Equity Strategy Weekly

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S&P 500 recovery ahead of the prior six cyclical recoveries, once again

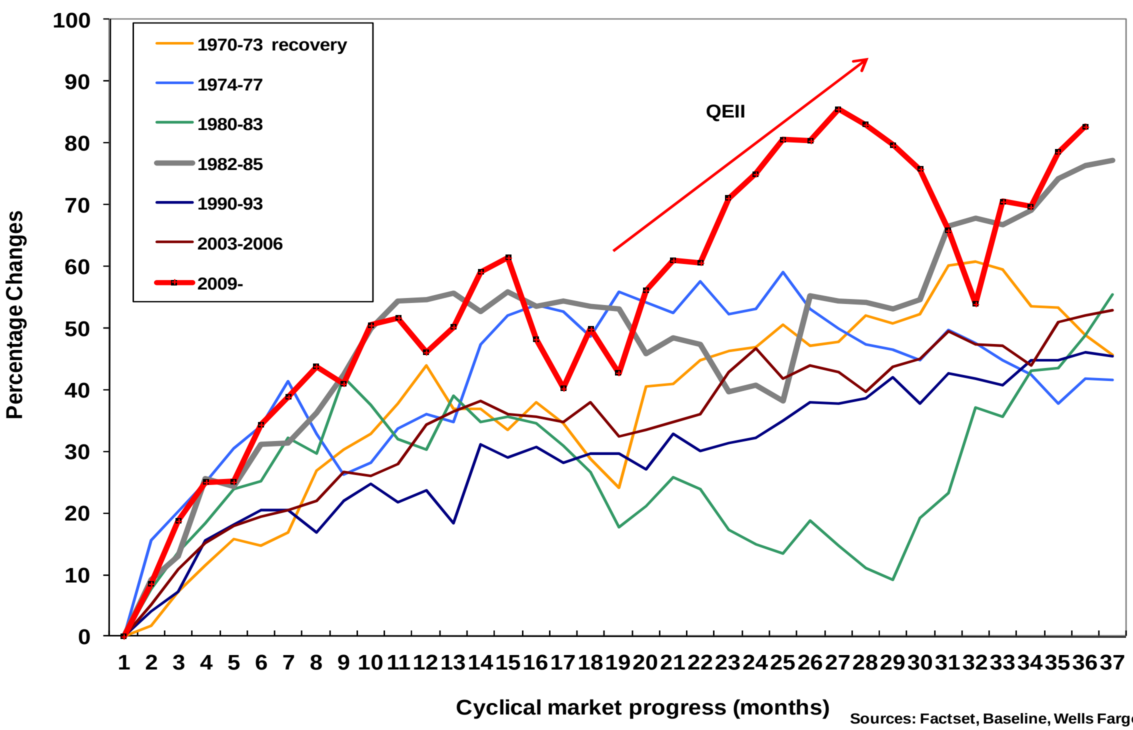
We suggest that while the current bounce does not necessarily mean the market cannot move higher in the intermediate term, we believe the recent move higher does suggest that the S&P 500 is once again trading at a relatively high risk level for so early in 2012. Our year-end target range continues to be 1325 to 1375 for the Index.

The cyclical recovery of the S&P 500 has generally been one of the strongest of the last seven recoveries. Overall, it has most closely followed the recovery after the 1980-82 double-dip recessionary period. We have plotted the last seven recovery cycles in Figure #1. This graph represents the performances of the last seven S&P 500 market recoveries indexed to zero at the start of each recovery.

The current recovery is plotted in red. As shown, this recovery that started in March 2009 has remained at the top end of the band of recoveries since its start. However, the expectation of a second round of Fed Treasury bond purchases to increase liquidity (QEII) resulted in a particularly strong move in the market between the 18th month of the recovery and the 27th month. QEI had resulted in stronger liquidity and better market

Figure 1

S&P 500 cyclical market performance indexed to bear-market bottoms



Sources: Factset, Baseline, Wells Fargo Advisors

Past performance is not a guarantee of future results. An index is not managed and is unavailable for direct investment.

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performance, and the announcement of QEII resulted in another strong S&P 500 move. That move, which clearly benefited from some of the new liquidity coming into equities, took the Index well above the rest of the prior cycles by April and May 2011 (and well above our year-end target for 2011).

As the QEII program was coming to an end, investors anticipated the possibility that the economy might thereafter slow with a declining liquidity feed from the Fed, and that the market may drift below the QEII highs. In fact, we did experience a softer economic period in the summer of 2011, with the S&P 500 declining below the levels of the 1982-85 and 1970-73 recovery periods, and below our year-end 2011 target range.

During the last 3-4 months, however, investors have noted the continuation in domestic growth during the second half of 2011, and psychology has moved beyond a mid-2011 period of broad mid-2011 double-dip recession fear. In a short period of time, the S&P 500 has now moved to and above the progress level of the 1982-85 recovery, once again, and into the middle of our year-end target level of 1325-1375. We suggest that while the current bounce above the 1982-85 recovery trajectory does not necessarily mean the market cannot move higher in the intermediate term, we believe the recent bounce does suggest that the S&P 500 is once again trading at a relatively high risk level for so early in 2012. We continue to target 1325 to 1375 for the Index for year-end 2012.

