



MONTHLY MARKET OUTLOOK AUGUST 2006

THE INVESTMENT ENVIRONMENT: A LEAP OF FAITH?

Stocks and bonds shrugged off geo-political strains, signs of slowing growth and the threat of higher inflation in moving higher last month. Gains in both markets point up the leap of faith among investors in limited economic fall-out from the latest conflict in the Middle East, in a growth slowdown material enough to contain inflation but not severe enough to send profits into reverse, and, in the stock market, in the kind of P/E multiple expansion triggered by interest-rate declines during previous growth “pauses.” However, the specter of “stagflation,” brought into focus by recent signs of moderating growth and rising inflation, casts a harsh light on those assumptions. That backdrop would be more damaging for bonds than for stocks, which continue to draw support from a relatively strong profits outlook through the end of this year. In a maturing growth cycle, however, a “defensive” tilt toward higher quality, more “liquid” (i.e., easily tradable) sectors of both markets offers the best means of enhancing returns amid heightened uncertainties.

The Economy: The Growth Cycle Shows Its Age.

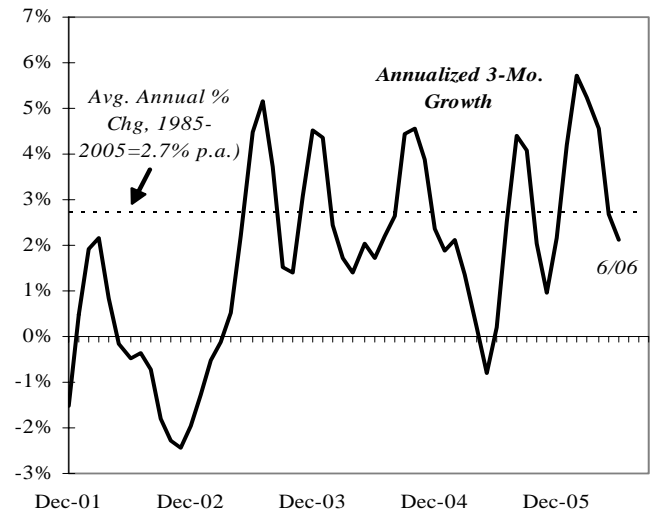
The economy is approaching a mid-cycle growth “pause,” whose depth and duration is unclear. Second-quarter growth of 2½% was less than half its rate in the opening months of the year. A sizable inventory buildup countered broad-based weakness in underlying demand—not the kind of pattern that typically produces a quick snap-back in growth.

In fact, more recent data showed little improvement in the economy’s tone early in the third quarter. *Moderate growth was confirmed both by July purchasing-manager surveys of manufacturing and non-manufacturing activity and by a disappointing employment report for the month that included a tepid (113,000) rise in non-farm payrolls and an increase in the unemployment rate to a five-month high.* What’s more, the volume of mortgage applications for home purchases (the first step in the housing pipeline) slipped to a 2½-year low in July from its tight range of the past four months, hinting at a more noticeable slowing of housing activity.

The news on consumer spending was more encouraging, however. July car sales climbed to a six-month high, propelled by improved confidence during the latter part of the month and by more

aggressive financing incentives. Chain-store sales also picked up during the period. However, spending remained moderate and uneven, with lower-income groups hit hardest by the run-up in fuel costs.

“PURCHASING POWER*” PROPELLING MODERATE CONSUMER SPENDING GAINS (% CHANGE)



Dec-01 Dec-02 Dec-03 Dec-04 Dec-05

* As measured by inflation-adjusted wages and salaries.

Source: U.S. Commerce Department

The economic outlook is clouded by the threat of still higher fuel costs, aggravated by the latest outbreak of hostilities in the Middle East, and by uncertainties over the depth and duration of future housing declines. However, some of the second-quarter’s growth slowdown may have been a payback for weather-related strength during the opening months of this year. Combining the two periods still left growth during the first half of the year at a healthy, 4%. *Equally important, the economy’s growth engines are strong enough to support moderate growth, typical of a middle-aged growth cycle, in coming months.* Gains in inflation-adjusted incomes (or “purchasing power”), though slowing, still have managed to avoid declines typical of past recessions. (See the chart above.) Moreover, homeowners continued to tap aggressively into home equity through the second quarter to finance spending, judging from a recent Freddie Mac survey.

