

Strategic Insights

Advisory Services Group

Advisory Services Group (ASG) Special Market Update

What should investors do?

We are recommending that long-term investors who are underweighted in equities to use the current market weakness as a buying opportunity. In addition, the Investment Strategy Committee announced a tactical tilt on Aug. 4, to reduce intermediate-term fixed-income securities by 2% and add to large-cap equities by 2%. ASG believes it is still too early to jump into the market in a big way, but long-term investors should use current market weakness to add to equity positions.

We think being slightly overweight in equities and slightly underweight in fixed income makes sense as the market has pulled back from its 2011 highs and currently trades below our yearend target range of 1250 – 1300 for the S&P 500. With the recent pullback, equities are cheap on historical Price/Earnings valuation basis, and we continue to see corporate earnings increase. With the tactical tilt, we didn't try to pick a bottom, but rather start to accumulate equities as ASG believes the recovery will continue, although slower than most.

What are three things that could help the market recovery?

1. Lower oil prices are good for the economy, giving consumers more purchasing power.
2. The Federal Reserve could engage in more stimulus if inflationary pressures abate.
3. Economic data may not be as weak as several recent reports suggest. If future economic news indicates the economy is more resilient, the stock market should recover.

Why has the market dropped so much recently?

The stock market has dropped sharply in the past few weeks because investors are

increasingly worried about politics in Washington and the health of the economy, both here and in Europe. Congress passed a budget compromise which takes away the risk of a default on government debt, but there is still a risk that government debt could be downgraded because the compromise was too little too late. On top of the political drama, recent economic reports have been weak, making investors worry that the economy may be headed into another recession. In addition, the market broke important support points that encouraged some technical selling. For example, the S&P 500 broke its uptrend from the March 2009 low, and the S&P 500 broke below its widely watched 200 day moving average. Violating these points likely triggered some trading programs as well as some nervous selling.

Is this market decline normal?

So far, the market has dropped about 12%. History shows that the stock market has a 10% correction about once a year. Last year, the stock market declined 17% between late April and early July. At that time, investors worried that the economy was heading back into recession, but the economy continued to grow.

Is the economy going into recession?

At this point, we would put the probability of recession at 25%. Of course, anything could happen. When the economy is weak, it is more vulnerable to unexpected shocks. For example, if the price of oil was to spike upward, or the European debt crisis worsen or a natural disaster hit, confidence and spending could decline, sending the economy into recession. Fortunately, oil prices are dropping now not increasing. Lower oil prices will be like a tax cut for consumers and businesses in the months ahead.

Please see page 2 for Important Information, Risk Factors and Disclaimers

What is the likelihood of another big drop like in 2008?

The 2008 bear market is still fresh in many investors' minds. In 2008, the U.S. economy was in recession for more than half a year before the financial crisis hit in September 2008. Earnings were declining and oil prices were rising much of that year. The failure of the government to pass legislation to provide funding to address the financial crisis only aggravated the other problems. This year the situation looks different as earnings are rising, oil prices are now declining and Congress did pass the debt-ceiling compromise. A repeat of 2008 could have occurred if Congress had not raised the debt ceiling and the government defaulted on its obligations. Fortunately, that did not happen. Nevertheless, investors are still worried about a repeat of the 2008 bear market.

What could get the economy growing again if the government is cutting the deficit, consumer sentiment is low and companies are reluctant to create jobs?

One of the big headwinds that hurt the economy earlier this year was the jump in gasoline prices. Now energy prices are declining again. If the national average gasoline price drops to \$3.50 per gallon or less over the next few weeks, consumers and businesses will have more money to spend on other goods and services. This would probably make consumers feel better and spending could increase.

Will the Federal Reserve provide more stimulus?

The odds of another round of stimulus have increased as the economy softened and oil

prices have dropped, reducing inflationary pressures. This time around the Fed could do something different than just buying more government securities outright. Instead, the Fed could sell short-term government securities and buy long-term government securities. This would lower mortgage interest rates without creating a lot of inflationary pressures.

Is the market overvalued or undervalued?

Corporate earnings have been increasing at the same time that the stock market has been declining. As a result, price-to-earnings ratio has declined, making stocks undervalued. Comparing the current level of the S&P 500 with the street's expected 12-month forward operating earnings puts the P/E ratio at about 11.9. This is below the average P/E ratio of 14.8 since 2007. Thus stocks are undervalued, in our opinion. The last time stocks were this undervalued was during the market correction of 2010, and before that during the bear market of 2008 when the P/E ratio dropped to almost 10.0. Both periods were buying opportunities for long-term investors.

Is the market due for at least an oversold bounce?

Yes, the stock market is oversold by many technical measures and is probably due for at least a bounce. However, it is impossible to know from what level. Often, a rebound will occur when selling is exhausted and bargain hunters go back into the market. Given recent market action, we could be close to that point soon, provided there is no further disappointing news for a while.

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