



MONTHLY MARKET OUTLOOK JULY 2005

THE INVESTMENT ENVIRONMENT: A "PATCH" OF BLUE?

Hopeful signs on the economy at mid-year gave rise to renewed optimism over the outlook for stocks. The market still faces several obstacles to a moderate, but sustainable rally, including a likely downdraft in second-quarter earnings growth, high and rising oil prices and the effect of a stronger dollar on U.S. international competitiveness, exports and "pricing power." However, the economy's resilience to the latest round of oil-price increases has raised hopes for a quick return to double-digit gains in corporate profits sufficient to reverse the modest decline in S&P 500 stocks during the first half of 2005. By contrast, once-cautious bond investors, capitulating to the latest decline in yields by moving toward more aggressive strategies, risk being whipsawed by a rebound in interest rates amid a more open-ended credit "tightening" cycle by the Federal Reserve.

The Economy: Thumbing Its Nose At Oil. The economy continues to show impressive resilience to a series of body blows from rising oil prices, a stronger dollar and credit tightening by the Federal Reserve. A mild "soft patch" probably left second-quarter growth at a still-respectable, 3% rate from an upward-revised, 3.8% pace during the first three months of this year. *More recent reports have shown the economy regaining momentum at mid-year, pointing toward a return to growth in the 3½%-4% range during the second half of 2005.* June's disappointing, 146,000 job gain has been overshadowed by other, more upbeat data, capped by increases in June auto and chain-store sales, healthier purchasing-manager surveys of manufacturing and non-manufacturing activity and by improvement in weekly leading indicators and company sales surveys for late June-early July.

While overall economic growth continues to hold up well, the usual mid-cycle rotation of strength from consumer spending and housing to business investment has been stalled by inventory adjustment in the auto industry, oil-related uncertainties over the economic outlook and by the debilitating effects of the dollar's rise. (See the inset at right.) *Lower long-term interest rates continue to act as a counter-weight*

to costly energy, stoking the "boom" in housing and its ripple effect on employment, wealth (through double-digit gains in home values) and refi

Enter The Dollar

The dollar's 12% rise this year against a basket of currencies has propelled it to a top slot among the main forces shaping economic performance at home and abroad. The rally has been supported by signs of stronger U.S. growth, political strains and relatively weak economic growth in Europe, and by more attractive interest rates here compared to other major money centers.

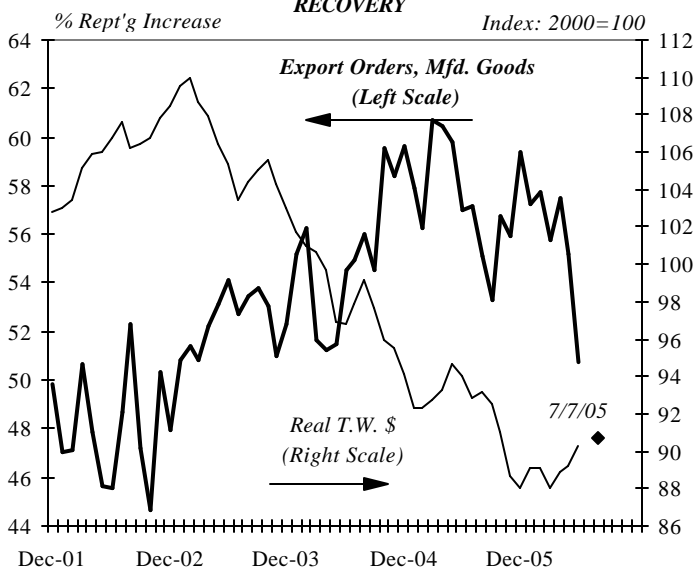
The dollar's role as a key currency in world trade and finance make its latest rise as important to the global economy as it is here. Overseas, gains in competitiveness against the U.S., China and other countries with currencies linked to the dollar are tempered by the increased cost of oil and other commodities, priced in dollars, along with higher effective financing costs for dollar-based borrowers.

