

Equity Strategy Weekly

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Worth noting

- Second quarter revenues are up an average of 15.0% and a median of 7.5% versus the second quarter one year ago. Those revenue comparisons were roughly 14.8% and 8.4% in the first quarter. Roughly 69% of companies have reported revenues ahead of consensus expectations in the second quarter, thus far.
- Fed Chairman Ben Bernanke also gave his semiannual testimony to Congress last week and stated that the economic recovery remains “unusually uncertain”. This is not new language from the Fed Chairman. In fact, over the last 18 months or more, Bernanke and a number of other Fed governors have used the word “uncertain” in many speeches when referring to the economy and the potential for recovery.

Second quarter results shaping up well – management guidance still mixed

Results for the second quarter earnings season are coming in well, thus far. With 175 of 500 S&P Composite Index names having reported, market-capitalization weighted earnings are up roughly 29% (see Figure #1). In the figure, we have plotted year-over-year market-cap weighted EPS growth back to 1992. Encircled are the last two earnings recession periods. While we expect overall second quarter EPS growth will decline as more companies report, we believe second quarter comparisons will meaningfully beat those from third and fourth quarters this year. Versus the first quarter (during which market-cap weighed results increased 52% against the weakest quarter in the recession), we have expected weaker year-to-year comps for second quarter, third quarter, and fourth quarter this year. Generally, guidance from managements continues to be relatively mixed.

So far, almost 78% of those reporting for second quarter have generated better than consensus results. We anticipate this number will soften as the earnings season matures. The median magnitude of surprise has been roughly 7% at this early stage of the second quarter reporting season.

Earnings breadth continues to progress sharply. We like to keep tabs on (and plot) the history of “up” versus “down” earnings over time. In Figure #2, we have included a graph of that earnings breadth indicator back to 1998. The two periods we have encircled represent the last two recessionary economies. As shown, we had four quarters during which there were more “down” reports than “up” earnings reports during the most recent recession. Since then, this earnings breadth ratio has increased from 0.87 to 4.03. A ratio of 4.03 means that for each company reporting lower second quarter earnings (versus one year ago), four have reported higher year-to-year earnings results. During the early 2000s recovery, this earnings breadth measure did not cross the current level until first quarter 2004.

