11.4	16.6	n.a.

*Europe, Australia, Far East

Source: IBES, as of January 19, 2006

growth potential generally is higher here than in most developed markets abroad (with the important exception of Japan and Canada), restructuring opportunities—particularly in Europe—still make these markets attractive.

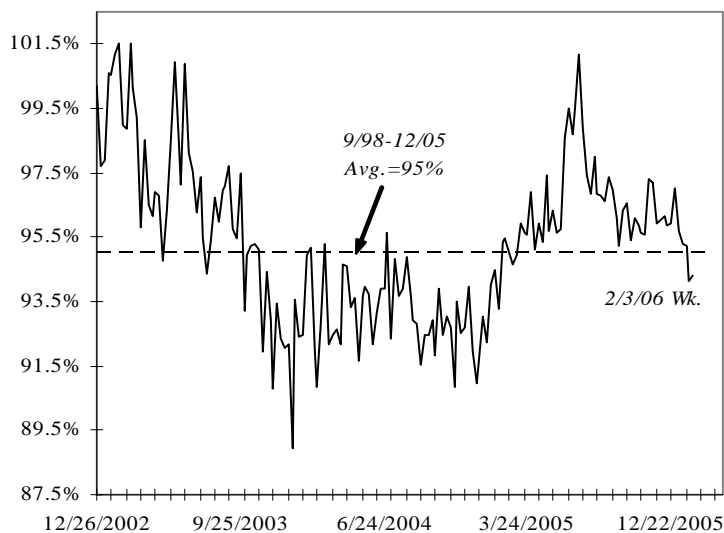
THE BOND MARKET: DIMINISHING STRATEGY RETURNS

"Flat Lined" In January. Bonds retreated during the latter part of January and into early February, reversing earlier gains and leaving the Lehman Aggregate Index of investment-grade, taxable securities virtually unchanged on the month. Higher-quality mortgage-backed and shorter-"duration" asset-backed securities led the way within the Aggregate universe, before turning leadership over to corporate and Treasury issues in early February. (See the Bond Market Scorecard on the next page.) Agency securities also did well in January before fading early this month, buoyed, in part, by strong foreign demand. Foreign central-bank demand for "agencies" has been rising steadily in the past year, judging from the growing share of Federal Reserve custody holdings on their behalf. Industrial bonds were the top-performing corporate sector in January. However, they lagged a rebound early this month that was led by utility bonds propelled by "technicals."

Municipal securities did well throughout the period, boosted by relatively light supply and by healthy demand among individual investors. The relatively strong performance by municipal bonds in recent

months has brought previously attractive yield ratios against

THE MUNI YIELDS ADVANTAGE EVAPORATES
Yield Ratio, Bond Buyer 20 GO Index Vs. 30-Year Treasury Bond (%)



Source: The Bond Buyer; Bloomberg Financial News, Inc.

However, non-investment-grade bonds were the market's best performing sector during January and into early February, buoyed by the rally in stocks (to which "junk" bonds historically have been closely tied), low default rates amid still-ample liquidity in the market and ongoing efforts by investors to "reach for yield." International bonds continued to be hurt by prospects for higher interest rates--particularly in Continental Europe, where declines in the region's Treasury markets out-weighted gains in the important U.K. and Japanese sectors.

BOND MARKET SCORECARD

Total Returns, In Percent

3 Mos. To

	<i>Jan '06</i>	<i>Jan</i>	<i>2005</i>	<i>2004</i>
Leh'm Aggregate	0.0	1.4	2.4	4.3
Treasurys	-0.3	1.2	2.8	3.5
Agencys	0.1	1.2	2.3	3.3
Mortgage-Bkds.	0.3	1.6	2.6	4.7
U.S. Credit	-0.2	1.4	2.0	5.2
Asset-Bkds.	0.3	1.1	2.1	3.0
Municipals	0.3	1.6	3.5	4.5
High-Yield	1.6	3.0	2.7	11.1
Non-U.S. Gov'ts*	-0.3	1.1	5.7	5.2

* Denominated in dollars, fully hedged.

Sources: Lehman Bros., Citigroup, Inc.

Narrowing The Strategy Options. Rising long-term interest rates are narrowing opportunities for enriching bond returns in an increasingly challenging investment environment. Investors likely will respond to the rate increases by tilting more heavily toward less price-sensitive, shorter-term securities. If so, the move would reverse a drift among some portfolio managers in recent weeks toward longer-dated issues, amid expectations of an early end to the Fed's credit tightening cycle. Floating-rate notes and Treasury inflation-protected securities (or "TIPS") could become even more attractive, along with shorter-term, fixed-rate securities, as a means of insulating portfolios from the effects of higher inflation and interest rates. In the market for 10-year TIPS, energy-led increases in inflation have kept the "all-in" yield on inflation-protected securities above that on a comparable, conventional security.

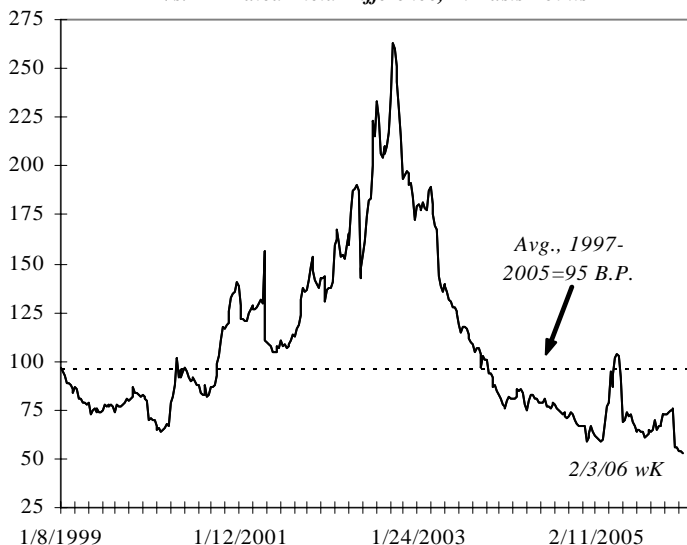
Sector strategy—a useful means of enriching returns in the past year—could become a more "defensive" tool in coming months, if worries build over the implications of rising interest rates for lower-quality investments. That, plus narrow "quality spreads," illustrated in the chart at right, could encourage a move by investors back to higher-rated issues.

"Yield-curve" strategy (i.e., the distribution of investments across various maturities to achieve a given "duration" target) also could become a less powerful means of enhancing investment returns, if long-term rates continue to rise. A "barbell" strategy of splitting investments between short and long-term assets has been one of the best means of enhancing portfolio returns since the Federal Reserve began raising interest rates in mid-2004. The reason: investors have benefited both from rising short-term interest rates, and from attractive total returns on Treasury bonds, as long-term interest rates declined.

AMPLE "LIQUIDITY," HEALTHY FINANCES

SQUEEZE "QUALITY SPREADS"

BBB Vs. AA-Rated Yield Difference, In Basis Points



Source: Merrill Lynch, Inc.

The barbell strategy will remain attractive while the Federal Reserve continues to tighten credit. However, its performance advantage over a "bulleted" approach—keyed to a single, intermediate security—will be diminished, now that long-term interest rates are rising. In fact, the added return on a blended, six-month/10-year Treasury portfolio over a bulleted, two-year portfolio with a similar duration dwindled in January to a sixteen-month low.

Gary Schlossberg

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