Here in the U.S., even the modest loss of international competitiveness this year, amid weakness in key export markets, dims chances for a more important role by foreign trade in supporting this recovery. More fundamentally, the dollar's rise effectively adds to disinflation pressures associated with rising fuel costs, undercutting a recovery of U.S. pricing power that is an essential ingredient for stepped-up investment by businesses. That, plus a stronger dollar's restraining influence on U.S. interest-rate increases, may be good news for consumers. By slowing the rotation toward business investment, however, it will keep the recovery more narrowly based and fragile than it might be otherwise.

activity. Added support to consumer spending is coming from subdued price pressures, permitting moderate gains in inflation-adjusted incomes. "Core," or underlying inflation (i.e., excluding the volatile food and energy components) has eased by more than a percentage point since peaking in March, with the slowdown to a 2.2% rate in May coming from reduced pressure on both goods and services costs.

Stronger second-half growth should allow the economy to draw more support from business investment, buoyed by improved business confidence in the outlook and by a recovery of auto output. However, a stronger dollar likely will slow that rotation, partly by retarding the recovery of pricing power and by restraining export growth and the long-awaited improvement in the U.S. foreign trade deficit. (See the chart below.) *The transition from “disinflation” continues to be more drawn out than expected, keeping inflation and interest rates low enough to foster strength in housing and consumer spending, but undermining the recovery of business investment and foreign trade that is typical in a maturing growth cycle.*

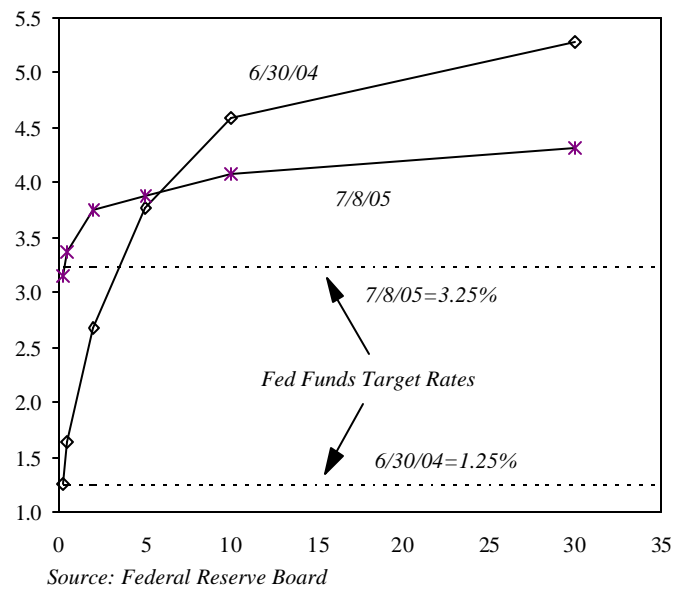
A STRENGTHENING \$ ADDS TO A DISAPPOINTING EXPORT RECOVERY



Sources: Institute Of Supply Mgmt., J.P. Morgan Chase, Inc.

Interest Rates: Still “Crying Wolf?” The financial market kept its split personality through most of June. Short-term money market rates climbed ahead of the Federal Reserve’s ninth straight hike in its Federal funds target rate on June 30 (to 3¼%), while long-term rates continued to move lower. The unusual convergence between rising rates on three-month Treasury bills and falling yields on ten-year notes left interest-rate differences at their narrowest in over four years. (See the chart at right.) The latest declines also kept long-term rates unusually “lean” compared to such valuation benchmarks as stocks and inflation. *By the end of June, the inflation-adjusted yield on the ten-year Treasury note remained as narrow as it has been at any time since the fall of 2002.*

NOT THE USUAL MID-CYCLE “CURVE FLATTENING”
The Treasury Yield Curve, Selected Periods; Yields In Percent



However, bond yields are up since mid-year, despite the influx of “flight” capital in the wake of the latest terrorist attack in London. What’s changed? Signs of strengthening economic growth and the wording of the Fed’s communiqué after its June 30 policy meeting, both of which pointed toward a more open-ended cycle of credit tightening than had been anticipated. Expectations of an early end to the Federal Reserve’s rate hikes probably has been most responsible for lower bond yields, until recently, in the same way that they triggered declines several months before the Fed’s last rate increase during the interest-rate cycles of 1994-95 and 1999-2000.

