"Bringing You National and Global Economic Trends for Over 20 Years"

MARCH 2003

WELLS CAPITAL MANAGEMENT

Economic and Market Perspective

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During the 1990s, the United States experienced one of the greatest and most dramatic advances in the application of technical science (the technology boom) in its history. Yet, we are currently being reminded that perhaps we still are not far removed from the era of the cave man. For in the contemporary period of terroristic threats, the only advice offered by the U.S. government to its citizens is to stock up on Spam and duct tape!

It is not that investors are seeing red, rather they are totally obsessed with the color orange, the color of the current government terror warning. No doubt this is a spooky time. Indeed, it is difficult to focus on fundamental economic and corporate earnings reports when being constantly bombarded by reports on the symptoms of smallpox and the "to do" list in the event of a dirty bomb incident. Are the horrendous nightmares being thrown about possible? Yes. Probable? No.

It seems more likely the current hysteria surrounding Iraq and terrorism is being greatly overblown. More probable is that a huge buying opportunity is being established in the stock market, should the outcome prove far less horrific than feared. In our view, by year-end, the direction of the stock market will be determined not by war and terror, but by the fundamental performance of the economy. Although the risk of war and terrorism will be with us for the foreseeable future, the intensity of these issues should be significantly reduced in a few months. Then investors and businesspeople will be left with the undertow of economic momentum. Traders may find a way to advantage themselves from the current market volatility, but investors are probably best served by ignoring the noise and staying focused, not on the color orange, but rather the strength of economic growth in the coming year. On this score, despite all the exogenous uncertainties, we remain optimistically inclined.

> *"By year-end, the direction of the stock market will be determined not by war and terrorism, but by the fundamental performance of the economy."*

Back to Fundamentals!!!

Despite being largely ignored at the moment, economic growth seems to have revived in the last few months. The unemployment rate fell 0.3 percent to 5.7 percent in January, on the largest non-farm monthly job gain since November 2000. The jobs picture is also being bolstered by a slowly improving, but persistent, downward trend in weekly initial unemployment claims. Household disposable personal income is up about 8 percent in the last year, one of its strongest growth rates in the last 15 years! Consumer refinancing activity remains at a pace nearly double a year ago. Housing reports remain remarkably robust. In January, non-auto retail sales surged by their largest amount since September 2000 and have grown at an average annual rate of almost 6 percent in the last six months. Far from pulling back into their cocoons, the consumer appears to be plowing ahead.

You would not know it by listening to most company comments, but about 60 percent of the Standard & Poor's 500 Index companies who have reported fourth quarter earnings met or exceeded Wall Street estimates. On a year-over-year basis, S&P 500 profit growth has now risen in each of the last three quarters. Perhaps more impressive than earnings reports is the recovery in corporate sales. Among S&P 500 companies, total top-line sales grew about 4 percent in the last year compared to a "decline" of about 4 percent a year ago. S&P 500 technology company sales growth has improved to about 10 percent after contracting by almost 25 percent in late 2001.

The biggest recovery in the corporate economy seems to be in the sector hit the hardest in recent years—manufacturing. The Purchasing Managers' Survey index has been strongly above the 50 percent level in each of the last two months. *BusinessWeek*'s production index, after contracting on a year-over-year basis by about 8 percent a year ago, has now risen more than 4 percent in the last year. Similarly, manufacturers' new orders are up about 2 percent in the last year compared to a contraction in orders of about 8 percent a year ago. Finally, competitive pricing conditions have improved markedly for manufacturers in the last year. The JOC Industrial Commodity Price Index is up more than 20 percent from its low last year, its biggest surge since 1994.

Lastly, one of the missing elements of this recovery, inventory building, is starting to kick in. From its low last April, business inventories have risen at a 4 percent annualized pace and have risen each of the last eight months. A renewed business willingness to stock the shelves, it may be a sign confidence is finally returning and may soon lead to greater employment and capital spending.

Impressive Policy Stimulus!!!

Our optimism for the economic outlook continues to rest mainly on the radically enhanced policy stimulus applied in the last year. A year ago, although the Federal Reserve was highly accommodative, other economic policies remained restrictive. The fiscal budget was in surplus, the U.S. dollar exchange rate was rising and long-term bond yields remained stubbornly high.

Today, all policies are on full steam ahead! The Fed is still priming the pump, but now, we additionally have $230 billion of fiscal stimulus, an 18 percent lower value of the U.S. dollar and a 4 percent 10-year Treasury yield as opposed to 5.25 percent. The good news is we have much more stimulative policies. The bad news is that these additional policies have not been accommodative very long. The U.S. dollar did not begin to decline until last April, the U.S. budget was still in surplus until last spring and long-term yields did not collapse until last July. Each of these policies have lag times, most as much as a year. This suggests fiscal policy, dollar weakness and lower long-term yields will not produce much noticeable benefit until the spring at the earliest and more likely in the summer.

Overall, current momentum in the economy seems to be accelerating and, although not yet that strong, it hardly seems close to any kind of double-dip recession. Moreover, with several economic policies becoming more impactual as the year progresses, we still think the consensus forecast for real Gross Domestic Product growth will prove too conservative. Currently, consensus calls for about 2.5 percent growth this year. Perhaps we are too optimistic, but at this point, still think real GDP growth may come in closer to 4 percent this year.

A Bond Story Gone BAD???

Although long-term Treasury bond yields remain near cycle lows, we think the fundamentals underpinning the bond market have worsened considerably. If an economic recovery takes hold, all the pieces for a major inflation fear and bad bond market are already in place.

As soon as economic recovery becomes accepted, bond investors will be quick to point out just how bad the inflation picture looks. The Federal Reserve will quickly be accused of "overstimulating"—taking short-term yields to 40-year lows and massively pumping the money supply during the last couple of years. While this policy looked appropriate in the heat of the economic meltdown, once the economy recovers, the same policy looks shamefully overaggressive and inflationary. Second, bond investors will quickly take note the U.S. government is back in red ink—implying upward "crowding out" pressure on interest rates and suggesting we face a period of rapid growth in the government bond supply. Third, recent weakness in the U.S. dollar will escalate fears among bond players that foreign demand for U.S. bonds will dry up, or worse still, that foreign investors will start dumping U.S. debt securities. Fourth, many will notice commodity prices have already been rising for about a year and are already up by more than 20 percent. Fifth, the two most important "inflation" commodities—oil and gold—have soared to new heights recently, already leaving many wondering what this implies about future inflationary pressure. Finally, the inflation buffer, the difference between the current 10-year bond yield and the rate of consumer price inflation, is close to a two-decade low at about 1.5 percent. If the economy recovers, bond investors may want to increase this buffer closer to its average in recent years of about 3.5 percent.

We do not believe the economy is headed for a major increase in inflation, but we do expect inflation to rise somewhat in the next couple of years and for "inflation fears" to potentially surge. Simply put, once the economy is perceived as growing again, we think the bond market story turns ugly in a hurry. We continue to recommend investors reduce overall bond weightings and shorten maturities in anticipation of a period of rising yields. We would not be surprised if the 10-year yield reaches 5.5 percent at the cyclical economic top.

Buy Those Stocks!?!!

A year ago at this time, most companies missed fourth quarter earnings estimates, but had favorable comments about results for 2002. Despite missing estimates, the optimistic company commentary about the future lifted stock prices. As mentioned earlier, about 60 percent of the companies have currently met or exceeded Wall Street estimates. However, stock prices have fallen anyway because most companies delivered pessimistic comments about the

outlook. The difference from last year is striking. A year ago, profit fundamentals were disappointing but expectations were optimistic. Today, earnings fundamentals have been surprisingly good, but pessimism is prevalent. A year ago, companies almost had to have a rosy outlook; after the events of September 11, unfavorable comments may have bordered on unpatriotism. Today, it would seem almost imprudent to have an optimistic view since everyone knows we are imminently facing a war and perhaps terrorist activities. Last year, the fundamental earnings reports were correct and company commentary led the market astray. Perhaps the lesson for this year is to listen to the fundamental reports and ignore the pessimistic commentary???

We think the stock market's risk-reward ratio is much improved this year compared to recent years. We do think the stock market is likely to head higher before the year is out, but just as important, we also believe its potential downside risk, should we be wrong in our outlook, is also far less than in the past. A year ago, had the economy recovered, the stock market probably would have risen 25 percent or more rather than declining by 20 percent once the economy disappointed. Today, if the economy recovers, the upside in the stock market may be 30 percent to 40 percent (which would take us back to the level we were at last March). However, what would happen if the economy does not respond and simply remains mirrored in a positive but sluggish growth pattern? In this latter case, we think the stock market would not go much lower than it already has. Why? Because this is the consensus expectation and the stock market is already priced for such an outcome.

A year ago, the stock market had considerable upside potential if the economy recovered, but also possessed significant downside risk if the economy disappointed. This stock market profile existed because most were optimistic about the economic outlook when 2002 began. Today is quite different. Expectations for growth are for the economy to remain about flat with last year, about 2.5 percent real GDP growth. If this occurs, the stock market probably remains flat within a broad range. However, if the economy surprises to the upside, then the stock market will also produce good results. We feel better about overweighting stocks this year not only because its upside potential is significant, but also because further downside risk is probably low.

A 30 percent to 40 percent advance in the stock market during the next year may seem extremely optimistic but is well within historic precedents. Since at least 1970, every ending of a recession has led to at least this big of an upside stock market move within one year of the stock market low. Consider the following percentages which record the advance in the S&P 500 from the recession low to its high in the ensuing year for each of the following recession years: 1970 – 50 percent, 1974 – 54 percent, 1980 – 43 percent, 1982 – 68 percent and 1990 – 35 percent. Again if the economy just muddles along this year, the stock market probably will too. That is, unless the economy fully declines into a double-dip recession, the stock market will not likely go much lower than the October lows. However, if the economy does finally respond, a 40 percent advance is not at all out of the question.

