



MONTHLY MARKET OUTLOOK AUGUST 2005

THE INVESTMENT ENVIRONMENT: HOPES AND FEARS

The stock market is at another crossroad, after a strong, earnings-driven performance by stocks last month. Worries over the outlook for oil prices and interest rates are creating a dilemma for equity investors, anxious to rotate toward more highly charged tech and “cyclically-sensitive” sectors, amid stronger, broad-based growth, but mindful of the superior performance by defensive stocks when the economy begins to labor under increased borrowing costs. The latest run-up in longer-term interest rates has created more clear-cut concerns among bond investors, who only recently extended maturities to benefit from the powerful rally in longer-dated bonds during the first half of this year. For both markets, the economy’s recent performance could be signaling a long-awaited shift to a typical, mid-cycle combination of respectable growth and broad-based interest rate increases—a mixed backdrop for stocks and a challenging one for bonds.

The Economy: Business-Led Growth Ahead? Two parallel messages have emerged from recent economic data. First, the recovery continues to regain momentum from a mild “soft patch” last spring. Second, economic growth is broadening out beyond consumer spending and housing to business investment and hiring.

Business confidence and the willingness to spend were on display in the July jobs report, capped by a healthy, 207,000 rise in payrolls that leaves growth in line with its average of the 1990s expansion. (See the chart on the next page.) A sizable, 0.4% increase in average hourly earnings should contribute to further growth of household incomes and consumer spending this quarter, too. Retail sales already are off to a good start, with near-record auto sales in July overshadowing disappointing gains at chain stores. Equally important, a return to double-digit growth in inflation-adjusted equipment spending during the second quarter (from a tax-related “hiccup” early this year) and a more recent return to inventory building from the spring’s auto-led slowdown provided added evidence of more aggressive business spending. Manufacturing already is responding to that strength, judging from

back-to-back increases that lifted the July purchasing managers’ activity index to a seven-month high.

HOW GREAT A LEAP FORWARD FOR THE CHINESE YUAN?

China’s modest 2% revaluation of the yuan on July 21 and the shift to an adjustable, multi-currency “peg” create potential challenges and opportunities for the country, the region and for the global economy. Any economic and financial impact could be magnified by similar changes elsewhere in Asia, associated with the yuan’s role as a quasi-peg for other Asian currencies. The immediate effect of the currency change has been to defuse a threatened Congressional move to impose a 27.5% tariff on Chinese exports here. Beyond that, increases in U.S. interest rates could be aggravated by reduced Asian investment in U.S. securities, as currency intervention declines with rising exchange rates. U.S. firms’ Asian affiliates will benefit from currency-related gains as local revenues are repatriated or translated to dollars for reporting purposes. By contrast, the added cost of converting dollars for payments in Asian currencies will hurt large U.S. retailers and other importers from China. In much the same way, balance sheets among Asian financial institutions funding dollar loans with local currency could be hurt by the revaluations, too.

The longer-term impact of the currency change on trade, investment and even exchange-rate movements is less clear. Speculation against the dollar, ahead of expected exchange-rate adjustments, periodically could boost dollar-support intervention and demand for U.S. securities. Second, the multi-currency peg could dampen yuan increases or send the exchange rate lower, during periods of dollar strength against other major currencies. Third, improvement in the U.S. trade deficit could be muted, as imports are sourced from other low-cost producers. For Asia, the yuan’s “de-linking” from the dollar should permit greater flexibility in monetary policy to combat excess money growth created as a by-product of currency intervention by the central bank. Ultimately, the change, combined with a growing middle class there, could encourage greater reliance on domestic-led growth—a more effective engine of global economic expansion. However, any growth slowdown during the transition could undercut commodity prices and U.S. “pricing power,” as excess production is diverted abroad at fire-sale prices. Currency

appreciation also increases the risk of renewed “deflation” in China—bad news for corporate profits and for banks already suffering from weak credit quality.