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Figure 1

Market Capitalization Weighted S&P Earnings
Quarterly Year-to-Year Changes

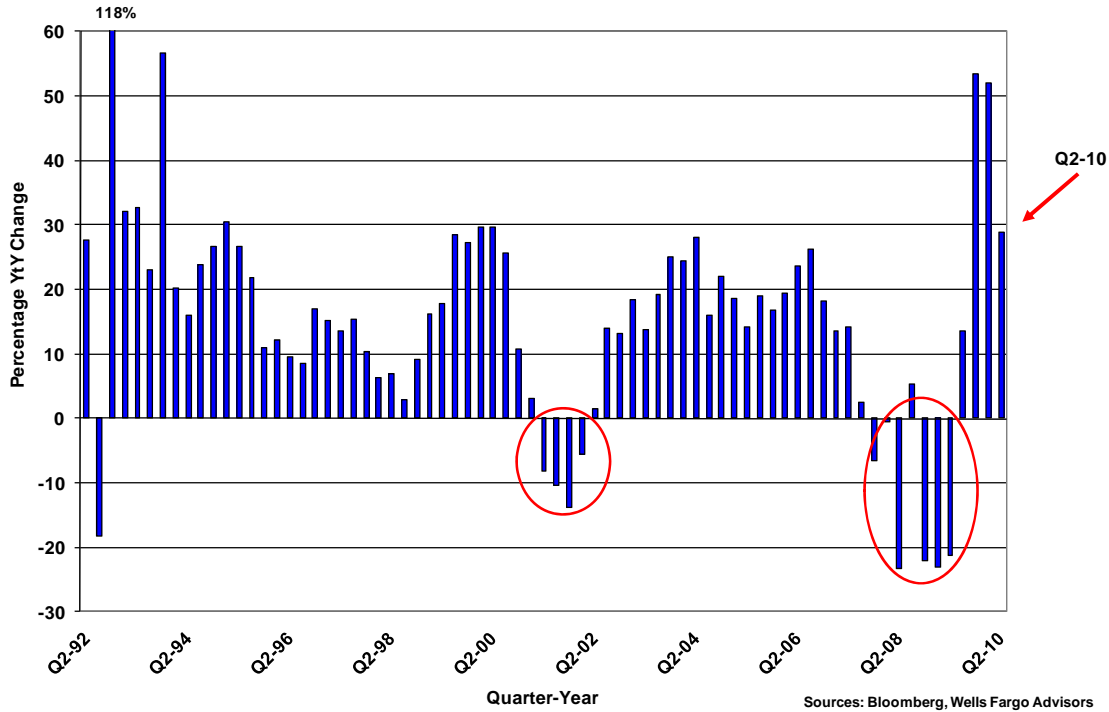
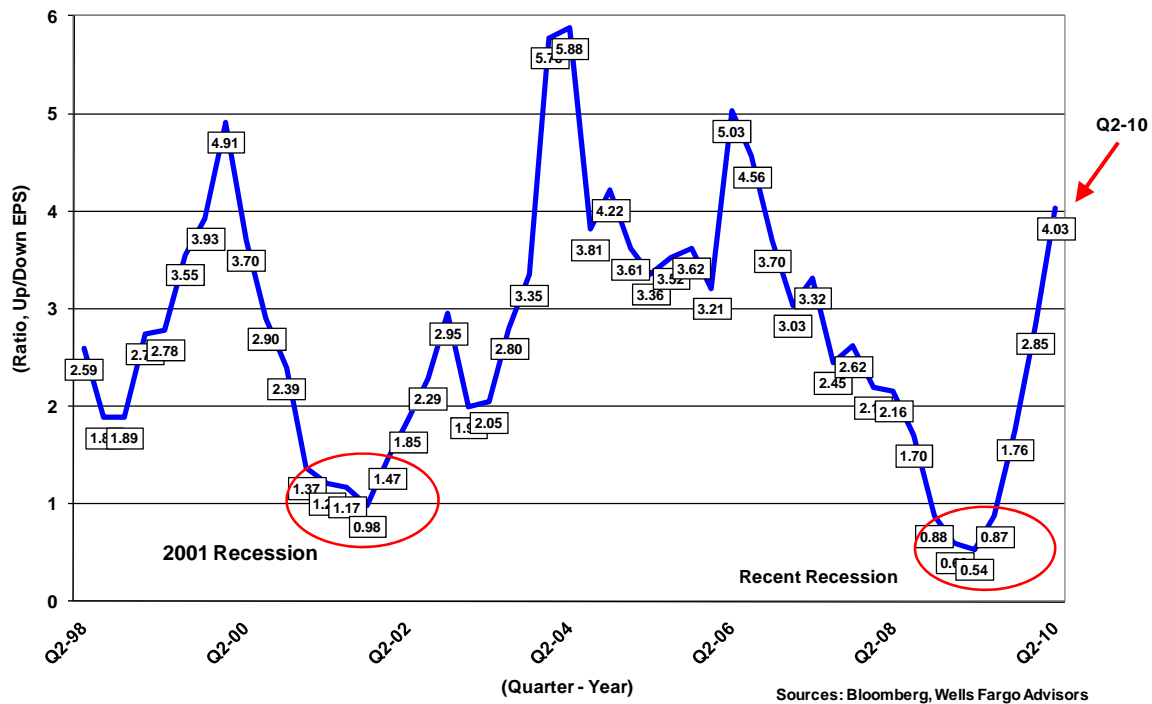


Figure 2

Ratio, Up to Down Earnings - S&P Composite Companies



Second quarter revenues are up an average of 15.0% and a median of 7.5% versus the second quarter one year ago. Those revenue comparisons were roughly 14.8% and 8.4% in the first quarter. Revenue surprises in the second quarter are 3.1% (on average) and 1.3% (at the median). For the first quarter of 2010, revenues beat the consensus estimate by 2.9% (average) and 1.5% (median). Roughly 69% of companies have reported revenues ahead of consensus expectations in the second quarter, thus far. Overall, margin expansion continues to be the driving force in EPS expansion.