Summary

Perhaps we will be proven wildly optimistic regarding our outlook for this year. It certainly has not been going very well so far. It is possible the Iraqi war situation could go badly or that the United States is again attacked by terrorists. It is even possible the economy simply does not show any response to the more accommodative economic policies the country has put in place.

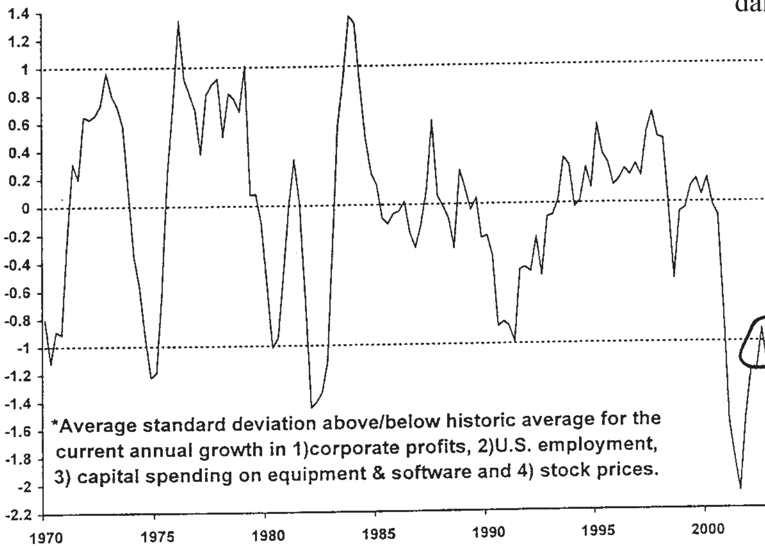
We admit some concern and sleepless nights surrounding these possible outcomes, but continue to believe investors are best served by focusing on a return to optimism both in the economy and in the financial markets. For those who are bold (or ignorant) enough to look through the current worries and see recovery, we think their reward will be the color of Green!

James W. Paulsen, Ph.D.
Chief Investment Strategist, Wells Capital Management

The Decline Has Been DEEP!!!!

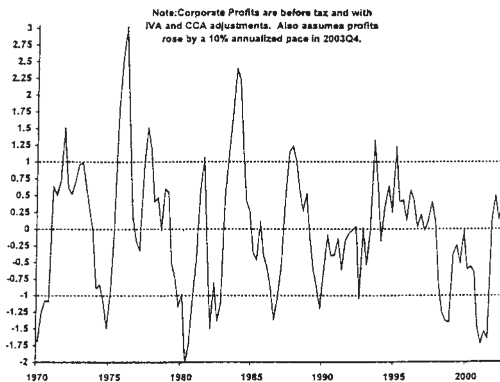
The four economic variables of primary interest are corporate profits, capital spending, jobs and the stock market. The lower four charts examine historic annual growth in these indicators expressed in terms of standard deviations above or below their respective average annual growth rates since 1970. The top chart combines all four variables into a single "watch indicator." A few points are noteworthy. First, the contemporary decline in the watch indicator has been far more pronounced than any other recession since at least 1970. This indicator hit a low last year of more than two standard deviations below normal. In the past, recession bottoms were reached at about one standard deviation. Second, the recovery thus far has been significant—this indicator has already improved by about one standard deviation from its low. However, despite this large improvement, it is now only back to about the bottom of previous recessions. The stock market is the worst—still about 2.25 deviations below normal. For the economy to be perceived as having finally recovered, the watch indicator will need to rise by at least one more standard deviation.

"WATCH INDICATOR"*
Standard Deviations Above/Below
20-Year Rolling Historic Average Annual Growth Rate

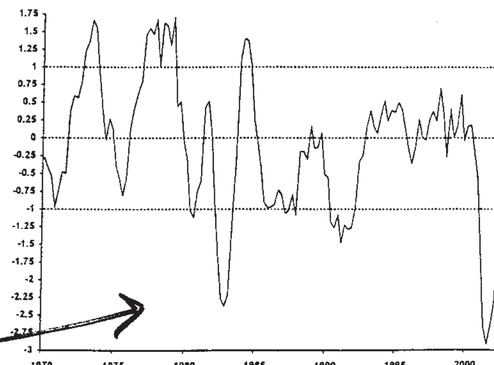


Although this has recovered by 1 Standard Deviation... ...It is still 1 SD Below Normal!!?

WATCH INDICATOR - CORPORATE PROFITS
Standard Deviations Above/Below
20-Year Rolling Historic Average Annual Growth Rate

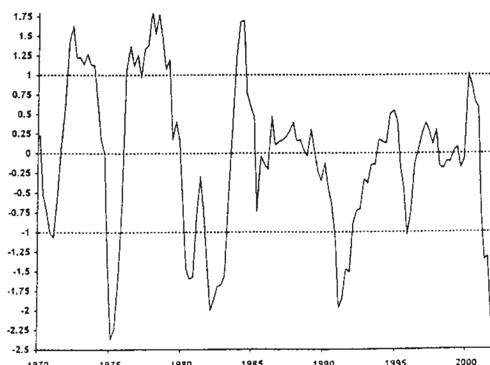


WATCH INDICATOR - INVESTMENT on Equipment & Software
Standard Deviations Above/Below
20-Year Rolling Historic Average Annual Growth Rate

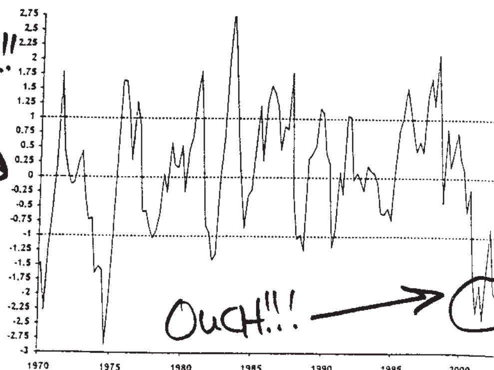


These Are the 4 most Closely "Watched" Indicators!!

WATCH INDICATOR - U.S. EMPLOYMENT
Standard Deviations Above/Below
20-Year Rolling Historic Average Annual Growth Rate

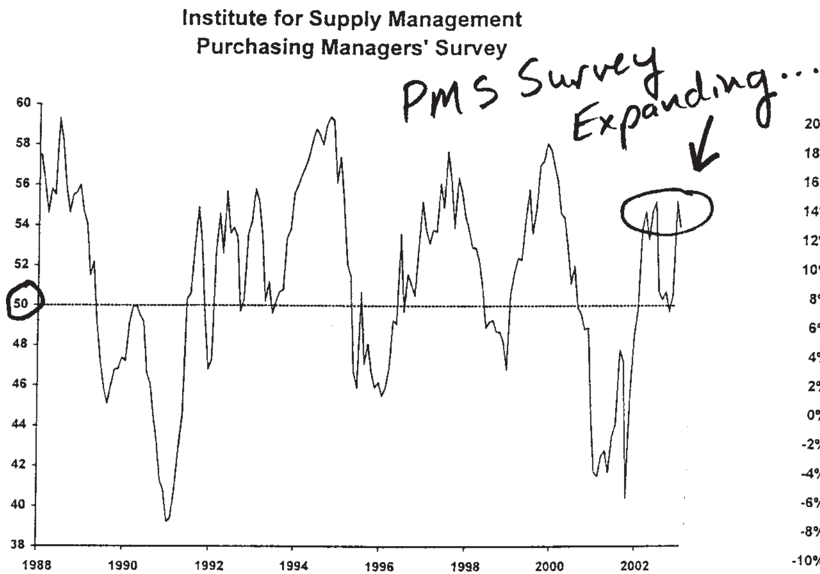


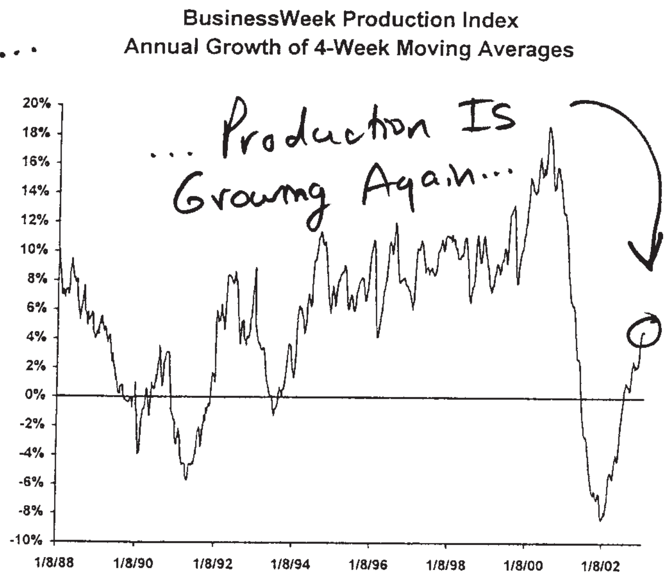
WATCH INDICATOR - S&P 500 Stock Price Index
Standard Deviations Above/Below
20-Year Rolling Historic Average Annual Growth Rate



Manufacturing Sector is Recovering!?!?

