



**QUICK MARKET UPDATE**

# Economic Data Slows

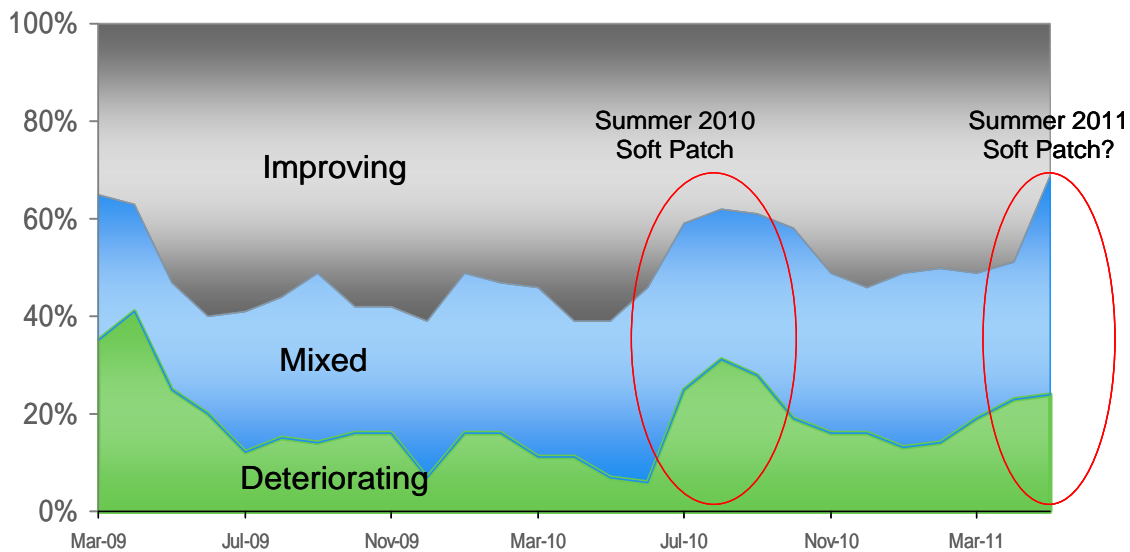
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June 3, 2011

The unemployment rate climbed to 9.1 percent and employers added just 54,000 new jobs in the month of May. Initial unemployment claims have started to decline. However, new claims are still over 400,000, a further sign of weakness in the jobs market.<sup>1</sup>

As we move into the summer months, a number of economic indicators have been slowing. The moderation in the economy is evident in our Points of Data Index, the 56 mostly domestic data points we track on a monthly basis. Our index has recently highlighted several turning points in economic activity, and the data have clearly deteriorated over the past two months, leading us to suggest a rebalancing of risk assets and a more cautious approach to the markets.

## Points of Data Index



Source: Wells Fargo Wealth Management, 6/3/2011

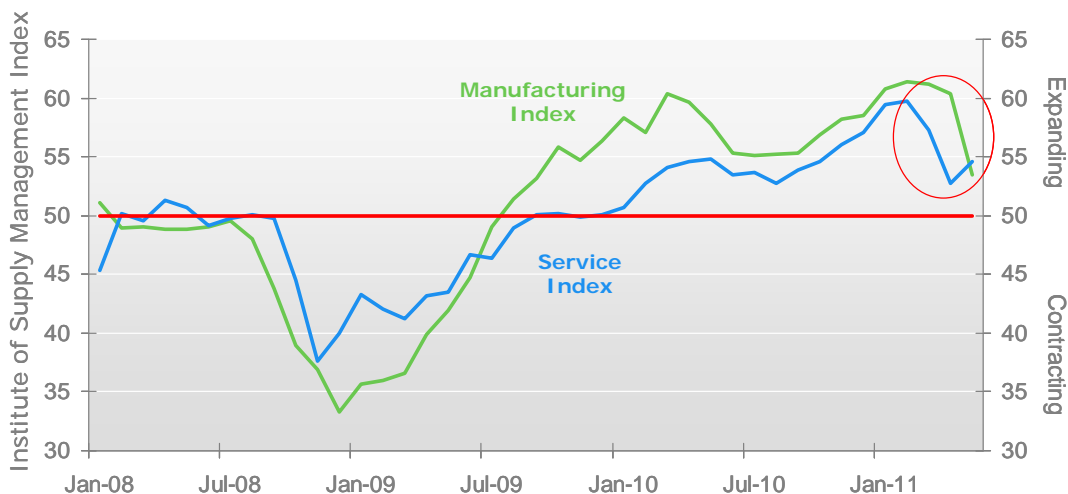
### Manufacturing Sector Takes a Hit

The current weakness appears most obvious in the manufacturing sector, where the latest Institute of Supply Management (ISM) Purchasing Managers' Index showed a decline from 60.4 in April to 53.5, with the forward-looking new orders index slipping more than ten points to 51.0. Any reading over 50 indicates expansion so the sector is still growing, but at a much slower pace than last month. The service sector gained in May rising to 54.6 from 52.8 in April,

<sup>1</sup> Bloomberg Finance LLP, June 2, 2011

a higher reading than economists had forecast, but this index, too, has recently lost some of its momentum.<sup>2</sup>

## Manufacturing Sector Slows



Source: Wells Fargo Wealth Management, Factset, 6/3/2011

Global Purchasing Managers' Index (PMI) also appears to be rolling over. It seems like the measures instigated in the emerging markets to stop their economies from overheating may be working, removing the fear that some of these countries may have been behind the curve. It seems emerging countries are now moving away from jawboning about the weak U.S. dollar and fighting inflation; focusing instead on a slower growth environment.