To date, second quarter market-cap weighted earnings growth has been strongest in the Consumer Discretionary (+43.6%), Industrials (+39.6%), Information Technology (+37.3%), Financials (+28.9%) and Materials (+21.0%) sectors. The slower earnings comparisons are being generated by the Utilities (+3.1%), Telecom Services (+4.8%), Health Care (+9.8%), Consumer Staples (+11.8%) and Energy (+20.8%) sectors.

We continue to carry a \$79 EPS estimate for the S&P Composite Index for this year and \$89 for next year, representing 21.0% and 12.7% increases, respectively.

Specific recommendations

The Information Technology sector makes up approximately 19.1% of the total market capitalization of the S&P 500. This sector's index has risen nearly 14% over the last 12 months versus a roughly 13% increase for the S&P 500. Many sub-industry groups within the Technology sector are dependent upon new product cycles to drive revenue and profits. The rewards for success in these industries can be very high but rapid product line obsolescence is the enemy always at one's back. To the extent the economy also affects these businesses; these stocks can also perform like those in the capital goods area of the Industrials sector. Currently, for clients with average risk tolerance, we recommend carrying an evenweight equity allocation to the Information Technology sector. "Buy" rated technology stocks among our correspondent research providers total 220 companies. The companies listed below appear attractive based on our Equity Strategy team's industry group work as well as the analysis performed by our Technology sector analyst.

- Broadcom Corp. (BRCM-NASDAQ-\$38.21)
- Cisco Systems Inc. (CSCO-NASDAQ-\$23.61)
- Intel Corp. (INTC-NASDAQ-\$21.71)

Weekly wrap and look ahead

All three major indices rose by noticeable amounts in last week's trading. The S&P 500 gained 3.5% (year-to-Date down 1.1%), the Dow Industrials rose 3.2% (YTD flat) and the NASDAQ Composite jumped 4.1% (YTD flat). Looking at the S&P sectors, six of 10 outperformed the Index while nine of 10 finished higher on the week. The best performing sectors were Industrials (up 7.2%), Materials (up 7.1%) and Consumer Discretionary (up 5.0%). The worst performing sectors were Health Care (down 0.7%), Consumer Staples (up 2.4%) and Utilities (up 2.6%). The volatile trading pattern continues. Up weeks in the market will likely be dominated by cyclical sector outperformance while pullback periods will feature the defensives outperforming on a relative basis. We do not expect much net change in the major indices from current levels between now and the end of the year but the week to week volatility will probably remain high. Once again, use this second year of recovery to prepare portfolios for a continuation of the global cyclical recovery.

Second quarter earnings reporting season is in full swing and the results so far have been better than our expectations. Through last Friday, with 35% of companies in the S&P 500 reporting, operating earnings are up almost 30% on a purely market cap weighted basis. Remember the S&P 500 is a capitalization weighted index. Of those reporting thus far, nearly 78% have come in ahead of "Street" consensus while just around 13% have fallen short of the average analyst estimate. Our projection calls for earnings to have risen 16% in the second quarter. Notable

sector earnings performance so far comes from Consumer Discretionary (+43.6%), Industrials (+39.6%), Technology (+37.3%) and Financials (+28.9%). It is not a surprise that the sectors most sensitive to the ebb and flow of the economy are leading the way in terms of year-over-year earnings growth. Expect this trend to continue as another heavy reporting week lies ahead.