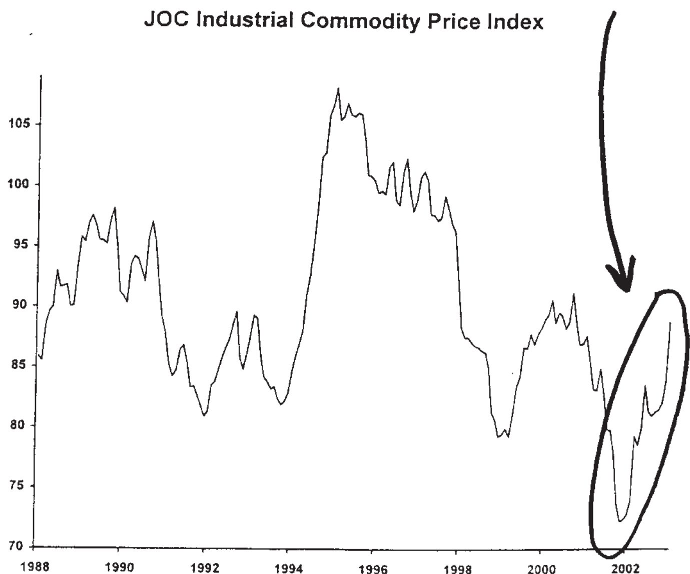
The manufacturing sector, perhaps the hardest hit sector in this recession, is starting to show signs of recovery! The purchasing managers survey has been above 50 percent in each of the last two months, the *BusinessWeek* production index is up more than 4 percent in the last year, industrial commodity prices have risen more than 20 percent from their early 2002 lows, and manufacturers' new orders are growing again. This represents the strongest and most widespread evidence of industrial recovery since the dot-com top in early 2000. Let's hope it continues to build.

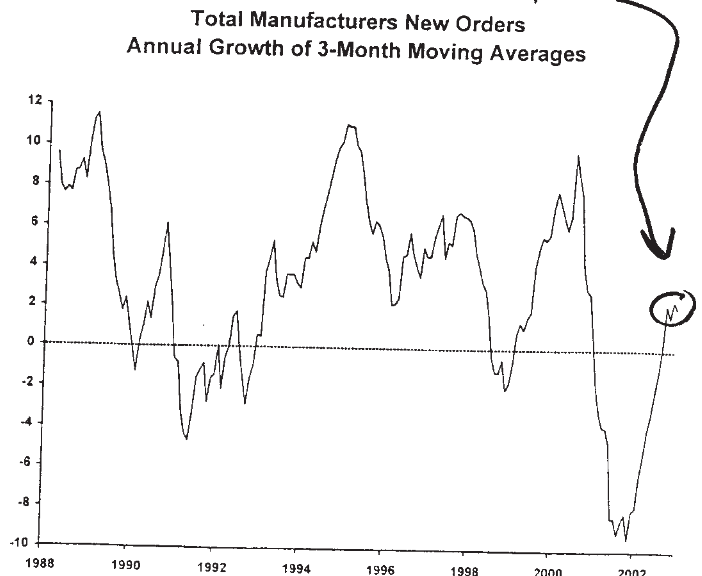




...Industrial Pricing Has Improved...

...And, new orders Are Rising Again!!!

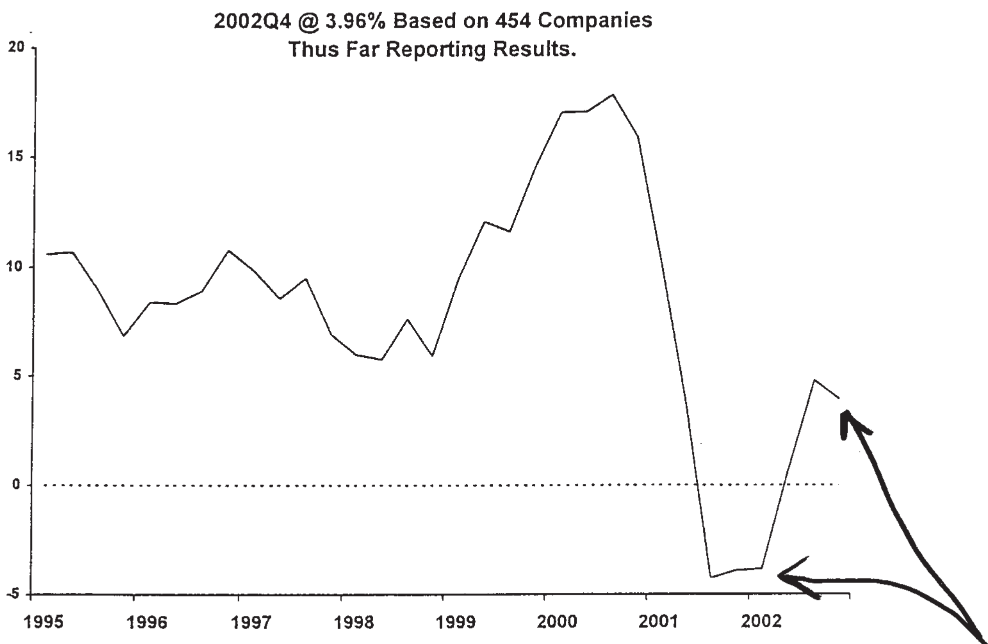




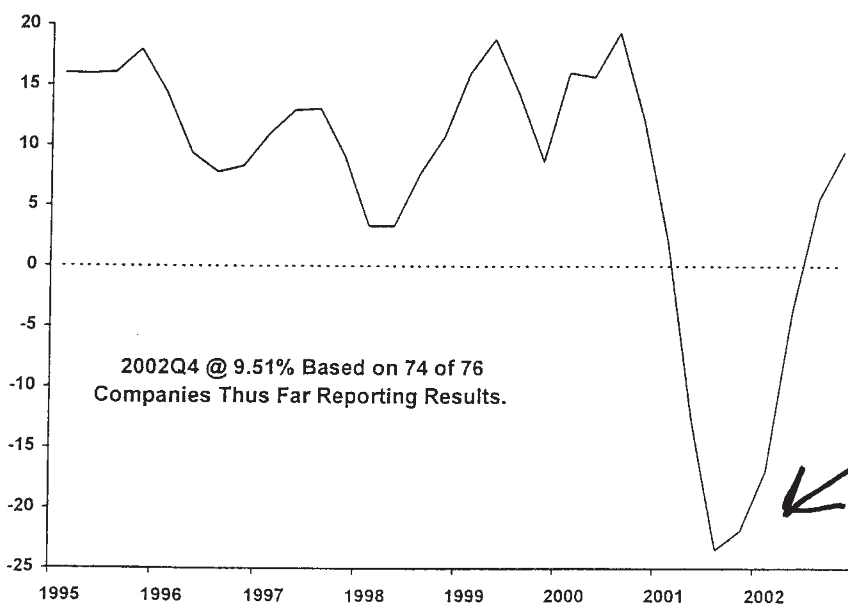
Top Line Growing Again!!??

One of the more unique characteristics of the 2001 recession has been the severe reduction in sales growth. A year ago, total S&P 500 company sales fell by almost 5 percent year-on-year, and S&P 500 technology company sales declined by about 25 percent on an annual basis. Today, the situation looks far better. For 454 of the 500 companies which have thus far reported fourth quarter 2002 results, the annual growth in S&P 500 total sales has been about 4 percent. While still slower than earlier in the decade, sales growth has improved markedly in the last year. For technology companies, the recovery has been even more noticeable. Through the fourth quarter of 2002, the annual growth in sales among S&P 500 technology companies has been about 10 percent—on par with mid-1990s results. Probably the main reason that profits, capital spending, inventory building and jobs have remained uncommonly weak in this recovery is because sales growth was hit so hard. The improvement in top line results illustrated by these charts suggest that some of these trends may now improve?!?

Annual Q/Q Total Net Sales Growth
S&P 500 Composite Stock Price Index



Annual Q/Q Total Net Sales Growth
S&P 500 Information Technology Sector

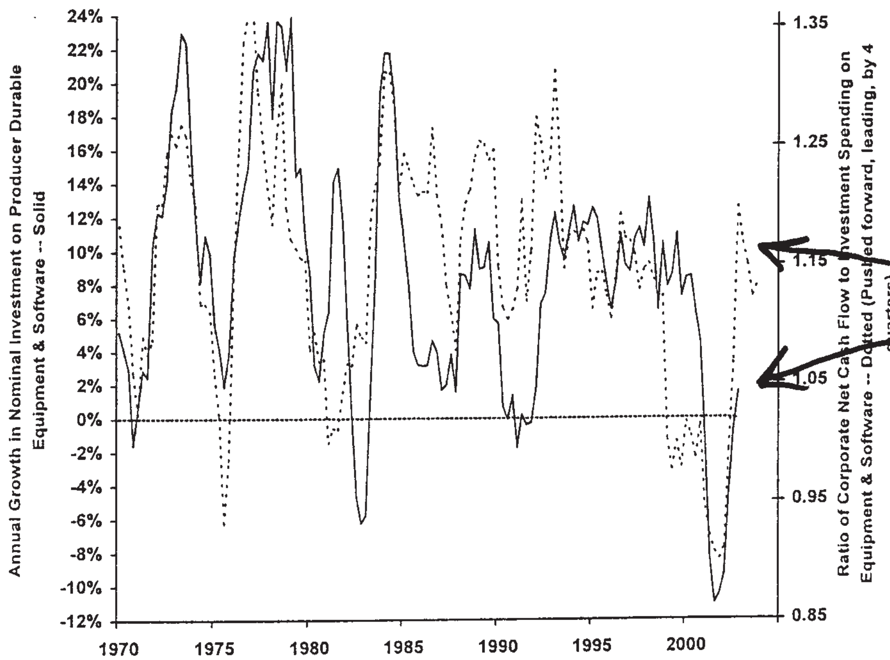


BIG IMPROVEMENTS!!...