Weekly wrap and look ahead

All three major indices turned in strong performances in last week's trading. The S&P 500 rose 2.2% (Year-to-date up 6.9%), the Dow Industrials gained 1.6% (YTD up 5.3%) and the NASDAQ Composite jumped 3.2% (YTD up 11.5%). Looking at S&P sector performance, just three of 10 sectors outperformed the Index but all 10 managed to finish the week with gains. The best performing sectors were Financials (up 4.2%), Information Technology (up 3.1%) and Telecom Services (up 2.4%). The worst performing sectors were Utilities (up 0.2%), Consumer Staples (up 0.9%) and Health Care (up 1.0%). While the market is in rally mode, expect those sectors most sensitive to the economic recovery to outperform.

Fourth quarter earnings season will still be going strong for another week or so. A number of closely followed companies have still not released results. Through last Friday, with nearly 60% of companies in the S&P 500 reporting, earnings are up approximately 3% versus the year-ago period on an adjusted basis and up nearly 28% on a purely market cap basis. Recall that the S&P 500 is a market cap weighted index. Of those that have reported, 60% have come in ahead of the "Street" estimate while 30% have fallen short of consensus expectations. Note that in the middle portion of most economic cycles, it is common for earnings growth to slow substantially because year-over-year comparisons get tougher. With the economy no longer climbing out of a big hole, we look for earnings growth of approximately 5% this year.

Last week's most anticipated economic report, the headline employment data for January, did not disappoint. More non-farm payroll jobs were added than the consensus expected and the unemployment rate dropped to 8.3% versus the expected 8.5% unchanged rate. Jobs were added across a wide swath of industries while government at almost all levels continued to shed workers. Wage growth, however, remains subdued. Wages are up only 1.9% over the last 12 months. That rate of increase is close to a 70 year low. In addition, keep in mind that it will take time to recover the jobs lost in the last recession. According to the St. Louis Federal Reserve, there were approximately 147 million employed persons in the United States in mid-2007 versus something in the neighborhood of 140 million today based on the recent data. Given that the U.S. needs to create approximately 125,000 jobs on average each month just to keep up with demographic additions to the labor market, the 243,000 new jobs added in January does not move the needle much (243,000 – 125,000 = 118,000). If 250,000 jobs were created each month looking ahead, it would take nearly five years just to get back to the mid-2007 level of employment. But things are going in the right direction. We expect further improvement in the unemployment rate as we move through the year with our year end target rate at 8.3%. Employment data will continue to be the most watched economic indicator on a monthly basis.

Other news last week was mixed. Consumer confidence came in well below expectations in January but that apparently did not keep people out of the auto showrooms as vehicle sales were quite a bit better than expected last month. Factory orders in January also fell short of expectations but the services segment of the economy, as measured by the ISM (Institute for Supply Management) Non-Manufacturing Survey, was stronger than the consensus estimate. All-in-all, recent economic data and our analysis of various leading indicators continues to suggest a modest growth environment in coming quarters.

This week's economic calendar is rather sparse. Most of the source for possible market movement will likely come from the reaction to headlines out of Europe as negotiations with private Greek creditors reach a critical point. Private bondholders are being asked to take a 70% principal haircut on their sovereign bonds and then exchange their current holdings for securities with 30 year maturities and a coupon rate of 3.6%. Under the current proposal, government entities like the ECB (European Central Bank) would not see any losses in principal on the Greek bonds they hold. Needless to say, this bifurcated proposal is causing friction between government negotiators and private sovereign debt holders. Expect some fireworks in the form of headlines to potentially move the markets in coming days.

Economic reports out this week include consumer credit, weekly initial jobless claims and an early February reading on consumer sentiment from the University of Michigan. Consumer credit surged in November but the December reading is expected to show a more modest rise. Last week's initial jobless claims reading was well below the 400,000 level again, showing the labor market is seeing some light at the end of the tunnel. It will be interesting to see if Friday's preliminary sentiment reading is lower than expected, following in the footsteps of last week's confidence report from the Conference Board that came in well below most estimates. Consumers are a fickle bunch, often saying one thing in the various surveys and doing another in reality. We do not look for a steady, sustainable rise in confidence until the housing market stabilizes and jobs are easier to find.

Wells Fargo Advisors
Sector Weighting Recommendations / S&P 500 EPS Estimates / S&P 500 Target:

Sector	S&P Weighting*	Wells Fargo Advisors Guidance	
Industrials	11.0%	Overweight	12.0%
Materials	3.7%	Overweight	4.0%
Telecom Services	2.7%	Overweight	5.5%
Utilities	3.5%	Overweight	7.0%
Consumer Discretionary	10.8%	Evenweight	11.0%
Energy	12.0%	Evenweight	12.0%
Consumer Staples	10.6%	Underweight	9.5%
Financials	14.4%	Underweight	11.0%
Health Care	11.5%	Underweight	10.8%
Information Technology	19.6%	Underweight	17.2%
S&P 500 Earnings Estimate for 2012:			$103.00
S&P 500 Year-End 2012 target:			1325-1375

Sources: Bloomberg, Wells Fargo Advisors
**Sector Weightings May Not Add To 100% Due To Rounding*
Pricing: based on February 3, 2012 close

Important Disclaimers

Past performance is not a guarantee of future results.

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