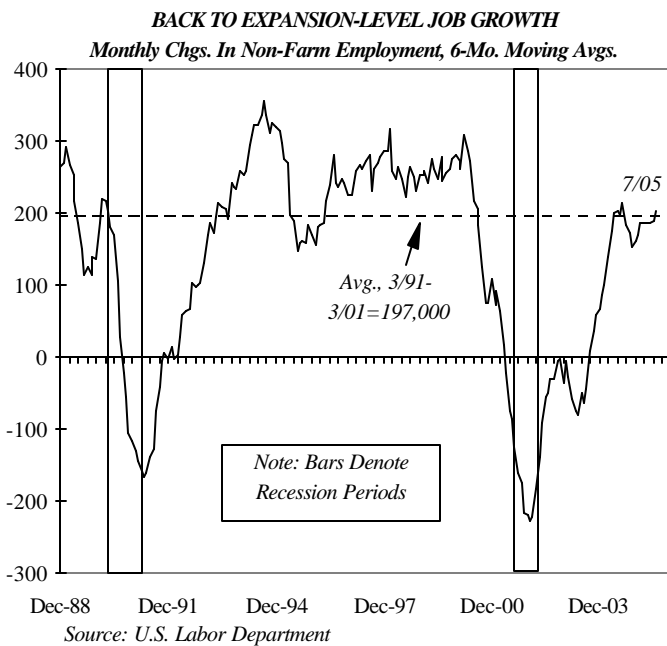
What could threaten the forecast of above-average growth in the 3.5% to 4% range during the balance of 2005? Housing—though still strong—increasingly is becoming a victim of its own success. *Rapid home-price increases out-weighed falling mortgage rates in June to send “affordability” to a 14-year low.* With rates now headed higher, even interest-only and other aggressive loan products may not be enough to insulate the nation’s hot spots from a slowdown in housing activity. The impact of rising interest rates extends beyond housing to construction jobs, other housing-related industries, gains in wealth and “refi” activity—all of which have helped cushion the economy from rising fuel costs when long-term rates were falling during the first half of the year. *Rising interest rates could heighten the threat to growth, by removing the “cushion” against another price “spike” in tightly-balanced energy markets.*

businesses in shrugging off the debilitating effects of “disinflation” and weak “pricing power” on spending. *The economic expansion could be tested, again, this year, but growth’s breadth and momentum early in the third quarter bode well for above-average strength during the balance of 2005.*

Rising Interest Rates: Just Another Drill? Longer-term interest rates are making another attempt at a sustained rise, after several false starts during the past year. They may succeed, this time, judging from the forces propelling yields higher in recent months. *A strengthening economy and prospects for a more “open-ended” credit tightening cycle by the Federal Reserve propelled the yield on the bellwether, ten-year Treasury note to a four-month high of nearly 4.4% by early August from less than 3.9% on June 1.* Strong employment and wage growth last month also may have tempered optimism over the inflation outlook, whose “core” rate (excluding food and energy) has moved lower since March.

The Federal Reserve will continue to do its part to boost those yields through “rapid-fire,” quarter-point increases in the Fed funds target rate, atop a tenth straight hike at its August 9 policy meeting. *In fact, the Federal funds futures market—a barometer of investor sentiment—already is “priced” for at least two (and possibly three) quarter-point increases during the balance of the year, which would boost the Fed funds target rate year to 4%-4¼% from its current 3½% reading.*

Barring an oil-induced slowdown in economic growth, the Fed’s goal of draining excess “liquidity” from the financial market probably will keep policy in a “tightening” mode through the early months of 2006. Two related monetary barometers have become more noticeably restrictive in recent months. The “real,” or inflation-adjusted Fed funds rate (a rough barometer of the “bite” to monetary policy) has moved from negative territory as recently as March to a four-year high after the August 9 rate hike. Accompanying increases in short-term money market rates have narrowed the gap between these short-term funding costs and rates on loans and investments, reducing their profitability and, ultimately, the volume of such funds flowing to the financial market. As indicated in the chart on the next page, neither measure is unusually restrictive by historic standards. However, both measures could be signaling the beginning of the end of an unusually extended tightening cycle.