Corporate Finance Looks Good!!!

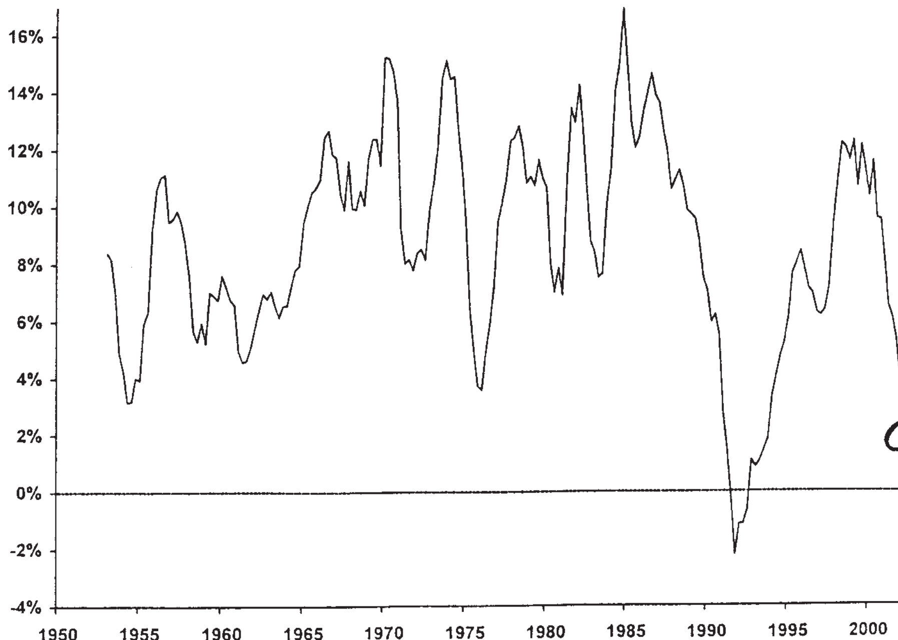
Corporations have improved their financial position in the last few years and now appear able, if not yet willing, to drive another capital spending cycle. The top chart compares the annual growth in equipment investment to the cash flow to investment ratio. Note the close relationship and the fact that the cash flow ratio leads investment by one year. Currently, the improvement in corporate cash flow is suggesting that a healthy surge in investment spending may be forthcoming. The lower chart shows that corporate financial improvement has not simply been limited to cash flow, as corporate debt growth has slowed to its second slowest growth rate in the postwar era. We think the corporate sector has reestablished buying power and could embark on another investment cycle?!?

Annual Growth in Equipment & Software Investment vs. Cash Flow to Investment Ratio



Equipment Investment To RISE!?!

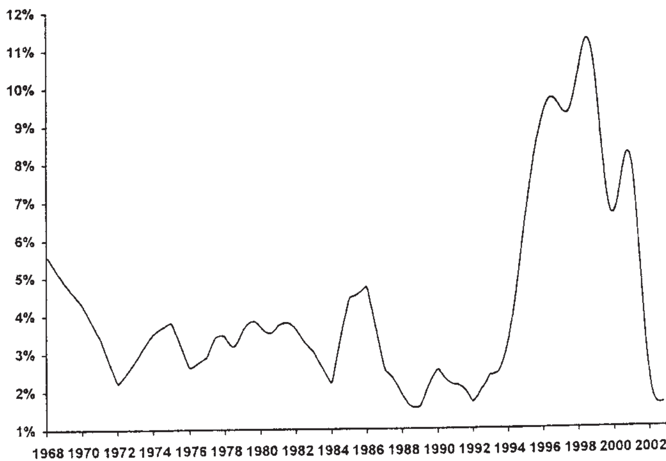
NonFarm NonFinancial Corporations Annual Total Debt Growth

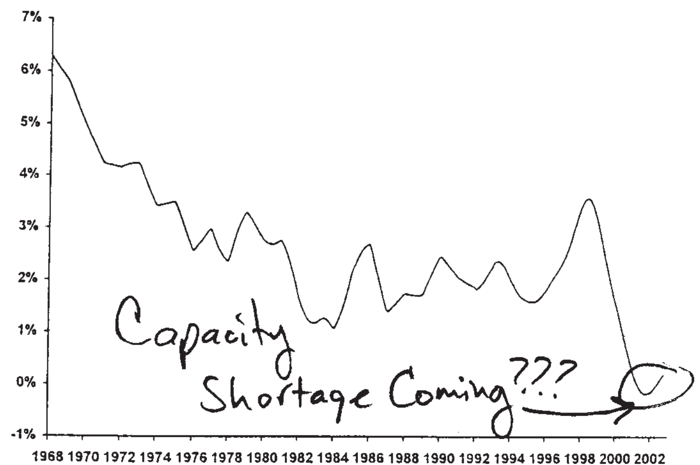


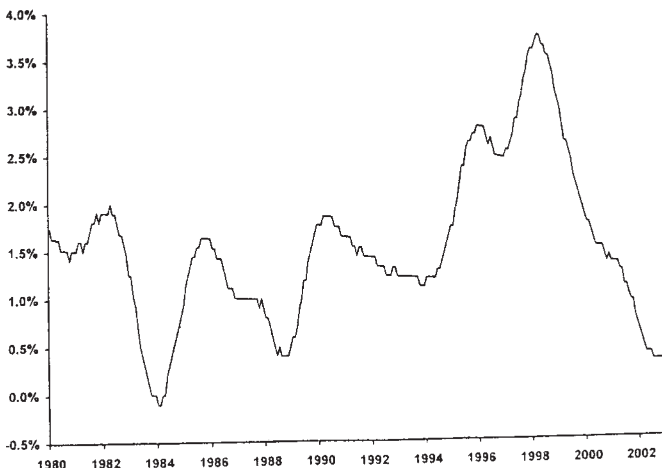
Corporations Have Deleveraged!!!

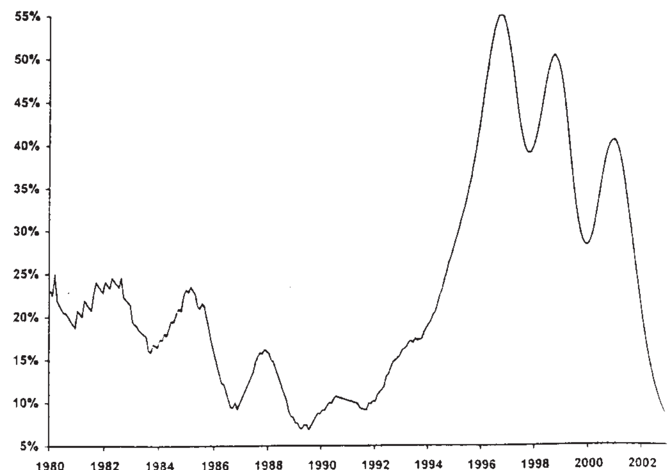
Capacity Glut Ending???

As these charts show, capacity growth surged to record levels during the late 1990s investment boom. In the last few years, however, additions to capacity have slowed significantly. This may allow utilization rates to rise quickly should economic growth improve and at the very least is probably already contributing to the improved industrial pricing power which is beginning to materialize.





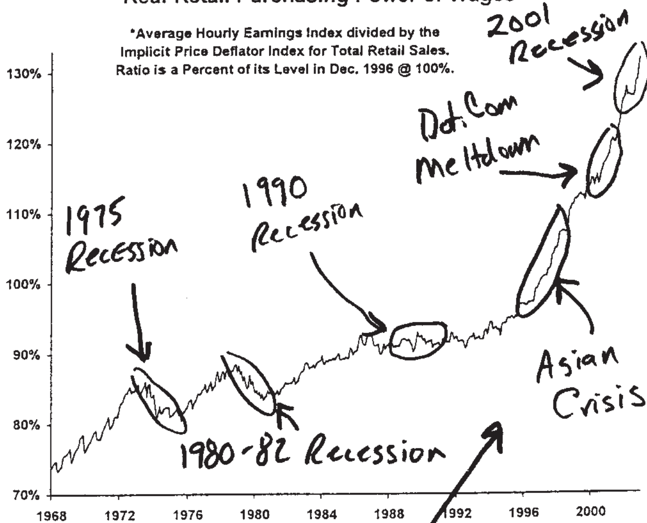




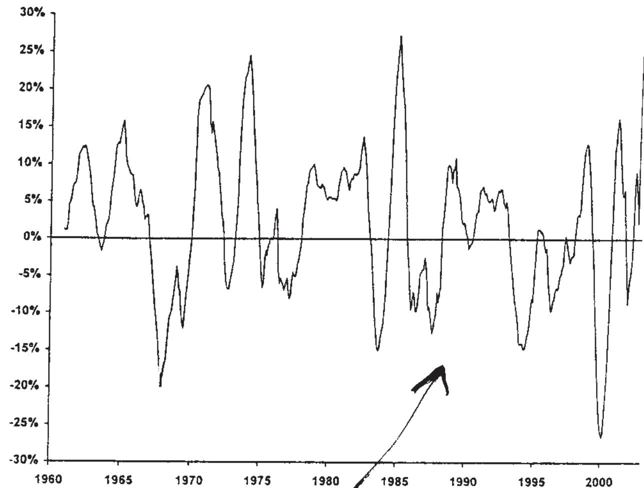
Consumer Finding Ways to Stay Healthy!!?