Though the Fed funds futures market (one barometer of the market’s policy expectations) is less optimistic on the outlook than it was a month ago, the implied, 3¾% rate on the December futures contract implies a “pause” at two of the remaining four policy meetings this year. *Barring a more serious “relapse” by the economy than the one experienced in the spring, however, odds favor a series of small, but steady increases in short-term rates by the Federal Reserve through the end of the year to absorb still-ample liquidity in the financial market.* Those increases are likely to carry long-term rates modestly higher, as investors take a more sober view of the policy outlook. Short-term interest rates could be as much as a full percentage point higher by the end of the year than they are now, while long-term rates still are expected to climb a more modest 0.5%-1%.

THE STOCK MARKET: "TIP-TOEING" AROUND OIL

A Mid-Year "Pause." May's powerful stock-market rally virtually stalled last month, amid rising oil prices, a stronger dollar and signs of slowing

growth, before regaining momentum early this month. The market's see-saw pattern since the start of the year left the S&P 500 benchmark with a moderate second-quarter gain, but still down slightly on the year through early July. Energy stocks were propelled to the top slot last month by rising oil prices. Interest-sensitive utilities were a close second, amid declining yields on competing bonds. As indicated in the table below, in fact, a growing number of lower-dividend, S&P 500 stocks sport after-tax yields exceeding those on ten-year Treasury notes, due to a combination of unusually low, long-term interest rates, relatively high tax rates on interest vs. dividend income (i.e., a top 35% vs. 15%, respectively) and increased pay-outs by a growing number of firms. *By early July, S&P 500 companies ranked in the first six deciles by dividend yield had after-tax yields exceeding those on 10-year Treasury notes, compared to the first five deciles in mid-2004. This, even as the gap between after-tax yields on high dividend stocks and on 10-year Treasury notes has narrowed in the past year.*

LOWER DIVIDEND STOCKS MOVE AHEAD OF 10-YR. TREASURY YIELDS,

AFTER TAXES (PERCENTAGE POINTS)

	7/8/05			6/30/04		
	Pre-Tax	After-Tax	Diff.*	Pre-Tax	After-Tax	Diff.*
10-Yr. Treasury Note	4.1%	2.7%		4.6%	3.0%	
<i>Median S&P 500 Dividend Yields:</i>						
Top 10 Companies	5.2%	4.4%	1.8%	5.9%	5.0%	2.0%
Decile 2	4.6%	3.9%	1.3%	5.2%	4.4%	1.4%
Decile 3	4.3%	3.7%	1.0%	4.5%	3.8%	0.8%
Decile 4	4.0%	3.4%	0.7%	4.1%	3.5%	0.5%
Decile 5	3.7%	3.1%	0.5%	3.8%	3.2%	0.2%
Decile 6	3.5%	2.9%	0.3%	3.4%	2.8%	-0.1%
Decile 7	3.2%	2.7%	0.0%	3.1%	2.6%	-0.3%
Decile 8	3.0%	2.6%	-0.1%	3.0%	2.6%	-0.4%
S&P 500 (Cap Weighted)	1.8%	1.5%	-1.1%	1.7%	1.4%	-1.5%

* After taxes, between dividends, by decile, and ten-year Treasury notes.

Source: Baseline, Inc.

Elsewhere, performance by economic sector in June was mixed, with rankings interspersed between tech and "cyclicals," on the one hand, and "defensive" health care, consumer staples and telecommunications services on the other. *For the quarter as a whole,*

interest-sensitive and defensive sectors more clearly out-performed so-called "high beta" tech and cyclicals before relinquishing that lead early this month.

Russell 1000 Value bested its Growth counterpart last month, largely on the strength of its dominant financial services sector and from weakness in Growth's key tech and health care components. Overall, however, performance was fairly evenly divided between the eleven constituent sectors making up the two benchmarks. *Moreover, Growth's setback, reversed in early July, wasn't enough to prevent quarterly returns from out-pacing Value for the first time in a year during the second quarter.* The small-cap Russell 2000 Index maintained its lead over the mid- and large-cap benchmarks for a second straight month in June and into early July, led by double-digit gains among REITs and in the important financial services sector. And unlike the pattern among larger-cap stocks, Russell 2000's relatively strong showing was led in the second quarter by its Value segment.