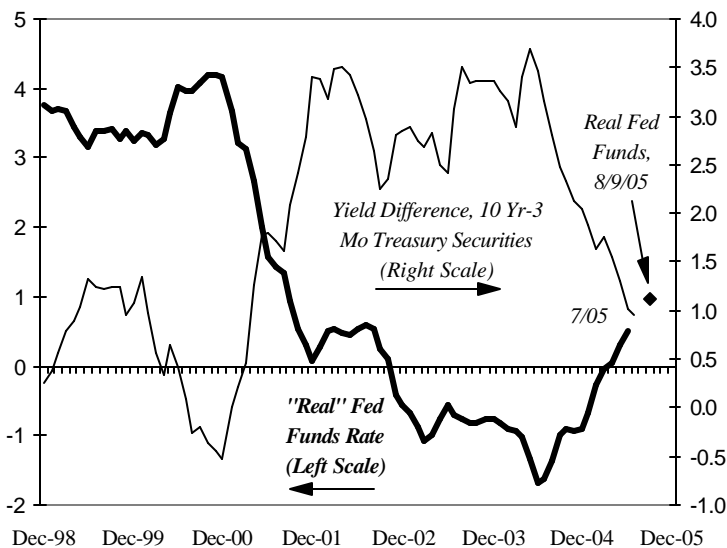
Among the other uncertainties in the outlook: the extent to which still-cautious auto manufacturers rebuild inventories after the recent draw down, and prospects for U.S. export growth following the second quarter’s impressive, double-digit growth. Slower productivity growth through the second quarter—a potential threat to unit labor costs, profit margins and business spending—is being countered, for now, by an easing of wage and benefit gains.

Still, the pattern and strength of this recovery is impressive and significant, signaling success among

Longer-term yields still are expected to rise more slowly than short-term rates, in a replay of the pattern during the last major “up cycle” in 1999-2000. *For starters, inflation pressures, a key to the outlook for long-term interest rates, should be tempered by intense competition, pricing power’s slow recovery and by the focus on maintaining above-average productivity growth.* Second, ongoing credit tightening by the Federal Reserve likely will keep inflation expectations subdued. Third, recent

increases in inflation-adjusted bond yields have left them closer to their historic norm, lessening the risk

STILL SOME ROOM LEFT FOR CREDIT BAROMETERS TO "TIGHTEN"
Percentage Points



Sources: Federal Reserve Board; U.S. Commerce Department

of a big snap-back in rates if investors demand a greater yield premium associated with a stronger economy. Increased supply of long-term bonds, associated with re-issuance of an estimated \$20-\$30 billion of thirty-year Treasury securities, could push yields higher, too. However, that impact will be tempered if, as expected, increased supply is met by demand from pension funds and other investors seeking to better match their long-term liabilities.

The transition to higher interest rates probably won't be a smooth one, disrupted, at times, by lingering “disinflation” pressures associated with intense global competition. *In the absence of further increases in oil prices, geo-political tensions or other external “shocks,” however, odds favor a more sustained rise in yields typical of the middle stages of an economic growth cycle as the expansion moves to firmer ground.*

THE STOCK MARKET: TORN BETWEEN PROFITS AND OIL

Powering Up, Again. Stocks regained momentum last month after a mid-year “pause,” with the S&P 500 posting its best gain since November on the strength of better-than-expected earnings reports for the second quarter. *Double-digit earnings growth for the 435 S&P 500 companies reporting through August 5 was well above the consensus estimate of less than 7.5% on the eve of the second-quarter releases.* The market’s see-saw pattern this year left the S&P 500 benchmark with a year-to-date return of less than 2.3% through the first week of August. Market volatility began to edge higher in late July, but not before falling to a 12-year low.