In our view, the consumer remains in pretty good shape. This page offers just a few reasons why the consumer has surprised, and will likely continue to surprise, with its resilience. By far the biggest positive for the consumer has been rising real wages. Until the mid-1990s, real wages were typically flat and often declining. Indeed, during the 1975, 1980-1982 and 1990 recessions, real wage growth was either flat or falling. It has been quite a different story since 1995. Perhaps because of persistently "rising" real wages, the consumer has made it through the Asian crisis, the dot-com meltdown, and the 2001 recession without faltering. We expect real wages to continue to climb this year, keeping the household sector from capitulation. In addition to rising purchasing power, the consumer is also being stimulated by a significantly reduced tax burden and by a lower interest cost burden. Finally, household savings are rising again. In the last year, real personal savings have risen more than 25 percent—a postwar high annual rate of growth! Although consumer spending might not accelerate a lot this year, as this page suggests, the consumer is also not likely to weaken much from its 2002 economic growth contribution.

Pretty Good Story Here...

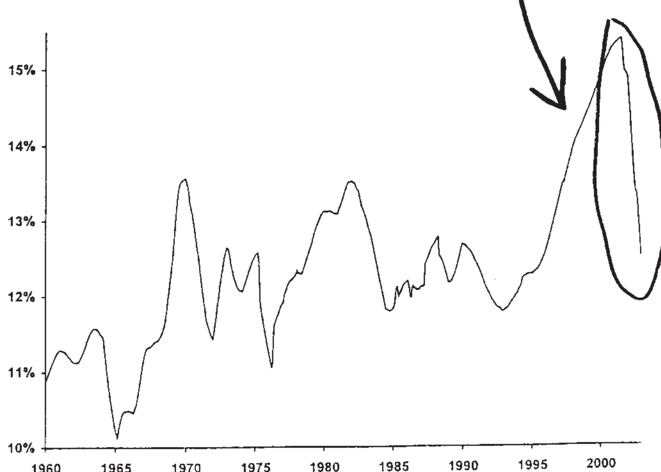


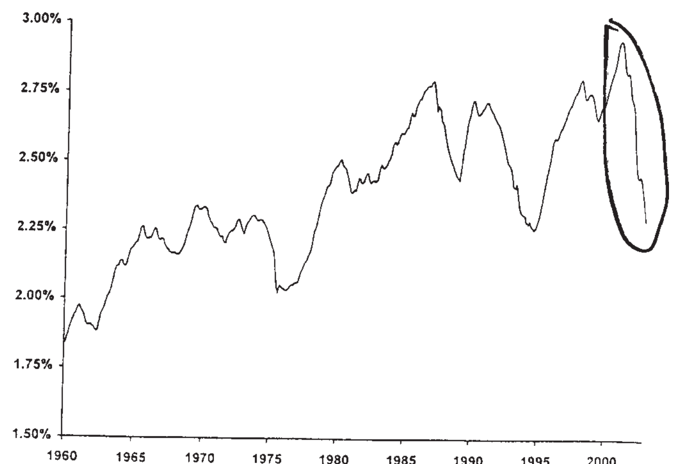
① Rising Real Wages!



② Surging Growth in Savings!!

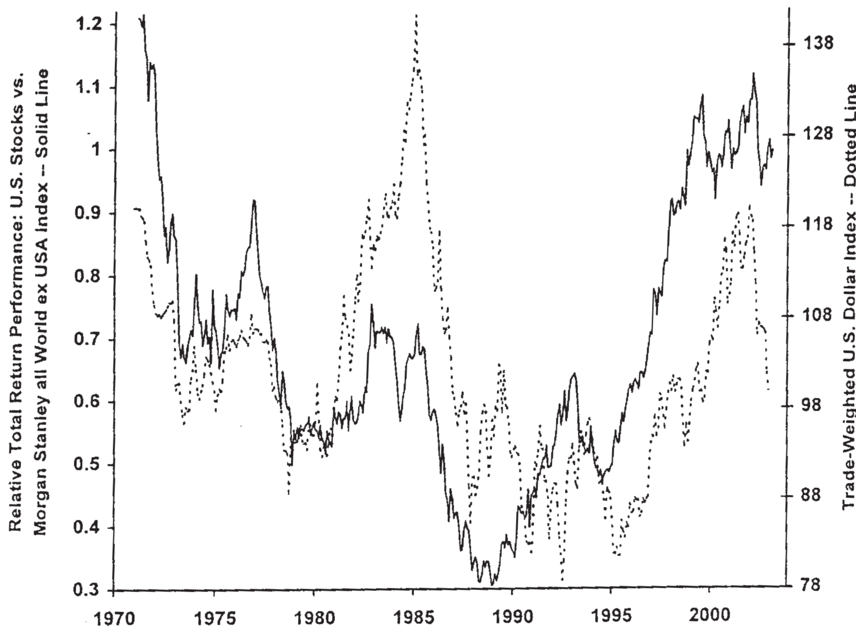
③ Paying less Taxes... And... ④ Less Interest Cost!!!

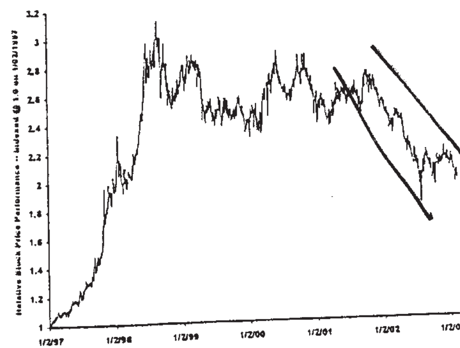


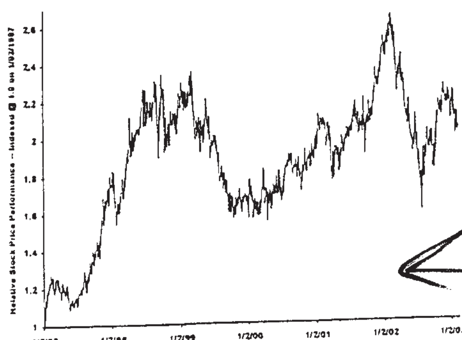


Time for International Equities?!??

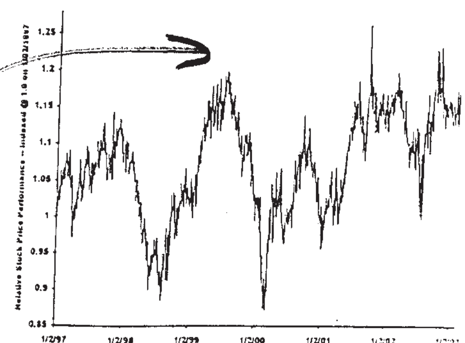
We think investors should overweight international stocks. The top chart overlays the relative total return performance between U.S. stocks and foreign stocks (solid line) with the trade-weighted U.S. dollar index (dotted line). Traditionally, foreign stocks have outpaced domestic equities during periods of U.S. dollar exchange rate weakness. While the dollar has declined from its peak last spring, we think the U.S. currency is in the early stages of a multi-year period of weakening. There have been two other major periods of dollar weakness since it was floated in the early 1970s—first, about a 10-year period during the 1970s and then about an 8-year period beginning in 1985. The point is, currency cycles tend to be long-term, multi-year events. Thus, in our view, it is not yet too late to tilt portfolios toward international stocks. The lower charts illustrate which regions and/or countries are thus far outpacing the U.S. stock market. U.S. stocks have underperformed relative to Canada, Pacific Rim (excluding Japan), and the United Kingdom. Thus far, U.S. stocks have held their own against Japan and the Euro-currency stock markets.



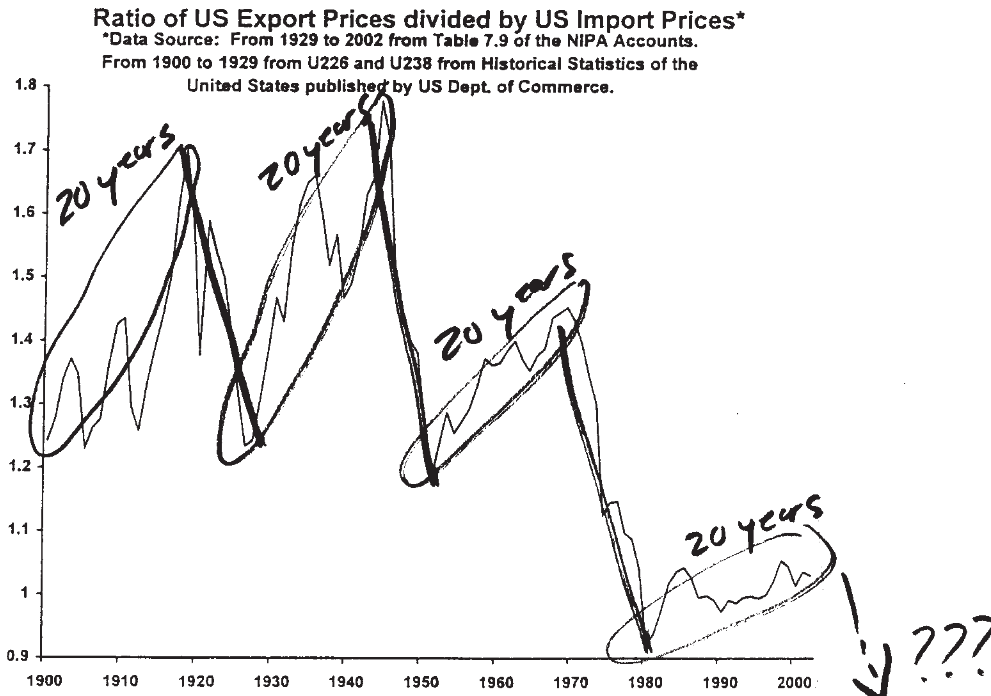




U.S. Stock Market Has held up Well vs. Japan and Euro Markets!??