Business investment spending still is being supported by high operating rates, the ongoing need to improve efficiency with high-tech equipment and relatively “lean,” non-auto inventories. U.S. exports are holding up well, too, supported by investment-led growth in

the global economy (well-suited for our equipment-oriented sales abroad) and by a weakening dollar's lift to U.S. competitiveness. Even housing's slowdown is being tempered by steady-to-lower fixed-rate mortgages and by prospects for a sixth straight year of economic growth in 2007. And in the construction industry, housing's decline is being outweighed by a typical late-cycle recovery of non-residential construction activity. (Please see the inset below.)

The growth cycle is beginning to respond to the stresses and strains from high and rising fuel costs, housing's slowdown and geo-political uncertainties. *However, historically low interest rates, still-ample liquidity and supportive economic "fundamentals" should keep growth on a moderate 2.5%-3.5% path into the first half of next year.*

CONSTRUCTION'S "SAFETY NET"

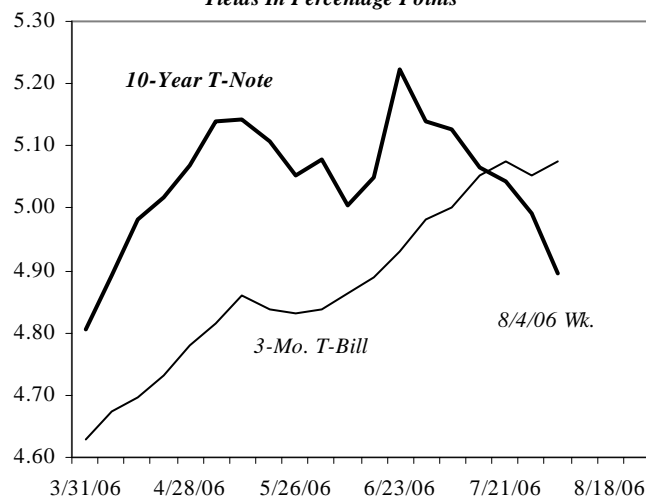
Nearly lost in all the attention on the housing slowdown have been the strong gains elsewhere in construction that have helped support industry and overall economic growth. Housing is taking its toll, with the value of building activity falling at an 8% rate in the second quarter compared to double-digit growth as recently as the July-September period last year. However, the cutback has been more than offset during the period by annualized rates of 16%-17% and more than 25% in public and in non-residential activity, respectively. Non-residential construction's double-digit growth in over the past year has been led by an explosive (78%) gain in hotel construction, with supporting, double-digit growth spread across office, industrial and parts of the retail sector.

Commercial construction tends to be a late bloomer in an economic expansion, and this cycle has been no exception. However, this upswing is being supercharged by healthy "fundamentals" affecting supply and demand that is being stoked by unusually abundant financing for this late stage of an economic expansion. Downtown-office and industrial vacancy rates are down to four and five-year lows, respectively, while limited hotel construction and a recent surge in consumer and business travel typical of a maturing economic expansion have lifted occupancy and room rates noticeably. The powerful gains in commercial construction may not have as much of a ripple effect on growth as housing, through gains in wealth, related spending and hiring. However, commercial construction's powerful recovery is one of the few broad sectors of the economy increasing its direct contribution to growth, while helping to sustain job gains in the high-paying building industry.

Interest Rates: Faith In The "Fed." Investors have shrugged off "unfriendly" inflation reports, keying, instead, on signs of slowing growth and assurances from the Federal Reserve on the inflation outlook in

sending yields lower during most of July and into early August. Worries over the lagged effect on the economy of "rapid-fire" rate increases during the past two years have made the Fed anxious for at least a temporary "pause" in this credit-tightening cycle. *Mixed economic data—featuring slowing growth and higher inflation—should provide policy makers with enough cover for a first move to the sidelines at the August 8 FOMC meeting after seventeen straight, quarter-point rate increases.* That view was shared by the Fed funds futures market, where the probability of an extended pause climbed to more than 85% at the upcoming meeting and remained above 50% through the end of this year.