“Risk” was back in vogue last month, as investors took a cue from signs of stronger economic growth by rotating into smaller and more highly charged sectors of the stock market. *High “beta” tech and*

EQUITY SCORECARD

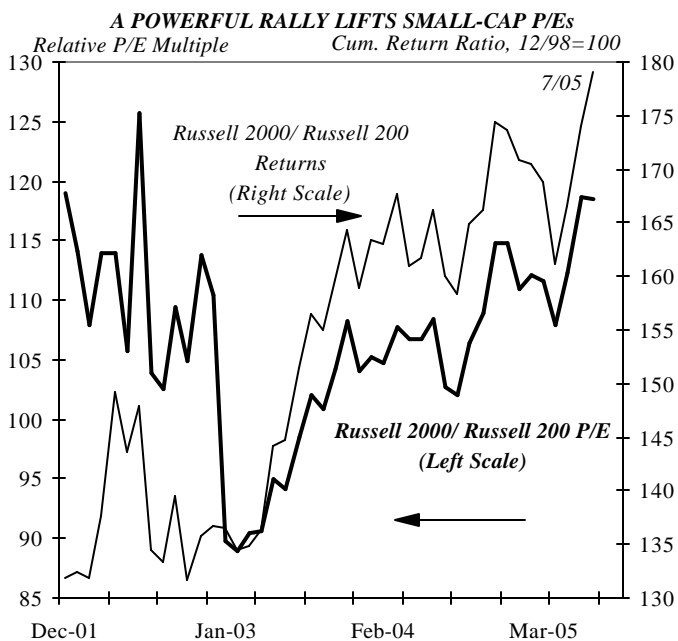
Total Returns, In Percent

	July '05	3 Mos. To July	Yr-To-Date July	2004
S&P 500	3.7	7.2	2.9	10.9
Russell 1000	3.9	8.0	4.0	11.4
Russell 1000 Growth	4.9	9.6	3.1	6.3
Russell 1000 Value	2.9	6.5	4.7	16.5
Russell Mid-Cap	5.3	13.3	9.4	20.2
Russell Mid-Cap Growth	5.8	14.0	7.6	15.5
Russell Mid-Cap Value	4.8	12.7	10.5	23.7
Russell 2000	6.3	17.7	5.0	18.3
Russell 2000 Growth	7.0	18.2	3.2	14.3
Russell 2000 Value	5.7	17.1	6.6	22.3
MSCI EAFE (\$ Terms)	3.1	4.5	1.9	20.2
(Loc. Curr. Terms)	3.7	11.5	12.0	12.7

“cyclically sensitive” stocks (most sensitive to the ups and downs of the overall market) joined energy stocks on the leading edge of the market’s rally in July. Interest-sensitive utilities and financials, along with “defensive” health care and consumer staples brought up the rear. Last month’s rally by the S&P 500 was broad-based overall, however, with gains posted by all ten of the broad sectors and by 97 of the 119 industry groups making up the index.

“Growth” stocks prevailed across the small-, mid- and large-cap segments of the market last month, too.

Russell 1000 Growth narrowed this year’s performance shortfall against its Value counterpart with solid gains in its dominant tech and consumer cyclicals industries. “Growth’s” relative strength was broad-based, too, extending to eight of the eleven identifiable sectors making up the two style benchmarks. Small caps widened their performance advantage over the mid- and large-cap Russell benchmarks, propelled by solid gains in tech and, to a lesser extent, the financial services and materials sectors. As indicated in the chart below, however, the relatively strong gains by the Russell 2000 small-cap benchmark in recent months have left its P/E multiple fairly high by recent standards. International stocks lagged the S&P 500 in July, due both to slightly weaker gains in Japan, Australia and in parts of Europe and, more importantly, to a strengthening dollar most of the month.