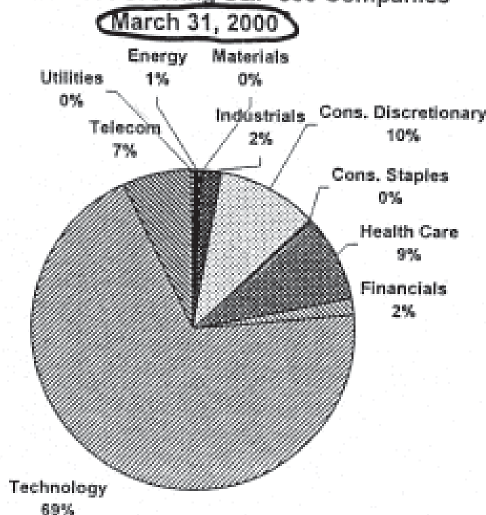
Time for a Devaluation???

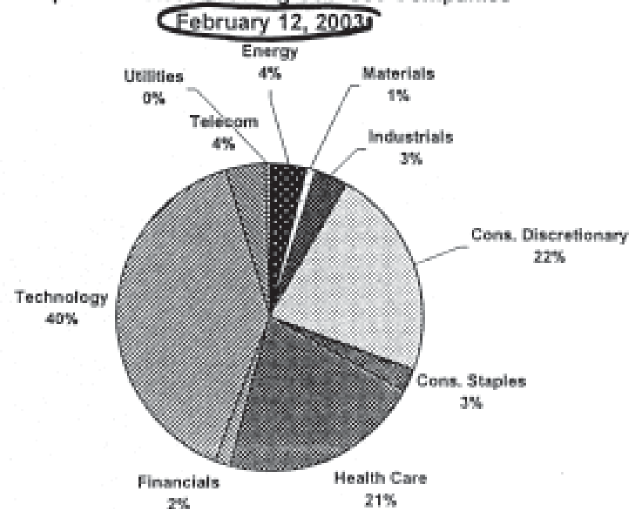


This chart shows a ratio of U.S. export prices to U.S. import prices since 1900. In a sense this is a proxy for the U.S. dollar exchange rate. A decline in export prices relative to import prices is similar to a period of U.S. dollar weakness. If history is any guide, we may be nearing another period of major currency devaluation—that is, a period where dollar export prices weaken relative to dollar import prices. This ratio has collapsed about every 20 years or has undergone three major periods of "devaluation" since 1900. The ratio has been rising since 1980 and by historical standards is due for another major decline. This seems quite possible, indeed even necessary, given the current record-setting U.S. trade deficit, which may take a major currency devaluation to correct?!?

Composition of "Growth" has Changed!?!

Interestingly, the composition of high growth portfolios became highly concentrated among technology stocks in March 2000. Indeed, tech and telecom comprised more than 75 percent of the fastest growing 100 companies within the S&P 500 at the dot-com top in 2000. However, today, growth within the S&P 500 is much more balanced with major representation from technology, health care and consumer discretionary companies. Less concentration probably also implies that growth stock indexes are again much less "risky" than they were a couple years ago?!?

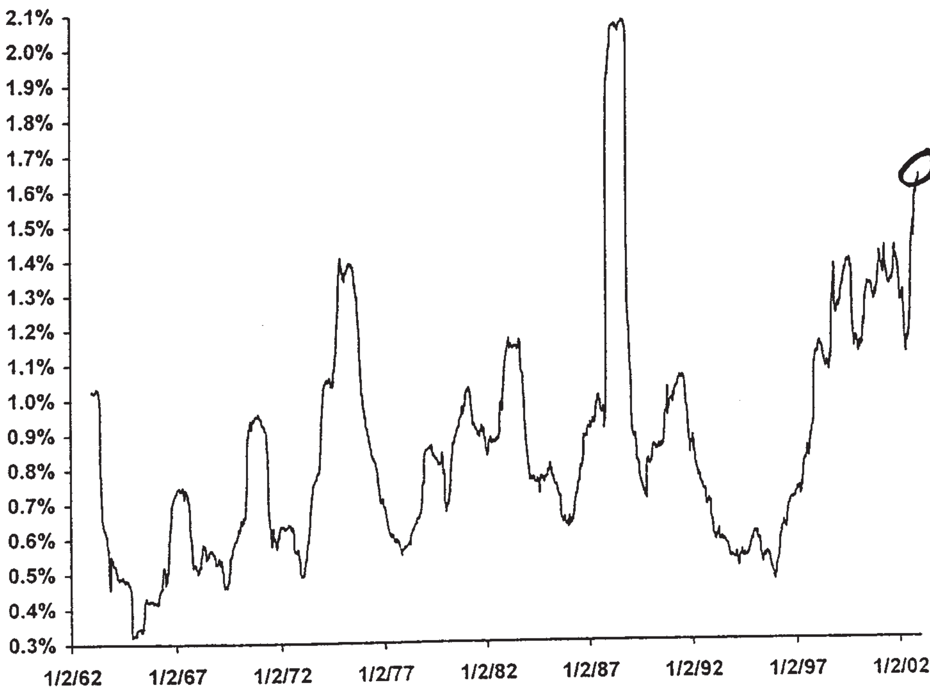




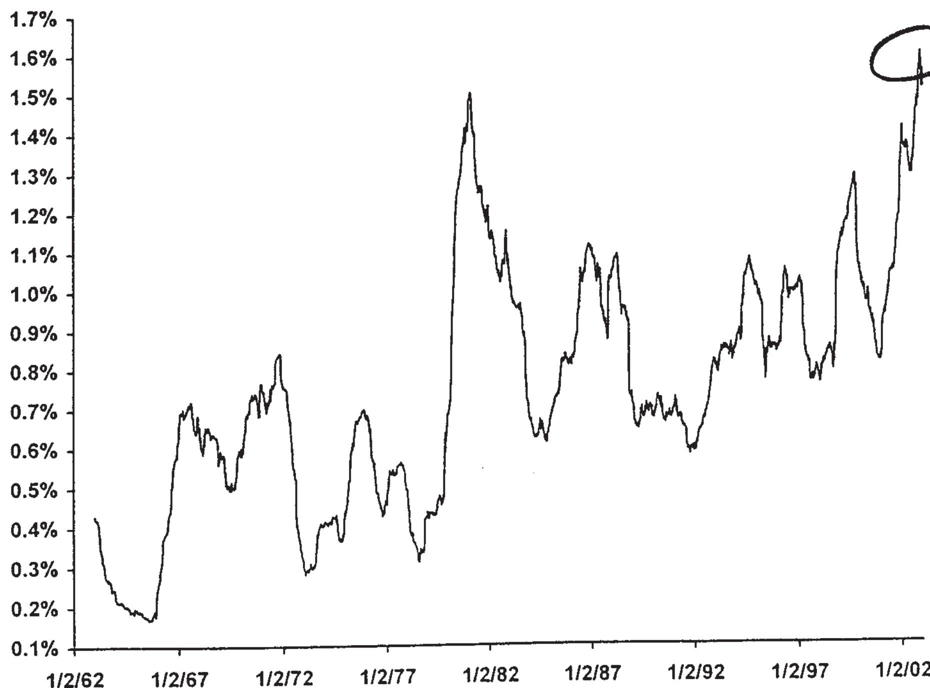
A Trader's Haven????

Volatility in the financial markets has seldom been higher—at least not in the postwar era. It is not only the stock market exhibiting near record volatility, but also the bond market. In the last year, the daily volatility in 10-year bond yields has been at a record level. While this may be a trader's delight, it is most upsetting for more traditional investors and may lead to less long-term financial market exposure. More importantly, what does persistently high stock and bond market volatility tell us about the economy? Anything?? Nothing??

Trailing 1-Year Standard Deviation of Daily Percent Changes in the S&P 500 Stock Price Index



Trailing 1-Year Standard Deviation of Daily Percent Changes in the 10-Year Treasury Bond Yield

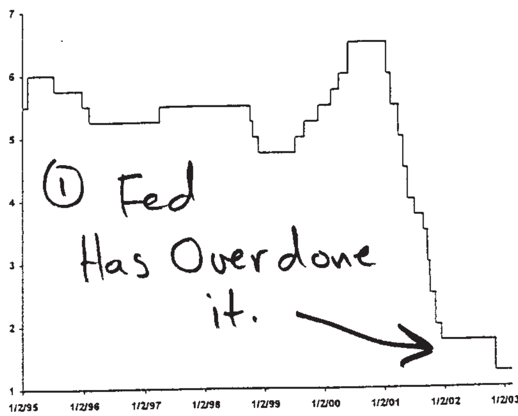


Extreme Volatility Persisting in Both Stock & Bond Markets?!?

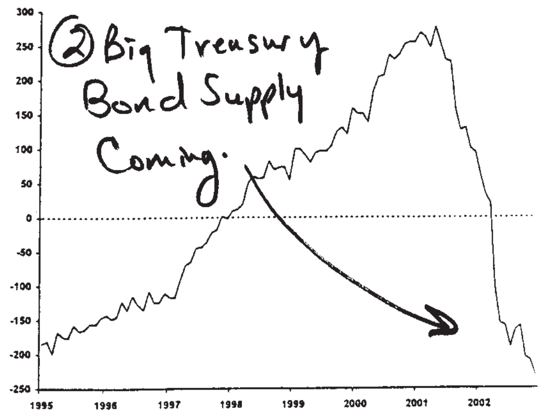
Bond Story Could Go BAD…FAST!?!?