Last week's calendar featured a number of closely watched housing-related reports. Housing starts in June fell 5%, more than the market expected. Existing home sales last month dropped 5.1%, which was in line with the consensus projection. Distressed sales (made up of short sales and foreclosures) were responsible for more than 32% of all sales last month. Inventories of homes on the market, along with the inventory banks are holding on their balance sheets, remain high and should keep a lid on prices for at least the next handful of quarters. Despite the government tax credits and record low mortgage rates, consumers are worried about jobs and are not keen to purchase big ticket items like houses and cars. That makes sense to us. Expect only slow improvement in the housing market over the next 12-18 months. Modest improvement in housing is a big part of our outlook for a modest improvement in the overall economy.

Fed Chairman Ben Bernanke also gave his semiannual testimony (formerly known as "Humphrey-Hawkins") to Congress last week and stated that the economic recovery remains "unusually uncertain" but the U.S. central bank remains ready to act "as needed". This is not new language from the Fed Chairman. In fact, over the last 18 months or more, Bernanke and a number of other Fed governors have used the word "uncertain" in many speeches when referring to the economy. Clearly the Fed, along with many other economists and market participants, are concerned about the possibilities of a double-dip recession as well as any number of other economic issues (employment, business spending, etc.). Uncertainty is the key concept driving the recent volatility in the markets. Keep in mind that by the time the recovery is "certain", stock prices will likely be higher. The market typically anticipates recovery and is a leading not a lagging or coincident indicator.

We also had some good news out of the Eurozone last week. German business sentiment came in higher than expected and the U.K. economy grew 1.1% in the second quarter, the most in four years. In addition, only seven out of 91 banks failed the much anticipated "stress tests". Five of those that failed were Spanish banks. In other news, the Bank of Canada raised its overnight target rate to 0.75% from 0.50%. The Canadian economy is bouncing back quickly.

In addition to a large number of earnings reports, this week's calendar features more data on housing, orders for durable goods, the Fed's latest Beige Book reading, jobless claims and both consumer sentiment and consumer confidence. On Friday morning, the government will also publish its first "guesstimate" of second quarter GDP (Gross Domestic Product). We continue to believe full year economic growth will be in the 2.8% area but the second quarter may be a bit higher than that. The Fed's Beige Book survey of the 12 regional districts is likely to show slower growth than earlier in the year and only small improvement in the labor environment. Sentiment and confidence surveys are starting to reflect the slowing economy we expect in the second half. Those surveyed over the last month or two have had less confidence not only in terms of current conditions but their outlook for the future has deteriorated as well. Sustained up moves in confidence/sentiment will not likely occur until the job market improves substantially.

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

| <u>Sector</u> | <u>S&P Weighting*</u> | <u>Wells Fargo Advisors Guidance</u> | |
|------------------------------------------|---------------------------|--------------------------------------|-------|
| Industrials | 10.6% | Overweight | 14.0% |
| Materials | 3.5% | Overweight | 7.0% |
| Telecom Services | 3.0% | Overweight | 5.0% |
| Consumer Discretionary | 10.2% | Evenweight | 11.0% |
| Energy | 10.8% | Evenweight | 11.0% |
| Financials | 16.3% | Evenweight | 16.0% |
| Information Technology | 19.1% | Evenweight | 17.0% |
| Utilities | 3.7% | Evenweight | 3.0% |
| Consumer Staples | 11.5% | Underweight | 8.0% |
| Health Care | 11.3% | Underweight | 8.0% |
| S&P 500 Earnings Estimates: | | 2010 = \$79, 2011 = \$89 | |
| S&P 500 Year End 2010 target: | | 1100-1140 | |

Sources: Bloomberg, Wells Fargo Advisors

*Sector Weightings May Not Add To 100% Due To Rounding
Pricing: based on July 23, 2010 close

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