Overseas markets continued to out-perform the U.S. sector by a wide margin last month, with double-digit returns in several European centers contributing to a performance premium of nearly 3.5 percentage points over of the S&P 500 during the second quarter. *However, the U.S. currency's dollar's rise dampened dollar-denominated returns to U.S. investors in June. That turned a healthy, local-currency gain during the second quarter into a*

EQUITY SCORECARD

Total Returns, In Percent

	June '05	3 Mos. To June	Yr-To-Date June	2004
S&P 500	0.1	1.4	-0.8	10.9
Russell 1000	0.4	2.1	0.1	11.4
Russell 1000 Growth	-0.4	2.5	-1.7	6.3
Russell 1000 Value	1.1	1.7	1.8	16.5
Russell Mid-Cap	2.7	4.2	3.9	20.2
Russell Mid-Cap Growth	1.9	3.4	1.7	15.5
Russell Mid-Cap Value	3.3	4.7	5.5	23.7
Russell 2000	3.9	4.3	-1.3	18.3
Russell 2000 Growth	3.2	3.5	-3.6	14.3
Russell 2000 Value	4.4	5.1	0.9	22.3
MSCI EAFE (\$ Terms)	1.4	-0.8	-0.8	20.2
(Loc. Curr. Terms)	3.4	4.8	8.4	12.7

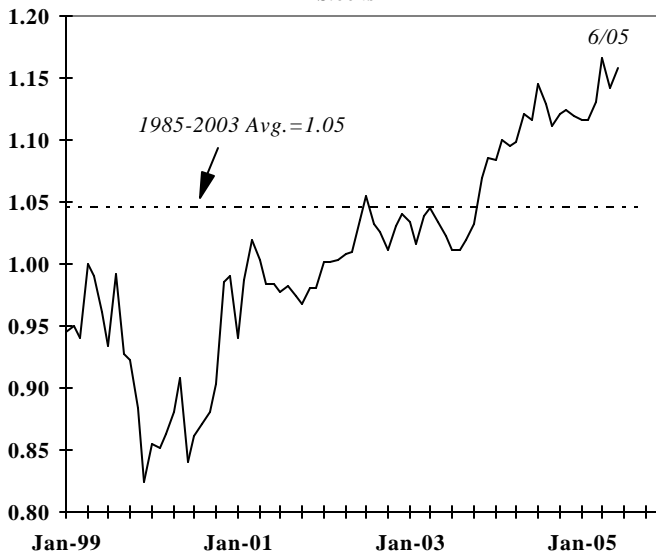
slight, dollar-denominated loss in the benchmark "EAFE" Index.

A Kinder, Gentler Second Half? The backdrop for stocks is turning "friendlier," as the economy shows signs of shrugging off the threats from higher oil prices, a stronger dollar and interest-rate hikes by the Federal Reserve. S&P 500 stocks first must navigate a seasonally difficult month in July, a period of sub-par returns and a relatively high incidence of losses since 1960.

Still, renewed optimism over the economic outlook should bolster the consensus forecast of a return to double-digit earnings growth in this year's second half, after a second-quarter gain expected to be in the mid-single digits. *Rising interest rates aren't expected to squeeze price-earnings (P/E) multiples too severely, either.* First, future increases in long-term rates are likely to be restrained by subdued inflation, reinforced by the Fed's "rapid fire" rate hikes. Second, the linkage between interest rates and stock values may be loosened during the early stages of any sustained rise in longer-term rates by an unusually large "discount" on stocks compared to bonds. And third, S&P 500 stocks tend to do reasonably well in the year after a mid-cycle decline in U.S. interest rates. *Stronger earnings growth and attractive valuations should provide a "window of opportunity" for high "beta" tech and cyclicals, before rising interest rates and slowing economic growth tilt the balance back toward "defensive" stocks late this year or in early 2006.*

Small caps could ride high beta's coattails, buoyed by the close correlation between the two and by their

"VALUE" INCREASINGLY "RICH" VS. "GROWTH?"
Ratio Of Median PEG Ratios,* Russell 1000 "Value" Vs. "Growth" Stocks*