It may be hard to believe, what with all the contemporary concern over deflation and economic malaise, but if the economy does recover this year, we think the bond market story will go bad…fast! As soon as an economic recovery takes hold, all the pieces for a major inflation fear and bad bond market will be in place. Quickly, attitudes would change toward (1) the Fed overdid it taking yields to 40-year lows, (2) with government deficits soaring to new heights concerns about a glut of government bonds will permeate the bond market, (3) the dollar is already falling and will fan fears of international bond investors fleeing the U.S. market, (4) commodity prices have already risen and appear to signal coming inflation, (5) the real yield on long-term bonds is less than 1.5 percent, far below the 3 percent to 3.5 percent "normal" inflation buffer of recent years, and, finally, (6) both gold and oil prices are signaling an inflation problem. It is not that we believe the economy is headed for a major increase in inflation. We think inflation may pick up in the next couple years, but remain modest. Rather, we anticipate a major inflation "fear" which would be enough to significantly raise long-term yields. We would reduce bond holdings and shorten maturities given the growing risk of rising yields.

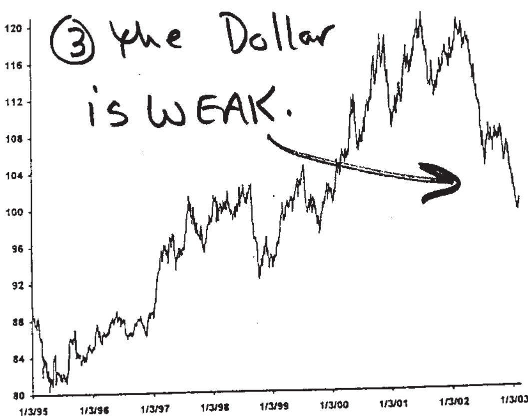
Federal Funds Target Interest Rate



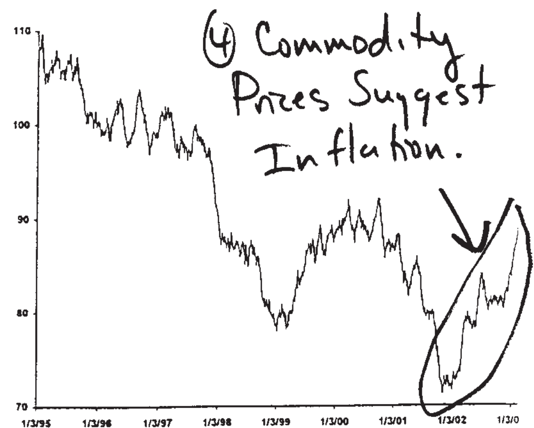
Federal Government Surplus or Deficit*
*Trailing 12 Month Rolling Sum



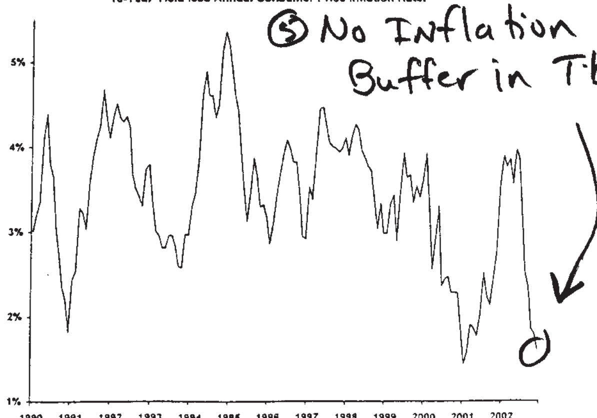
U.S. Trade-Weighted Dollar Index



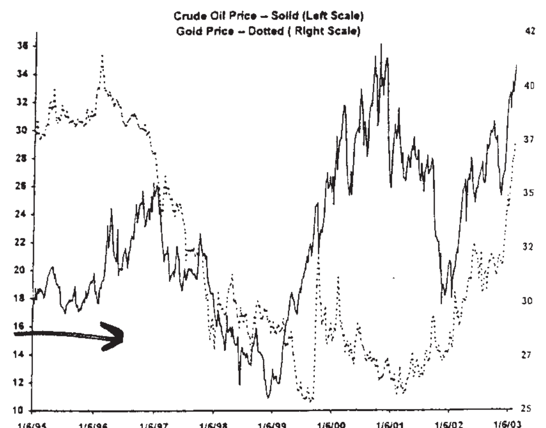
JOC Industrial Commodity Price Index



Real (Inflation-Adjusted) 10-Year Treasury Bond Yield*
10-Year Yield less Annual Consumer Price Inflation Rate.



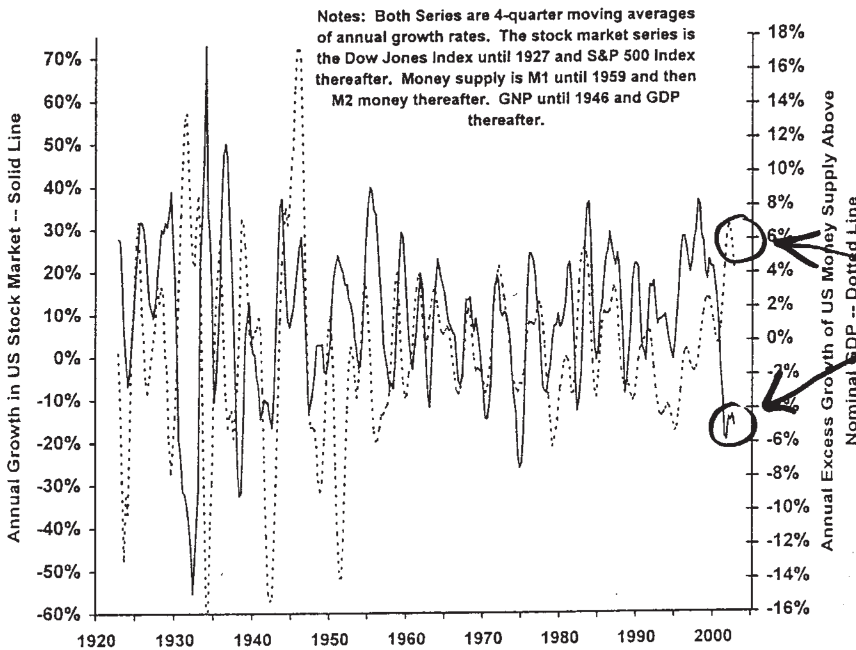
Prices of Crude Oil and Gold
Crude Oil Price – Solid (Left Scale)
Gold Price – Dotted (Right Scale)



Will Liquidity Work???

As shown in the top chart, recently the annual growth rate in "excess" financial liquidity (i.e., money supply growth in excess of nominal GDP growth) has been at its fastest clip since World War II. There is a lot of liquidity sloshing around the system, and we think it should eventually help both the economy and the stock market. As illustrated, there has been a close relationship between liquidity growth and the stock market. This large of a divergence (in terms of time and magnitude) between the trends in liquidity growth and stock prices has happened only once. That was in the early 1930s! That time, excess liquidity growth began rising in mid-1929, and the stock market did not bottom until mid-1932— almost three years later. Today, stock prices are still struggling for a bottom, almost 2 and a half years after liquidity growth bottomed in mid-2000. Why isn't liquidity growth stimulating the stock market? And the economy? We are not sure, but we still think it is a good bet that eventually the positive trend in liquidity growth will produce a handsome upside in the stock market?!?

**Annual Growth in the Stock Market vs.
Annual Growth in Excess Financial Liquidity**

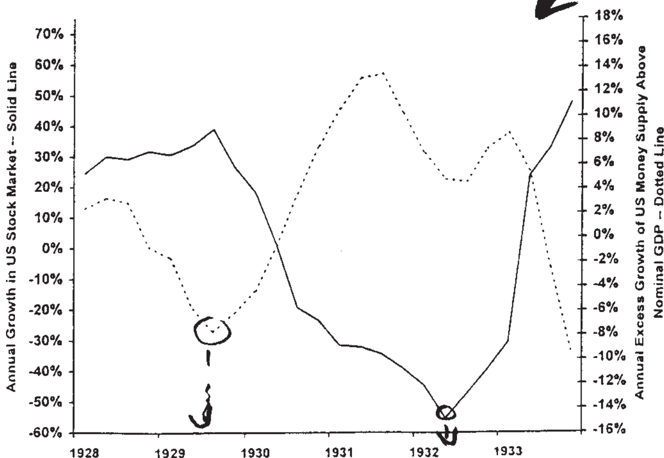


BIG GAP?!?

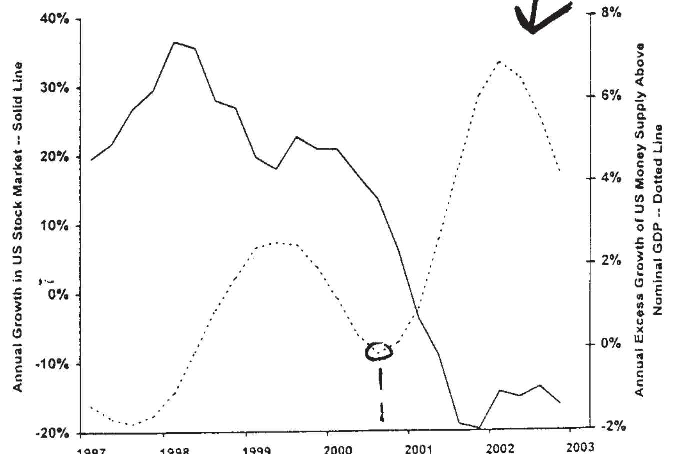
In 1929... it took 3 years of rising Liquidity Before Stock Market Took off!?