A "BULL-MARKET INVERSION" OF THE "YIELD CURVE"
Yields In Percentage Points



Source: Federal Reserve Board

Investors apparently have signed on to the Fed's view that inflation soon will be following growth lower. The bond rally during much of the past month has featured a so-called "bull-market inversion" of the Treasury "yield curve," in which broad-based declines in interest rates have been led, at times, by more inflation-sensitive, long-term bond yields. (See the chart above.) Supply worries, associated with the Treasury's announcement of a shift from semi-annual to quarterly sales of the thirty-year bond, were swept away by the rally. By contrast, "flight capital," triggered by the Mid-East conflict, periodically contributed to the market's strength earlier last month. *The impact of international capital movements on U.S. interest rates could be tested in coming months if, as expected, more aggressive interest-rate hikes abroad trigger accelerated declines in the dollar.*

The biggest threat to an early end to credit tightening? Stubborn inflation. *Investors keying on slower second-quarter growth shrugged off a jump in consumer-price inflation (excluding the volatile food and energy components) to a twelve-year high.* (See chart on next page.) However, investors' inflation expectations could sour, if the economy regains

momentum or if structural forces—less sensitive to the economy’s strength or weakness—continue to nudge inflation higher. Among them: further rent increases, efforts to push a greater share of health-care costs onto workers and improved “pricing power” associated with a weakening dollar, diminishing excess capacity and merger-related industry consolidation. Investor perceptions have become increasingly important, as the stimulus has been taken out of monetary policy, making the Fed’s actions as much “market dependent” as they are “data dependent.”

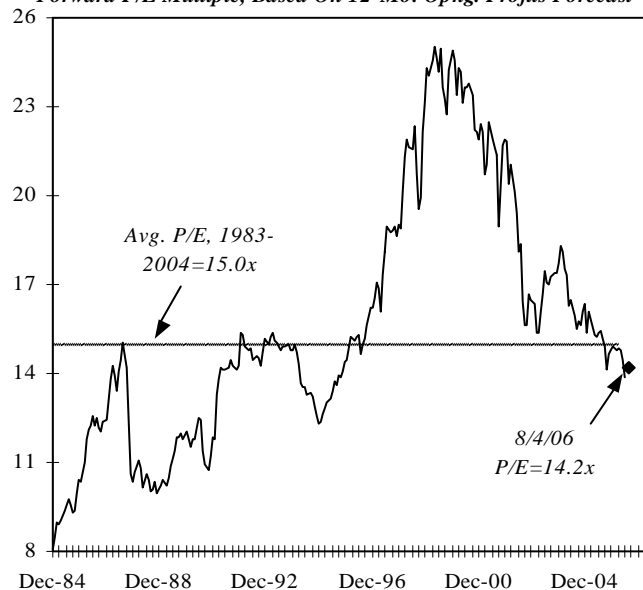
Investor complacency over recent increases in inflation has left bond yields all the more vulnerable to a less sanguine view of the inflation outlook, by allowing the yield premium over expected price increases to be squeezed to an eleven-year low. *Even if inflation proves to be more stubborn than expected, however, increases in long-term rates should be fairly limited, as long as the Federal Reserve maintains its inflation-fighting credentials by extending the credit tightening cycle with further increases in short-term rates.* And if inflation pressures soon begin to recede with more moderate economic growth, as the Federal Reserve anticipates? Then bond yields may well have peaked in this interest-rate cycle.

THE STOCK MARKET: A TUG OF WAR

“Sideways.” Stocks managed to edge forward for a second straight month in July, and extended those gains through the first week of this month. The bad news: a disappointing, 3.6% return thus far this year, despite double-digit earnings growth during the first half. Moreover, July’s modest gain masked heightened volatility that peaked at mid-month near its early-June high for the year. *The good news is that stocks have weathered “body blows” from heightened geo-political uncertainties, worries over the threat to earnings growth from slowing economic growth and cautious remarks on company prospects during the second-quarter reporting season.* Moreover, the fairly modest returns amid strong earnings growth has left S&P 500 valuations, based on consensus forward earnings estimates, at its lowest reading in a decade and with a still-sizable discount against bonds. (See the chart at right.)