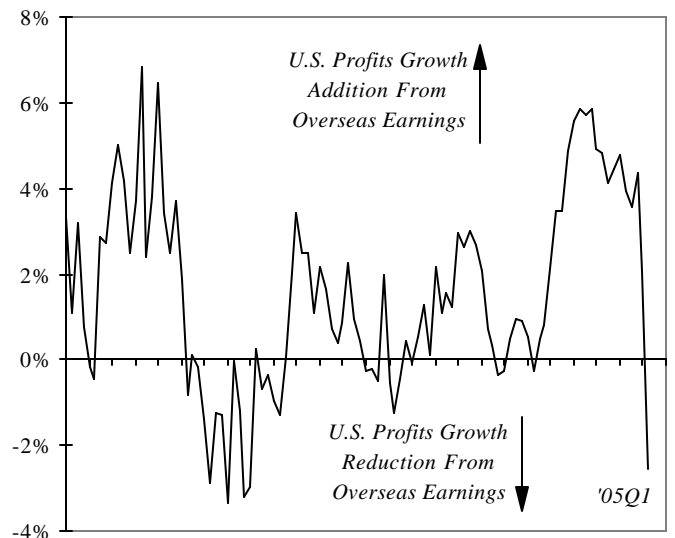
* P/E multiple divided by long-term earnings growth estimates.

relatively favorable earnings outlook. "Growth" stocks are better-positioned against "value" now than they have been in recent years, too, partly because of attractive valuations after an extended period of underperformance. *As indicated in the table below, Russell 1000 Value, already fairly "rich" by recent standards against its Growth counterpart based on relative P/Es, is looking all the more so after accounting for Growth's more robust, long-term profits outlook in a so-called "PEG" ratio.*

The dollar is a wild card in the stock-market outlook for several reasons. First, it quickly affects dollar-based returns for U.S. investors on largely unhedged international stocks. Excluding the effects of currency changes, prospects overseas continue to be buoyed by relatively attractive valuations on international stocks, favorable European earnings prospects, associated with future cost cutting and other restructuring, along with relatively high dividend yields in a number of markets abroad.

WEIGHING THE IMPACT OF OVERSEAS EARNINGS ON U.S. PROFITS GROWTH

Difference, Rolling 3-Yr. Growth Between Total & Domestic Profits; %



Dec-79 Dec-83 Dec-87 Dec-91 Dec-95 Dec-99 Dec-03

Note: Earnings as measured by after-tax operating profits .

Source: U.S. Department Of Commerce

Second, swings in overseas earnings (keyed, in part, to movements in the dollar) can influence overall earnings performance materially, even over extended periods of time. *For example, weakness in overseas profits of U.S. affiliates has cut U.S. operating-earnings growth by an average 2½ percentage points in the past three years compared to a near-six percentage-point contribution September 1999 and September 2002.* (See the chart above.) Lastly, a stronger dollar ultimately dampens earnings of trade-oriented firms in

the U.S. most exposed to competition and reduced pricing power globally.

Foreign Exposure And The Dollar: A Mixed Impact On Stock Prices. While the dollar can be an important “swing” factor in overseas and total earnings growth, it isn’t always the driving force behind stock performance. As indicated in the table below, a stock index based on thirteen S&P 500 industries with the highest exposure to foreign sales in recent years shows a mixed performance compared to the S&P 500 during the major swings in the dollar’s exchange rate dating back to the late 1980s. The table, which also includes a Morgan Stanley Multinational Index as a point of added comparison, does show the expected underperformance of “dollar-sensitive” industries vs. the S&P 500 during the dollar’s rise between October 1999 and February 2002. However, the Multinational Index narrowly out-performed during the period. Moreover, both

foreign-oriented indexes out-performed the S&P 500 during the dollar’s rise between October 1994 and the start of the global financial crisis in July 1997.

Both groups also have held up better than the S&P 500 benchmark since the dollar started rising at the start of this year. The relationship has been a bit more predictable during periods of a weakening dollar. For example, the table at left shows the Multinational Index and that of dollar-sensitive industries out-performing the S&P 500 during three of the four periods of major currency declines since 1989. Lagging performance by the two groups during the dollar sell-off between February 2002 and December 2004 probably reflected the tech-telecomm “bust,” which hit hardest at “mega” caps (dominating the Multinational index) along with the highly exposed, computer equipment and software industries.