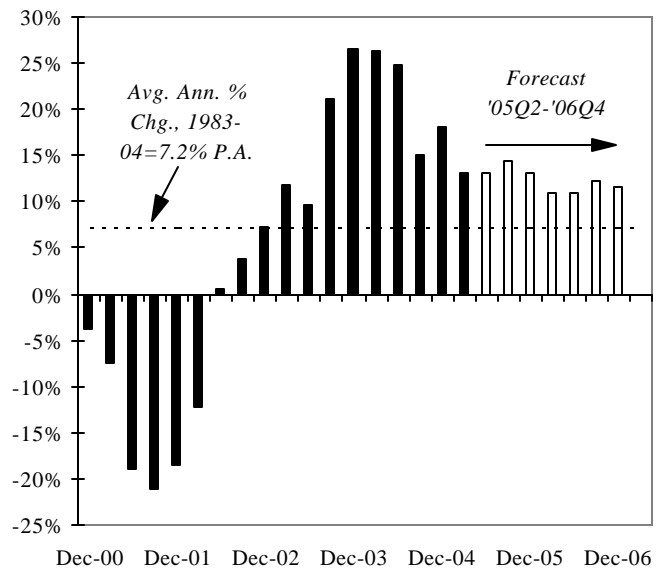


Source: Russell Mellon Analytics, Inc.

More “See-Sawing,” Or A Bona Fide Summer Rally? August’s tendency toward below-average returns means that “seasonals” won’t provide much of a performance “tail wind,” either. However, seasonal patterns haven’t had much effect on the stock market’s performance thus far this year. S&P 500 stocks have done best when performance normally is weakest and have declined during typically strong months of the year. That pattern has a good chance of continuing through August, because of thin, summer trading that makes it one of the most volatile months of the year.

Moreover, “fundamentals” driving the market still are reasonably intact. Solid, broad-based growth increases the odds of a ninth straight quarter of double-digit profits growth during the July-September period, with the strength expected to continue next year. (See the chart above right.) However, building on July’s impressive gain hinges on the stock market’s ability to overcome worries about dual increases in oil prices and interest rates, which short-circuited the rally early this month. Valuations aren’t an overriding threat, either. Increasingly upbeat earnings-growth forecasts have helped steady the S&P 500 price-earnings multiple during periods of market strength in recent months. Moreover, stocks still are “cheap” compared to bonds, despite recent

CONSENSUS S&P 500 EARNINGS GROWTH FORECAST STILL UPBEAT
Yr.-Ago % Chg In Opng. Profits, First Call Consensus



Source: First Call, Inc.

increases in long-term rates.

Gauging Energy's Impact On The S&P 500.

Energy may not have shaped the economy's performance thus far this year, but it's impact has been apparent in S&P 500 earnings growth, total returns and, to some extent, valuations. *For example, second-quarter earnings growth of 41% for energy companies accounted for 3.5 percentage points of the 11.5% growth for the S&P 500 as a whole—the difference between a respectable gain in the high single digits and a ninth straight*

quarter of double-digit growth. And the 30% year-to-date return by energy stocks through August 9—nearly double that of second-place utilities—masked declines in five of the S&P 500's ten broad sectors in accounting for nearly all of the benchmark's 2.7% gain.

Lastly, energy's powerful rally since 2003 has biased lower the S&P 500's P/E multiple. Why? Because the energy sector's relatively low P/E multiple has become increasingly important in the cap-weighted, S&P 500 index, as the stock prices in that sector have soared. *Excluding energy, July's S&P 500 P/E multiple would have been 18.3 times forward earnings, using data by Factset, Inc., instead of Factset's reported multiple of 17.9.* (See the table on the previous page.) Not only is the P/E multiple for non-energy stocks greater than that of the overall index, the premium over its long-term average is larger, too. The table shows a premium of more than 17% on non-energy's current P/E multiple over its average since 1985, compared to about 12.5% for the entire index. The difference is due to a remarkably large discount on the current P/E multiple for energy stocks. The P/E premium in non-energy extended to seven of those nine S&P 500 sectors as of July, with the largest gap in utilities and consumer cyclicals.