Performance was about as narrowly based in July as it was in June, with six of the S&P 500’s ten sectors up and just 59 of the 129 industry groups contributing to those gains (vs. 58 the previous month). *“Defensive” consumer staples and health care showed signs of cementing their leadership role within the S&P 500, out-performing the more highly charged tech and cyclically sensitive sectors of the market for a second straight month amid uncertainties over the outlook for economic and corporate earnings growth.*

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



Source: S&P, IBES, Federal Reserve Board

Small caps continued their seesaw pattern against large-cap stocks, slumping last month after out-performing the S&P 500 in June (then moving ahead of the benchmark, again, during the first few days of August). July’s setback extended to the Russell MidCap Index, leaving that benchmark below both the large and the small-cap segments of the market on the year. *Elsewhere, the Russell 1000 Value Index out-performed, again, last month, boosting its already sizable performance advantage thus far this year to more than twelve percentage points over its Growth counterpart.* (See the Equity Scorecard table below.) Value’s advantage over Growth last month was broad-based, extending to ten of their twelve constituent sectors. Equally important, gains in Value’s important financial services, integrated oils and utilities sectors all contributed to the indexes’ rise, while Growth’s important tech and consumer “cyclicals” sectors both declined.

EQUITY SCORECARD

Total Returns, In Percent

	July '06	3 Mos. To July	Yr-To-Date July	2005
S&P 500	0.6	-2.1	3.3	4.9
Russell 1000	0.2	-2.6	3.0	6.3
Russell 1000 Growth	-1.9	-5.6	-2.8	5.3
Russell 1000 Value	2.4	0.5	9.2	7.1
Russell Mid-Cap	-2.2	-5.4	2.6	12.7
Russell Mid-Cap Growth	-3.6	-8.5	-1.1	12.1
Russell Mid-Cap Value	-0.6	-2.1	6.4	12.7
Russell 2000	-3.3	-8.1	4.7	4.6
Russell 2000 Growth	-5.2	-11.8	0.6	4.2
Russell 2000 Value	-1.4	-4.3	8.9	4.7
MSCI EAFE (\$ Terms)	0.7	-4.1	4.3	13.5
(Loc. Curr. Terms)	1.0	-2.9	11.3	29.0

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

Overseas markets barely edged out the S&P 500 last month, led by good-sized gains in such European centers as the Netherlands and the U.K., before slipping behind the U.S. benchmark early this month. *A weakening dollar has continued to enrich returns on overseas stocks for investors throughout the period, a trend that likely will continue as the dollar's decline picks up speed with rising interest rates abroad.* Since the start of this year, the "EAFE" benchmark for international-equity returns has returned nearly nine percentage points more than the S&P 500 in dollar terms, with the U.S. currency's decline accounting for over eight of the twelve percentage-point gain.

Earnings Growth Or "Multiple Expansion?" Stocks face several hurdles to improved performance in coming months. For starters, August tends to be difficult for equities, featuring below-average returns and above-average volatility. *And while the market impact of global economic and political "shocks" historically has been short-lived, an ongoing crisis (like the current fighting in the Middle East), threatening growth, inflation, interest rates or other market "fundamentals" could have a more enduring impact on performance.*

More importantly, slower economic growth has left stocks in the middle of a tug of war between those pulling back, amid worries over the impact on a still-favorable earnings outlook, and those positioning portfolios for an expansion of P/E multiples from expected interest-rate declines. *Better-than-expected earnings in the April-June period kept growth in double digits for a remarkable, twelfth straight*

quarter. However, cautionary remarks by reporting companies, cost pressures and slowing economic growth have left some investors doubting the consensus forecast of double-digit profits growth through the end of this year.

Lower interest rates could turn out to be the market's "ace-in-the-hole," despite the uncertainties swirling around stocks. Rising P/E multiples associated, with declining interest rates, had a material effect on stock prices during two previous growth "pauses" in the mid-1980s and mid-1990s. *As indicated in the table below, for example, multiple expansion added 35% to the S&P 500 as economic growth slowed and interest rates declined in 1985-86, and lifted stock prices nearly 12% above what they would have been in the absence of multiple expansion during a similar episode in 1994-95.*

GAUGING THE IMPACT OF P/E/ EXPANSION DURING TWO PREVIOUS ECONOMIC "PAUSES"