THE BOND MARKET: “CRYING WOLF?”

FOREIGN EXPOSURE'S MIXED IMPACT ON STOCK PERFORMANCE

	% Change Stock Prices			
	% Chg. In \$	S&P 500	Multinational*	\$ Sens. Ind.
<i>Rising Dollar</i>				
10/94-7/97	19.6%	29.2%	37.2%	34.9%
10/99-2/02	11.9%	-8.5%	-8.1%	-11.5%
12/04-6/05	2.9%	-3.4%	-2.3%	-2.0%
<i>Falling Dollar</i>				
6/89-2/91	-14.0%	3.6%	14.2%	5.2%
1/94-10/94	-4.0%	-2.6%	7.3%	3.2%
8/98-10/99	-5.9%	35.4%	39.2%	57.2%
2/02-12/04	18.0%	3.3%	0.2%	2.0%

BOND MARKET SCORECARD

* Morgan Stanley index of 50 large-cap multinational stocks.

Sources: Data from J.P. Morgan Chase, Inc., Citigroup, Inc.

	Total Returns, In Percent			
	June '05	June	June	2004
	3 Mos. To		Yr-To-Date	
Leh'm Aggregate	0.6	3.0	2.5	4.3
Treasurys	0.6	3.6	3.2	3.5
Agencys	0.5	2.7	2.3	3.3
Mortgage-Bkds.	0.4	2.3	2.2	4.7
U.S. Credit	0.8	3.6	2.5	5.2
Asset-Bkds.	0.3	1.9	1.6	3.0
Municipals	0.6	2.9	2.9	4.5
High-Yield	2.0	2.8	1.1	11.1
Non-U.S. Gov'ts*	1.0	3.2	4.4	5.2

* Denominated in dollars, fully hedged

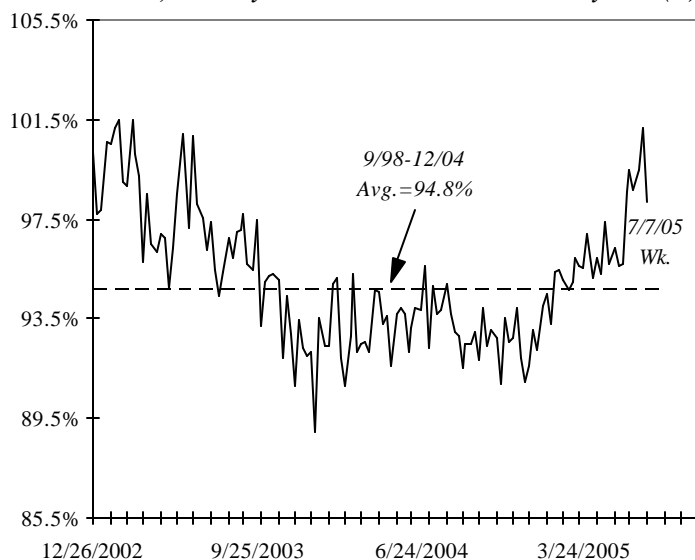
What Sell-Off? Bonds slipped in early July after three straight monthly gains that produced the best quarterly showing by the benchmark Lehman Aggregate Index since last fall. Performance was led by long-term Treasury securities, boosted by the surprising decline in bond yields that made them one of the best performing asset classes last month and for the second quarter as a whole. For example, the second-quarter return of over 9.4% on long-term Treasury bonds was more than four percentage points above the Russell 2500 Value Index—the best-performing U.S. equity benchmark during the period.