A LOOK AT S&P 500 SECTOR P/E VALUATIONS

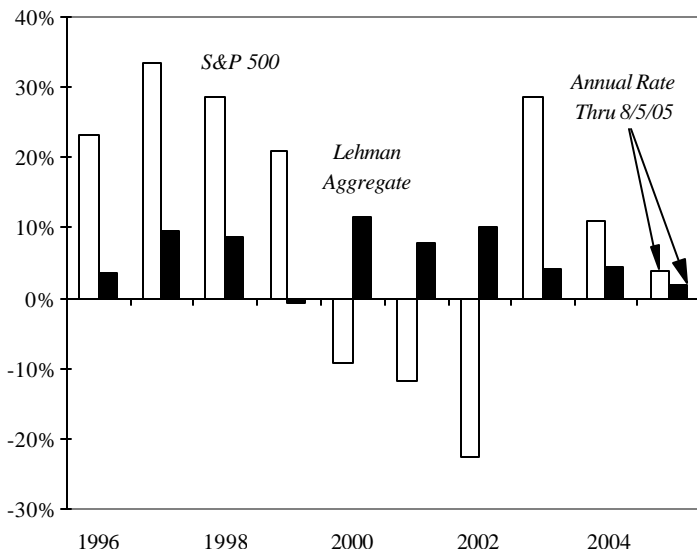
	Multiple Of Fwd. Earnings		% Diff.
	7/05	Avg., 1/85-7/05	
Energy	14.3	19.2	-25.8%
Consumer Discretionary	19.2	16.2	18.8%
Consumer Staples	17.8	17.9	-0.7%
Financials	13.0	12.2	6.5%
Health Care	20.4	19.1	6.9%
Industrials	17.7	15.5	14.5%
Information Technology	25.2	22.7	11.1%
Materials	15.7	15.7	0.0%
Telecommunication Services	16.7	15.4	9.1%
Utilities	16.8	11.7	43.2%
S&P 500	17.9	15.9	12.4%
Memo: Non-Energy Sectors	18.26	15.60	17.1%

Source: Factset, Inc.

THE BOND MARKET: "LANDFALL" FOR RISING INTEREST RATES?

Few Places To Hide. Rising long-term interest rates had a predictable effect on the bond market, sending

HEADING TOWARD A LACKLUSTER YEAR BOTH FOR STOCKS & BONDS (TOTAL RETURNS IN PERCENT)



the Lehman Aggregate Index of investment-grade, taxable bonds to its worst monthly loss since April 2004. *Last month's setback—all the more painful, because of the recent tilt by money managers toward longer-term securities—continued into early August.* That left the Aggregate with an annualized return of little more than 1.9% through August 5, nearly two percentage points below that of the S&P 500 and on track for its worst showing since 1999.

Treasury issues were hit hardest by the sell-off, followed by investment-grade, corporate securities. Utilities led the way lower in the corporate sector. *Industrial bonds were protected from the worst of the declines by a relatively strong economy, which helped check concerns over increased corporate debt and worsening credit quality, associated with stepped-up leveraged buy-out activity.* The resilience

of industrial issues contributed to the relatively strong showing by BBB-rated securities, where industrials are most concentrated. Mortgage-backed were among the best-performing, investment-grade sectors of the market, benefiting from reduced "pre-payment" risk associated with rising interest rates and their effect on refinancing activity. Asset-backed securities were cushioned from the sell-off by their relatively short "duration," or price sensitivity to a given change in interest rates.