	Sept. '85	June '86	Dec. '94	July '95
EPS (\$\$)	19.8	19.6	37.1	40.6
10-Yr. Treasury Yield (%)	10.4	7.8	7.8	6.3
P/E Ratio (x Fwd. Earnings)	9.3	12.5	12.3	13.7
S&P 500	184.1	245.3	455.2	557.4
Wio. P/E Increase		182.3		499.4
% Difference	n.a.	34.6%	n.a.	11.6%

Sources: S&P, Inc., IBES, Inc., Federal Reserve Board

Incidentally, "defensive" S&P 500 sectors outperformed the more highly charged tech and "cyclically sensitive" market segments during the growth pause/multiple expansion" interval in 1985-86 and during most of a similar period during the first half of 1995. (Not surprisingly, interest-sensitive utilities and financial services outperformed defensive stocks during these two growth pause intervals, as rates moved lower.)

Style Points. Equity strategy is most commonly framed by the market's so-called "economic" sectors. Constituent sectors of the Russell and S&P benchmark and style indexes are arranged this way, as are most discussions over the future direction of the market. For example, a central issue in the outlook, at the moment, is whether market leadership will be maintained by defensive consumer staples and health care, or rotate toward "high beta" tech and cyclically sensitive materials, industrials and discretionary consumer goods industries. *However, economic sectors often are more a proxy for, rather than a "pure play" on desirable characteristics at a given stage of the economic cycle. In the high-beta/defensive stock debate, for example, most investors are less interested in consumer staples and health*

care, per se, than in “liquid” (or easily tradable) stocks with relatively stable earnings that are fairly insensitive to the economy’s “ups” and “downs.”

Identifying key characteristics cutting across sectors that are most attractive at any stage of the business cycle often can materially enrich returns beyond those based on economic sector allocations. Rolling twelve-month returns since 1990 were screened for periods of under-performance by the S&P 500, defined as those in which gains fall below their long-term average 8% a year between 1990 and mid-2006. As expected, the market’s two defensive sectors outperformed the more highly charged tech-cyclicals group when the overall market was struggling.

THE BOND MARKET: MORE THAN JUST A WHISTLESTOP?

Two For Two! The bond market extended its mid-year rally with a second straight monthly gain that continued into early August. *July’s return—its best since April 2005—nudged the Lehman Aggregate Index of investment-grade, taxable bonds back into the black” on the year.* Investors apparently were more impressed with lower interest rates than with the threat to credit quality from slowing growth, judging from the relatively strong performance of lower-rated, BBB-rated issues within the Aggregate benchmark. Performance rotated in early August back toward the higher-quality sectors, which continue to hold a comfortable advantage since the start of the year.

Long-term securities—whose long “duration” leaves their prices most sensitive to changes in interest rates—benefited most from the latest decline in yields. However, the near 3.5% return on thirty-year Treasury bonds since the end of June still left them with a sizable (5.7%) loss since the start of the year. Corporate bonds also were among the best-performing sectors of the market last month. *Industry returns within the corporate sector were fairly uniform, judging from their low dispersion, pointing up the soothing effect of ample liquidity and low default rates on credit-quality concerns.* However, that uniformity begs the question of whether investors are being compensated adequately for exposure in some of the more cyclically sensitive sectors of the market.

Mortgage-backed securities, close behind corporates since mid-year, rallied last month despite declining interest rates and increased pre-payment risk. Some investors reportedly were attracted to the market by expectations of an approaching end to the Fed’s credit tightening, potentially opening up so-called “carry trade” opportunities through relatively cheap, short-term borrowing for investment in higher yielding long-term securities. Asset-backed issues

However, “low-beta” and, particularly, the “mega cap” style groups enhanced performance more often during these periods and enjoyed a more noticeable return advantage, as well. Median returns of 3.2% and 3.9% for low-beta and mega-cap, respectively, have been well above the median of less than 1% for the defensive group defined in terms of the two economic sectors. Mega caps, at least, are well positioned to continue that pattern in coming months, because several years of under-performance have left them relatively “cheap” compared to other broad sectors of the market.

lagged the overall market in July and into early August, eating into a still sizable performance advantage against the Aggregate benchmark on the year. The group has been hurt, recently, by a rotation toward longer-term, lower-quality securities in the Lehman Aggregate universe.