Among the broad market groupings, corporate securities led the way higher in the taxable, investment-grade sector last month and (with Treasuries) for the entire second quarter, despite credit-quality concerns that unsettled that part of the market during the spring. Investors willing to reach down the “quality curve” helped propel non-investment grade securities to a top slot last month among the broad sectors of the bond market. Lower-quality issues lead the way last month, despite a struggling stock market (to which the high-yield sector is closely tied). However, they still lagged badly for

On Borrowed Time? Once-cautious investors, bracing for a sustained sell-off in the bond market this year, appear to have capitulated to the latest interest-rate decline. The shift toward a bond strategy more in synch with lower interest rates has been apparent in at least one recent money-manager survey showing a steady tilt away from shorter-term securities, more resilient to price declines during periods of rising interest rates. *By June, that same survey (illustrated in the chart at right) showed portfolios over-weighted in longer-term securities for the first time since September 2003.* Another indication

MUNI YIELDS STILL ATTRACTIVE VS. TREASURYS

Yield Ratio, Bond Buyer 20 GO Index Vs. 30-Year Treasury Bond (%)

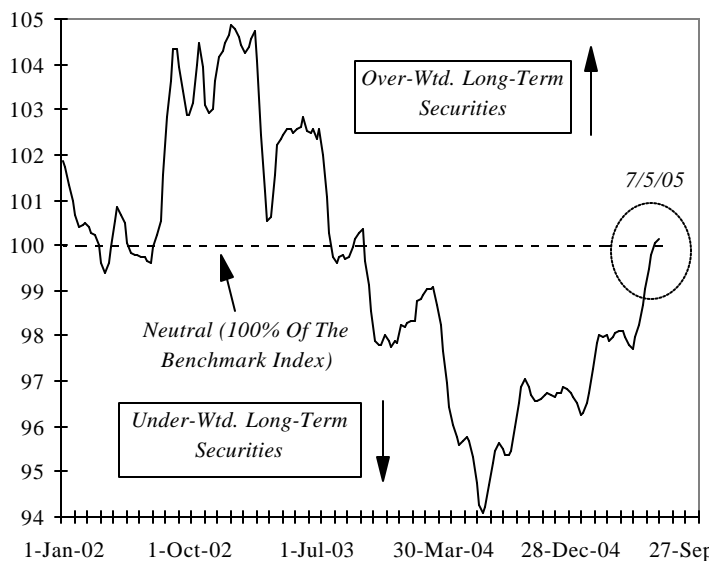


Source: *The Bond Buyer; Bloomberg Financial News, Inc.*

the second quarter as a whole. Municipal securities edged out the taxable sector last month, but still fell short of the Lehman Aggregate for the second quarter as a whole. As indicated in the chart on the previous page, the rally in Treasury bonds has out-paced gains in the tax-exempt sector, keeping yields on long-term munis (as measured by the Bond Buyer Index of 20 GO bonds) attractive compared to long-term Treasury issues. *So powerful was the Treasury rally in June, in fact, that long-term taxable yields dipped temporarily below those on municipal bonds on a pre-tax basis for the first time in nearly two years.* Non-U.S. Treasury bonds (hedged against currency risk) also lagged U.S. Treasury issues during the second quarter, despite a relatively strong finish in June. Gains overseas were led throughout the period by those in Canada and in several European markets. Bond performance in Europe has been buoyed by weakening growth prospects there and by expectations of an interest-rate cut in the Euro zone area.

of the greater risk tolerance among investors: last

INVESTORS "CAPITULATE" TO FALLING YIELDS
Portfolio Duration Vs. Target, In %; 4-Wk. Averages



Source: *Stone McCarthy Research Associates, Inc.*

month’s relatively strong showing by several of the bond market’s lower-quality sectors, amid signs of slowing growth and lower long-term interest rates.

However, investors still risk getting whipsawed by even a modest rise in bond yields during the second half of the year, because of the “lean” yield “cushion” against potential price declines amid historically low interest rates. *Look for a quick return to shorter-term securities, therefore, if, as expected, signs of oil-resilient growth and gradually rising inflation set the stage for a more sustained rise in longer-term interest rates after several false starts.* Lower-rated securities could benefit, for a time, from the boost to credit quality amid signs of firming economic growth, ample liquidity and historically low interest rates. Added support for high-yield bonds may come from a rebound in stocks.

A rotation back to higher quality corporate, agency and similar segments of the market probably won't begin in earnest until rising interest rates begin to dampen growth more noticeably late this year or in early 2006. *Narrowing differences between short- and long-term rates expected during the period should keep at least one element of bond strategy fairly steady: a “barbell” approach of splitting portfolios between shorter- and longer-term securities, which tends to do best when yield spreads are diminishing.*

Gary Schlossberg
2005

July 8,

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