

# The Week

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*Tom McManus, Chief Investment Officer*

## Updating Our Investment Report Card, and A Close Look at Retail Sales

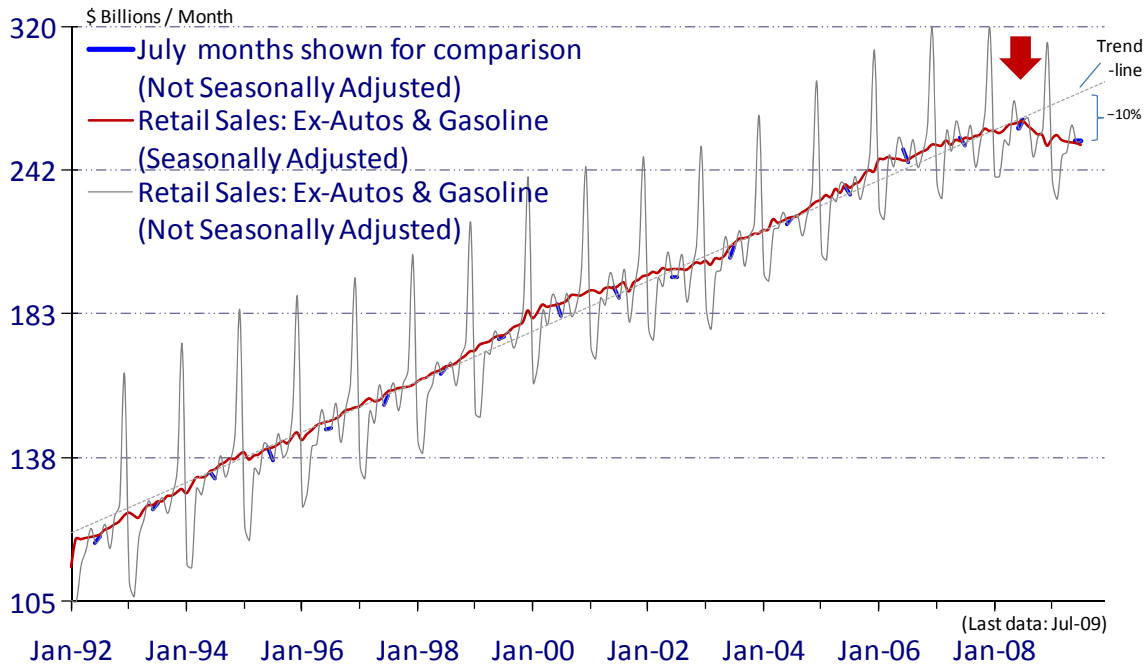
- Some time ago, we developed a market report card — a tool that conveys a qualitative rating of the investment outlook in four major subject areas. While many of our models and indicators are quantitatively based, our cumulative assessment of each of them is more difficult to quantify — thus we assign letter grades like a student may receive in school. The subjects are 1) the Macro-Economy; 2) Asset Valuation; 3) Market Liquidity; and 4) Investor Sentiment. The simple letter grade we apply (on a scale from A+ to F, with the average at B–) is based on conditions in the relevant sphere and its contribution — positive or negative — to the investment outlook generally.

Today, we assign the following grades: Economy: C–; Valuation: B–; Liquidity: C+; and Sentiment: B–. Three scores have changed since the last revision: valuation has worsened a little (from B to B–); sentiment has become a little less supportive (from B to B–) as investor fear has given way to more confidence; and liquidity has improved a little more (from C to C+).

- Our assessment of the broad **macro economy** remains unchanged at C–. There is clear evidence that the pace of the decline has slowed, and some indications (e.g. industrial production) that conditions in some sectors are starting to improve. But sales at retail establishments remain under pressure (see chart overleaf), especially for discretionary items, underscoring our wariness about the pace of the recovery, given the importance of the household sector and the drag of its continued deleveraging.
- **Valuation** is now “average,” in our view. In the US equity market, the median dividend yield of dividend paying stocks is now 2.2% according to Value Line, down from an average of 3.3% from October through April, and a peak of 4% in early March! Of course, only a select group of companies pay any dividend whatsoever, but we have found that — for most companies, anyway — a dividend represents management’s conservative estimate of what investors can expect in the future. So we find the dividend yield a helpful valuation measure, especially when earnings are significantly higher or lower than “normal.”
- **Liquidity** has improved further as the Fed’s actions have removed a good deal of the “fear premium” imbedded in some interest rates. These so-called “credit spreads” have declined dramatically from their peak levels seen in October, and the elevated level that persisted through April. Despite significant improvement, we don’t believe liquidity has yet achieved an “average” level.
- **Investor sentiment** has become notably more optimistic in the past several months. While there are still many non-believers, the “weighted opinion” of investors seems to believe: a) the financial crisis and risk of severe economic contraction has been averted; 2) we are now on a path to recovery. The CBOE volatility index — a measure of investor apprehension calculated from the price of stock index options — fell to 25%, down from an average of 50% seen between October and April. While there is no sign of complacency yet, investor confidence has returned to a point where we assign an “average” score.
- **Inevitable “bumps on the road” toward economic recovery are likely to create better buying opportunities in upcoming months, better than what we see today.**

## Retail Sales (excluding Autos, Auto Parts and Gasoline Stations) Still Weak

Current Sales Remain Stubbornly Below the Longer-Term (pre-Recession) Trend



Note: Arrow depicts sharp slowdown began in August 2008.

Source: Commerce Dept.

Our chart shows the recent history of sales at retail establishments except auto dealers and gasoline stations, which are excluded to allow a better estimate of the underlying trend. The long-term trend (see label) has been increasing about +5.5%/yr., and prior ups and downs in the economy caused very little divergence in that trend.

Retail sales are subject to huge seasonal variations — note the large, periodic swings — so it is dangerous to draw any definitive conclusions based on one month's data, without understanding how the weather and calendar may have affected sales.

When sales began to decline last August — especially for discretionary items such as furniture, electronics and appliances — the drop was very noticeable. Over the past year, total sales have fallen -4.5%, putting us about -10% below the trend line. The bulk of the decline was seen in discretionary items, which comprise about 40% of retail sales and fell — by themselves — about -10%. The remainder — sales at grocery and drug stores, restaurants and bars, and general merchandise stores — make up the remaining 60% and have basically held steady. Despite this relative strength, stores in these sectors, too, have been suffering as consumers continue to tighten their belts.

Of course, discretionary spending beneficiaries have more to gain from a robust, "v-shaped" recovery, and the strongest companies will probably gain significant market share, as sustained soft sales prove fatal to weaker players. Smart stock pickers could potentially be rewarded in this arena, but asset allocators can also potentially benefit from paying close attention to discretionary retailers. As fear gives way to confidence and eventually to enthusiasm, aggressive investors seek out the most beaten-down issues to bet on a strong recovery. Whenever we see this behavior reflected in stocks, we remind patient investors that this recovery will require time.

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Asset allocation does not guarantee a profit or protect against loss. Investors should consider their ability to continue investing through periods of low price levels.

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