BOND MARKET SCORECARD

Total Returns, In Percent

	July '05	3 Mos. To July	Yr-To-Date July	2004
Leh'm Aggregate	-0.9	0.7	1.6	4.3
Treasurys	-1.4	0.5	1.8	3.5
Agencys	-0.9	0.6	1.4	3.3
Mortgage-Bkds.	-0.5	0.7	1.6	4.7
U.S. Credit	-1.0	1.2	1.5	5.2
Asset-Bkds.	-0.6	0.4	1.0	3.0
Municipals	-0.5	0.9	2.4	4.5
High-Yield	1.8	5.6	2.9	11.1
Non-U.S. Gov'ts*	-0.4	1.6	4.1	5.2

* Denominated in dollars, fully hedged.

Sources: Lehman Bros., Citigroup, Inc.

Elsewhere, municipal securities stumbled last month, though the decline was less severe than in the taxable sector of the market despite a looming increase in supply. Relatively attractive yields on long-term tax-exempts compared to Treasurys in recent months helped cushion munis from the worst of the latest sell-off. *For example, the ratio of the Bond Buyer Index of 20 General Obligation (GO) bonds to comparable long-term Treasury securities, though down to less than 97% in early August from over 101% at mid-year, still is above its three-year average of less than 95%.*

Last month's sell-off extended to non-U.S. Treasury securities, though the decline also was more modest than the setback in the U.S. Treasury sector or in the broader Lehman Aggregate universe. Cushioning the drop in overseas returns was the relatively modest setback in the Canadian sector and moderate increases in Australian and Swiss issues. However, non-investment grade corporates were the bond market's star performer last month. *These high-yield securities drew on their close connection to a rallying stock market to post a third straight healthy return that lifted their benchmark's*

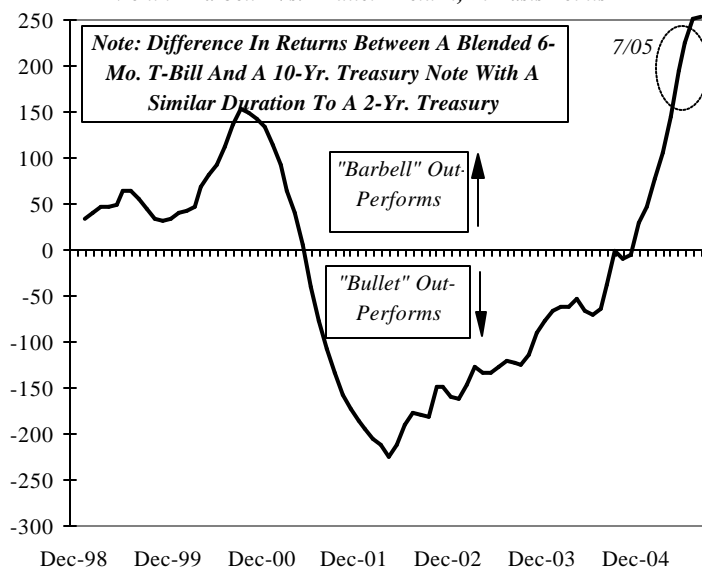
cumulative gain to 5.6% during the May-July period. Investors' appetite for risk last month allowed lower-quality (Caa-rated) issues to lead the way among high-yield bonds last month with a near-3% return.

Back To Defense. Further increases in longer-term interest rates should be a powerful inducement for investors whipsawed by recent increases to shift back toward shorter term-securities. At least one money-manager survey has shown investors over-weighted in longer-dated securities since the latter part of June, lured there by rising bond prices earlier this year amid an unexpected decline in yields. Investors were reminded of the risk of over-weighting portfolios with long-term securities in July. *Fairly uniform yield increases of just over a quarter percentage point in July produced losses of 2.3% on a 10-year Treasury note compared to less than 0.3% on a two-year security, whose shorter "duration" makes its price less sensitive to interest-rate changes.*

Sector performance has varied during past interest-rate cycles, offering little insight to which markets will do best during this period of rising yields. Reduced pre-payment risk kept mortgage-backed securities ahead of most other investment-grade sectors of the market during the last three periods of rising rates. However, even they lagged the Treasury market during the last sustained increase in yields during 1999-2000. Likewise, high-yield securities were a strong performer during the run-up in rates in 1994, but suffered more than investment-grade issues during the cycles of 1989-90 and 1999-2000.

