



QUICK MARKET UPDATE

Are You *Still* Waiting for Things to Get Better?

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When we published our Quick Market Update, “Are You Waiting Until Things Get Better?” two years ago, we reviewed recessions throughout the past 60 years and found that the stock market has almost always recovered before the economy eventually reached a bottom. At that time, we suggested that investors should consider adding to battered-down equity positions based on historical patterns of stock market returns and the low valuations of the S&P 500. While that was sound advice then, and recognizing that past performance is no guarantee of future performance, the market has rebounded 75 percent since the date of our report. This dramatic rise in stock prices over the past two years has led investors to question, once again, whether now is a good time to invest in the stock market.



Source: Bloomberg, Standard & Poor's

A Market of Stocks

Investors need to remember that the equity market is not a “stock market,” but a “market of stocks.” Taking a closer look at various segments of the stock market may reveal some attractive areas that, in our estimation, haven’t fully recovered. Those investors who are underweight equities or who are prepared to put some money to work in the markets may find equities that have attractive valuations and potential long-term prospects.

The chart below compares the total return of three different stock market indices segmented by market capitalization—the share price multiplied by the number of shares of the underlying companies. The red line represents the Russell 2000 Index—measuring the performance of the small-cap segment of the U.S. equity market—while the green line depicts the Russell Mid Cap Index—consisting of approximately 800 securities and measuring the performance of the mid-size level companies in the U.S. equity market. Although past performance is not necessarily an indicator of future performance, since March 30, 2009, these indices have returned 108 percent and 112 percent, respectively.



Source: Bloomberg, Russell's

However, the blue line—representing the Russell 50 index—has only returned 58 percent. This index contains the 50 largest domestic stocks by market capitalization. These stocks have not experienced such dramatic price appreciation and represent the least valued segment of the U.S. stock market at this time.

In fact, the valuation of the Russell 50 companies has an average price-to-earnings (PE) ratio of only 14 on their current earnings. The Wall Street consensus is for these stocks to grow earnings per share by 13 percent, which will result in a PE ratio of only 12.4 if stock prices do not rise by the end of the year. As the table below illustrates, this valuation is significantly lower than the mid- and small-Cap indices.

	S&P 500	Russell 50	Russell Mid Cap	Russell 2000
Price to Earnings	15.5	14.0	20.1	32.7
Dividend Yield	1.8%	2.0%	1.6%	1.3%

Source: Bloomberg, Standard & Poor's, Russell's

First Quarter Earnings Continue to Climb

We believe that these stocks are not only inexpensive, but also have solid fundamental prospects for earnings growth. In fact, earnings growth for large-Cap U.S. stocks continues to be surprisingly strong. First quarter 2011 earnings results have extended the string of positive earnings surprises that we have experienced since the start of the latest economic recovery. With most S&P 500 companies having reported for the first quarter of 2011, more than 67 percent have had positive operating earnings surprises with earnings growth now estimated to be 18 percent year-over-year according to Standard & Poor's.

Although the domestic recovery remains somewhat uneven, the demand for goods in emerging markets has helped to boost company earnings. In fact, first-quarter earnings results, driven by strong overseas demand combined with an upside surprise in revenue growth, recently led our equity research team to increase the 2011 earnings estimate for the S&P 500 Index from \$94 to \$96 and to issue an initial conservative estimate for 2012 of \$106. We expect to see earnings increases to continue for the remainder of 2011, particularly in developed and emerging-market international companies, and small-cap companies that comprise the Russell 2000 Index.¹ Investors are reminded that these earnings estimates may or may not be attained.

It is also important to note that dividend payouts are rapidly increasing for many of the largest companies. With many companies flush with cash, raising dividends is becoming increasingly popular as a way to return cash to shareholders. During the first four months of 2011, 149 S&P 500 companies raised their dividends with an aggregate increase of \$22.1 billion. The median dividend increase for these companies was a robust 14.7 percent. For the same period last year, 104 companies raised their dividends with an aggregate increase of only \$8.7 billion.²

Price Targets

Our Equity Research Group has price targets for more than 80 percent of the stocks in the Russell 50, and we project they will show an average 16.8 percent return over the next 12 months. We use many of these stocks in our proprietary Large Cap Equity Strategies: Growth,

¹ For more details see "[Stronger than expected first quarter earnings suggest the global economy continues to expand](#)"

² We remind investors that dividends are not guaranteed and are subject to change or elimination at any time.

Value, and Core. These strategies are designed to deliver—but do not guarantee—superior after-tax total returns in the large-Cap sector of the U.S. stock market and can be customized to help meet individual client preferences.

In addition, the largest stocks have a tax-advantaged yield that is comparable to an intermediate-term bond. The largest 50 stocks have a two percent average dividend yield that is subject to only 15 percent in Federal taxes. A comparison of after-tax yields in the table below shows that this yield is competitive to the yields of a five-year municipal bond or a seven-year Treasury note on an after-tax basis. Investors should note that yields and market values will fluctuate over time, and can potentially result in a decline in value.

	Dividend Yield	5 Year Muni	7 Year Treasury
Nominal Yield	2.0%	1.6%	2.8%
Less Federal Taxes*	0.3%	0.0%	1.0%
Yield After Federal Tax	1.7%	1.6%	1.8%

*Source: Wells Fargo Fixed Income. *Assumes 35% tax rate
For illustrative purposes only*

Taking the Next Step

Looking at just the headlines and the broad market indices is like looking at the surface of the ocean. You can see whether the ocean is smooth or choppy, but you don't necessarily see the vast majority of activity that occurs beneath the waves. We believe the key to looking for the next set of opportunities, that some investors may wish to consider, is to dive deeper into the different segments of the market to see what is really happening. Investors who have remained on the sidelines during the past two years, may be lamenting the lost opportunity or perhaps are skeptical of the legitimacy of current market strength. In our view, one of the keys to a successful investment strategy is aligning the strategy with financial goals. Further, depending on an investor's tolerance of risk, the strategy could contain exposure to a diversified asset allocation, which includes equities, fixed income, real assets and complementary strategies. For those investors trying to realign goals with a specific investment strategy, we suggest not trying to time the market for entry points. Instead, easing back into the market may help to adjust for volatility without missing out on opportunities for economic gains.

Data for this QMU sourced from Bloomberg unless otherwise noted.

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Indexes represent securities widely held by investors. S&P 500 Index is a capitalization-weighted index calculated on a total-return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation and financial companies.

The Russell 50 Index measures the performance of the 50 largest stocks in the domestic market by market capitalization.

The Russell Midcap Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index.

The Russell 2000 (Small Cap) Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000®.

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