Today, it's already been 2½ years of Rising Liquidity Growth without Rising Stock Prices???

**Annual Growth in the Stock Market vs.
Annual Growth in Excess Financial Liquidity
1928 to 1933**

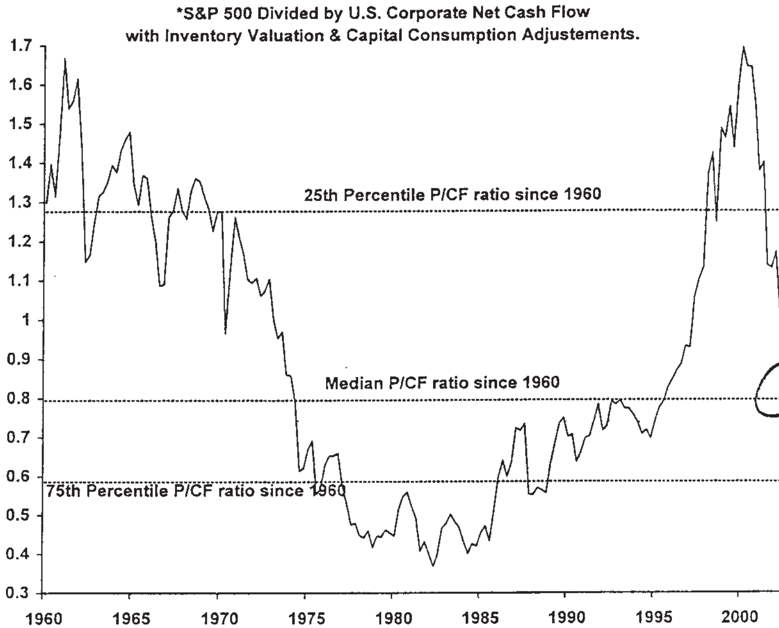


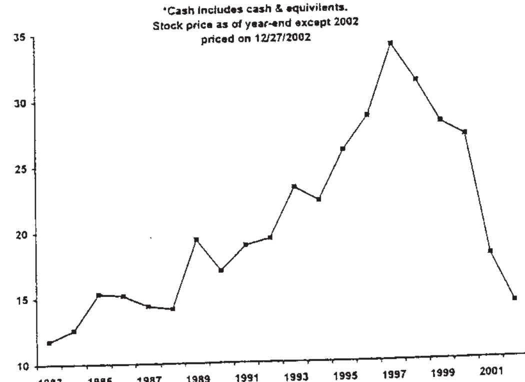
**Annual Growth in the Stock Market vs.
Annual Growth in Excess Financial Liquidity
1997 to 2002**

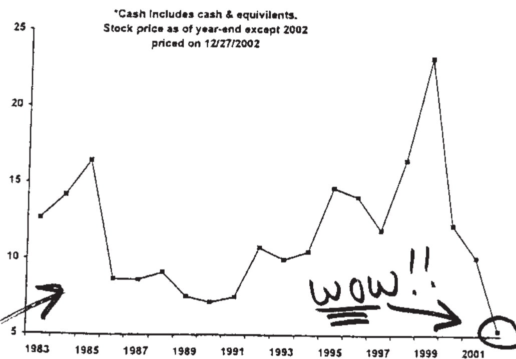


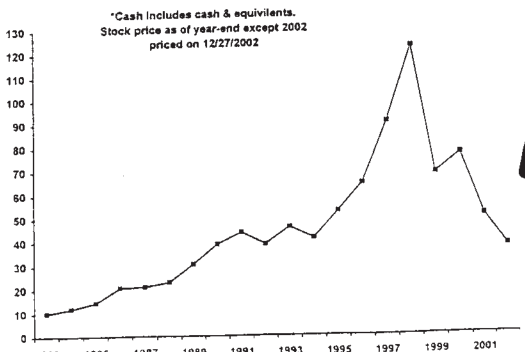
Stock Market a Better Value???

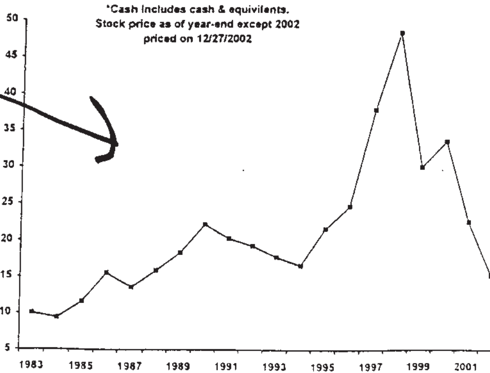
In some ways stocks remain very highly priced. Price-to-reported earnings multiples, price-to-book values and price-to-dividend ratios all remain very high by historic standards. However, some measures of value are beginning to show some promise. This page illustrates one such measure. The top chart shows the price-to-cash flow ratio for the S&P 500 index. On a cash flow basis, the multiple is almost back to average since 1960! And given how low both inflation and interest rates are today, the stock market should probably be trading above average. The lower four charts show that many S&P 500 sector price-to-cash valuations are also getting quite low. For the median S&P 500 company, the current price-to-cash ratio is back to levels not seen since the 1980s. For the median S&P 500 technology company, price-to-cash ratio is at its lowest level since at least 1982! Indeed, for the median tech company, cash covers 20 percent of the stock price. Although certainly not cheap, we do not think the stock market is nearly as overpriced as most seem to suggest???







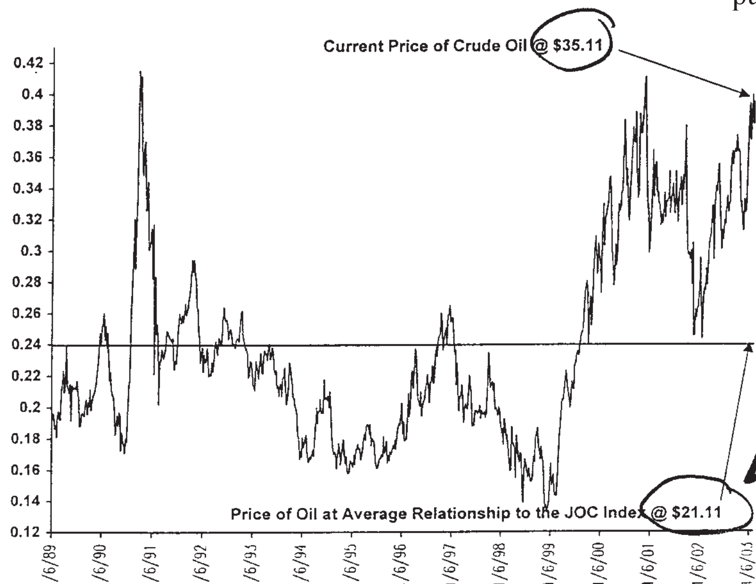




Gold & Oil "WAR" Premiums?!?

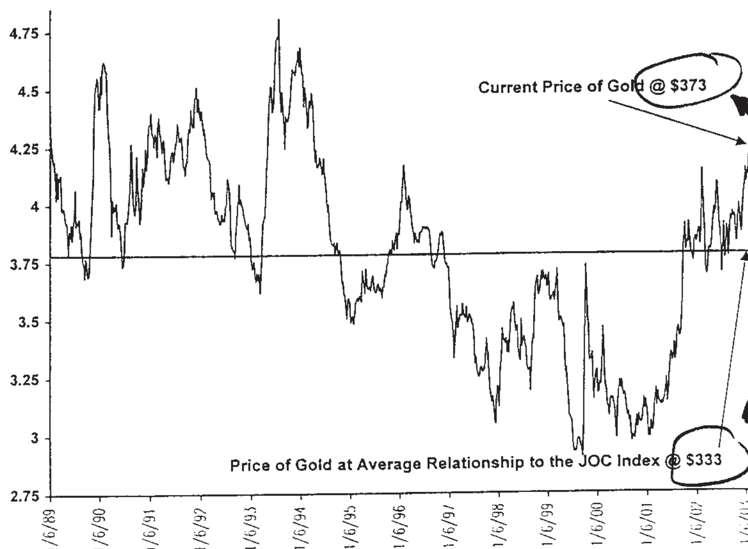
Everyone knows there is a "war premium" in the prices of gold and crude oil; but how much? These charts examine this question. In the top chart the price of crude oil "relative" to overall industrial commodity prices since 1989 is illustrated. The price of oil should be up because all commodity prices have risen, reflecting the slowing improving economy. Since 1989, the price of oil has traded at an average ratio of 0.24 to the JOC industrial commodity price index. Currently, at about $35, it is trading at a ratio of about 0.4. If oil were trading in line with general commodity trends it would have a price today of about $21. This implies the war premium for crude oil may be as much as $14. As shown by the lower chart, gold is also trading above its normal cyclical level and perhaps possesses some downside risk should the war come to a conclusion. However, the downside risk for gold seems far less than for oil—our work suggesting a downside "normal" target of about $333 an ounce. Just food for thought…may want to put some protection under those long oil and gold trades?!?

Relative Price of Crude Oil
Price of Oil divided by JOC Industrial Commodity Price Index



Big Potential For Collapse After War For Crude Prices...

Relative Price of Gold
Price of Gold divided by JOC Industrial Commodity Price Index



... But Not Much Collapse Potential For Gold Prices??!

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