If the economy can weather the threat to economic

"BARBELL'S" ADVANTAGE BEGINS TO LEVEL OUT Rolling, Six-Month "Barbell" Vs. "Bullet" Return, In Basis Points



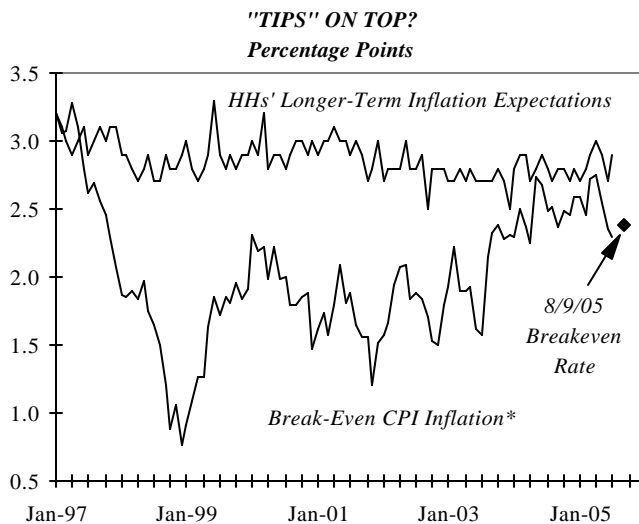
growth, lower-quality sectors of the bond market should continue to benefit from still-ample credit and from expected gains in the stock market. *A tilt toward higher quality securities still is expected late this year or in early 2006, however, as rising interest rates begin to dampen the economy's growth prospects.*

Yield curve strategy (the distribution of investment across various maturities to achieve a targeted duration) continues to favor a “barbell” approach of splitting investments between shorter and longer-term securities. *However, barbell-related gains are likely to come more slowly, now that convergence between yields is being driven by a broad-based rise in rates.* Returns using that strategy were super-charged earlier this year by the combination of rising short-term rates, associated with credit tightening by the Federal Reserve, and falling long-term rates. During July, however, the barbell's lead over a “bulleted” strategy (i.e., focusing on a single maturity to achieve a given duration target) leveled out amid more broad-based rate increases. (See the chart below.)

Time For “TIPS?” One casualty of inflation's slowdown has been the market for Treasury Inflation-Protected Securities (or TIPS), which lagged conventional Treasury bonds for a fourth straight month in July and (like other bonds) suffered their worst setback since April 2004. *TIPS' overall return is calculated by applying its stated interest rate to a principal amount indexed to the CPI. In this way, their performance rises and falls with inflation—just the reverse of the way it is supposed to work for conventional bonds.* While potential TIPS investors have been discouraged by the recent easing of price pressures, recent trends can be a poor predictor of the longer-term inflation outlook.

Moreover, demand for the securities also is affected by the relationship between actual inflation and the so-called “break even” rate, which simply is the difference between yields on conventional securities and a TIPS issue of similar maturity. TIPS will out-perform conventional debt if inflation exceeds the break even rate over the life of the bond, and lag if inflation falls short of expectations. *At the moment, TIPS appear attractive, based on those yield comparisons.* The current break even rate of less than 2.4% is just under the 2.5% increase in the CPI over the past twelve months. Moreover, the actual rate is expected to move higher in coming years, judging from surveys of economists and households

that put long-term inflation at 2.6% and 2.9%, respectively. (See the chart below.) *The more favorable comparison between relative yields and inflation should provide an early lift to demand, with added support likely if, as expected, inflation re-accelerates in coming months.*



* Based on yield differences between 10-yr. conventional & TIPS issues.
Sources: Bloomberg Fin'l News, Inc.; University Of Michigan

Gary Schlossberg
2005

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