Much like asset-backed, high-yield securities have lagged the Lehman Aggregate since mid-year but still maintain a comfortable performance advantage over the benchmark since the start of 2006. Within the high-yield sector, the lowest quality (Ca-D) segment led the way in July before relinquishing that lead early this month. That still left the group with a stunning, 23% total return on the year. *Lower-quality, non-investment-grade issues have tended to track the stock market in recent years more closely than the higher quality segments of the market, suggesting a closer connection in that part of the bond market with the same strong earnings growth and ample liquidity boosting stocks.*

Municipal securities under-performed the Lehman Aggregate for a second straight month, as well, before edging ahead in early August. Munis’ year-to-date returns remain above those in the taxable sector on the year. *Buoyed by light supply and relatively strong retail (or individual) demand, tax exempts’ relatively strong performance, recently, left the yield on the Bond Buyer Index of 20 General Obligation (or GO) bonds at its lowest level against long-term Treasury bonds since early June.* Overseas, non-U.S. Treasury securities lagged their U.S. counterpart last month and into early August, leaving year-to-date returns slightly below those on U.S. Treasuries after leading most of the year. Much of last month’s weakness centered on markets in Asia and Australia, while Canadian and several European money centers actually out-performed the U.S.

Bond Strategy: How “Risk Free?” Investors have been optimistic enough about the outlook to deploy more cash to bonds, but not enough to change materially sector strategy or the maturity distribution of their investments. Caution in the market has been understandable, given uncertainties over the economic and the interest-rate outlook. *Perhaps the biggest risk facing bond investors is that gathering expectations of lower interest rates could collide with rising inflation, particularly if the economy can sustain moderate growth.*

BOND MARKET SCORECARD

	Total Returns, In Percent			2005
		3 Mos. To	Yr-To-Date	
	July '06	July	July	
Leh'm Aggregate	1.4	1.5	0.6	2.4
Treasurys	1.2	1.6	-0.1	2.8
Agencys	1.1	1.3	1.1	2.3
Mortgage-Bkds.	1.4	1.4	1.4	2.6
U.S. Credit	1.5	1.5	-0.1	2.0
Asset-Bkds.	1.0	1.2	1.7	2.1
Municipals	1.2	1.3	1.5	3.5
High-Yield	1.0	0.6	4.2	2.7
Non-U.S. Gov'ts*	1.1	1.6	0.1	5.7

* Denominated in dollars, fully hedged.

Sources: Lehman Bros., Citigroup, Inc.

Despite the bond-“friendly” news in recent weeks, economic growth and interest-rate uncertainties still favor a low-risk strategy in the fixed-income market. *Of the four broad performance “engines,” a tilt toward higher quality sectors and securities would seem to be the most secure.* For one thing, narrow yield differences mean that investors aren’t being paid for the added risk of investing in lower quality segments of the market. Moreover, lower-rated issues likely will be more vulnerable to credit quality concerns, either because slowing growth is heightening worries over earnings growth or rising interest rates are raising questions about burdensome debt or other financial weaknesses responsible for the relatively low credit rating.

A move to extend portfolio “duration,” by tilting more toward longer-term securities, may be riskier than the shift toward higher quality sectors of the market. *However, with inflation expected to rise only gradually, and the Federal Reserve intent on maintaining its inflation-fighting credentials by raising short-term rates when necessary, any future increases in bond yields likely will be limited.* Moreover, there’s a good chance that these long-term

rates will be moving lower, if the growth slowdown is severe enough to trigger early interest-rate cuts by the central bank.

Perhaps the greatest risk centers on so-called “yield-curve strategy,” or the distribution of investments along the yield curve to achieve a given average maturity. The combination of rising short-term rates and steady-to-lower long-term rates has made this more obscure facet of bond strategy one of the more powerful performance engines in recent years. The advantage recently has moved back toward the so-called “barbell” strategy of splitting investments between short and long-term securities, as short-term rates have moved back above yields in the bond market. *However, the range of possible changes in the pattern of interest rates—and the associated risks in yield-curve strategy—is greater than it is for the other engines of fixed-income performance.* Steady-to-more-restrictive policy will continue to favor “barbells.” However, an early shift toward “easing” by the Fed would tilt the balance quickly toward a “bulleted” strategy of investing in intermediate securities, which tend to lead other sectors of the market when interest rates are moving lower.

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