### **The key question: Is this just a summer slowdown or something more systemic and longer term in nature?**

In our view, the current scenario in the economy and markets is somewhat similar to 2010. Last year, the equity markets ran hard through May before experiencing a tough summer as the economy slowed. While a recovery was on its way by summer end, the passage of a second round of quantitative easing (QE 2) helped spur the equity markets back to new highs later in the year.

However, the factors impacting the economy today are different than they were last year, and we do not believe QE3 will be needed to stimulate the economy. Among the factors that could pull us out of the summer doldrums:

- Lower energy and gas prices—lower prices may lead to an increase in consumer spending, especially during the back to school season. Consumers got hit early with a spike in gas prices in the second quarter. Such a spike typically doesn't happen until after Memorial Day

<sup>2</sup> Bloomberg Finance LLP, June 2, 2011

when the summer driving season begins. The good news is that retail gas prices are now off four percent from their peak and crude is down 12 percent over the past month.<sup>3</sup> Declining oil and gasoline prices may help consumer confidence, which has already seen an increase as measured by the Bloomberg Consumer Comfort Index over the past 2 weeks.<sup>4</sup> Commodity prices in general don't have to substantially decline, they just need to be less of a drag than they were on first quarter economic growth in the coming quarters.

- Lower interest rates—although we don't expect interest rates to go lower, the current level of interest rates makes borrowing costs cheaper—albeit at the expense of savers. This again could help put more money in the hands of consumers. In addition, the rally in the bond market that has recently sent 10-year Treasury yields below 3 percent and muni bond yields lower might move investors back into equities, specifically some of the solid, higher dividend-paying issues.<sup>5</sup>
- Federal budget and debt issues meaningfully addressed—the second half of the year may move us beyond the daily conversation of the debt ceiling and the threat of possible U.S. debt downgrades from the rating agencies. A truly bi-partisan solution to this would be positive for the economy and business confidence levels. This may be an unrealistic expectation, but certainly any type of first-step resolution may be viewed positively.
- Japan supply disruption is over—the auto sector may return to full production, which is likely to positively impact third and fourth quarter growth. Such an increase in production would be, in part, in anticipation of a rebound in demand, but also make up for output lost as a result of the Japan earthquake.
- In our opinion, earnings remain solid and valuations are not stretched— first quarter revenue growth and earnings surprises were on the upside and companies continue to provide positive guidance for the second half of the year. In our view, many corporations have solid balance sheets and plenty of cash, which is being used to increase dividends, repurchase shares and for mergers and acquisitions. We expect the latter activity to pick up in coming months.
- Tax incentives for higher capital expenditure—the stimulus package passed by Congress last December most likely allowed business to accelerate depreciation in capital expenditures. Capital expenditure is already expected to be 9 to 11 percent in 2011 and could accelerate further towards the end of the year prior to the expiration of these incentives. Companies may find it more favorable to invest excess corporate cash vs. increasing their head count this year, keeping job creation numbers low but accelerating business spending.

In the coming months the economic numbers could continue to be relatively weak. However, the biggest risk to the global recovery and to the capital markets may lie in some of the larger

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<sup>3</sup> Bloomberg Finance LLP, June, 2011

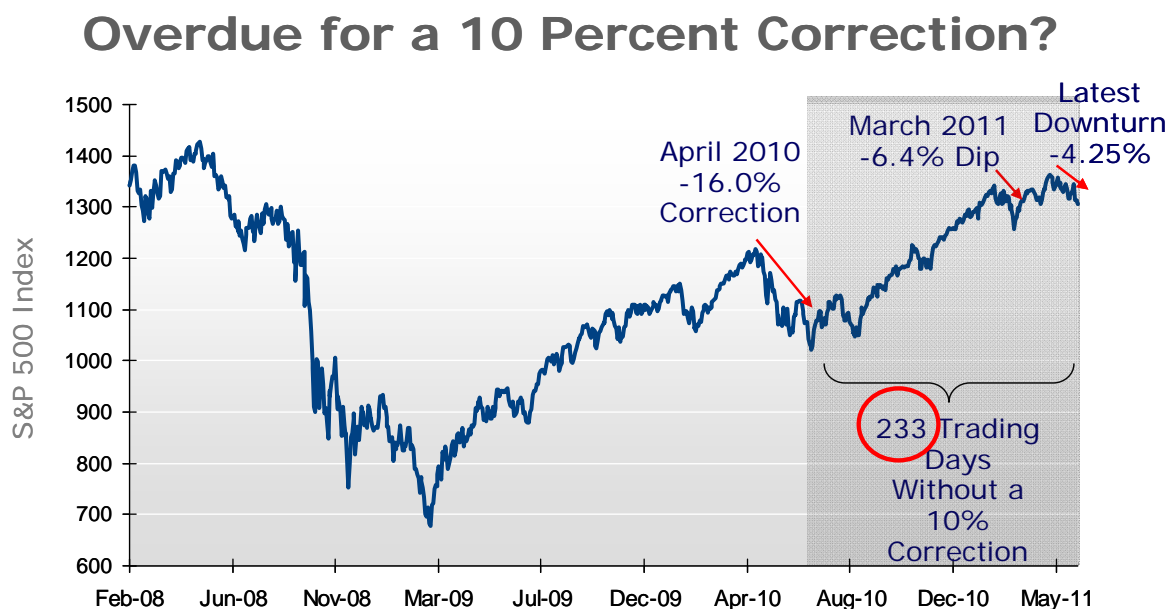
<sup>4</sup> Bloomberg Finance LLP, June 2, 2011

<sup>5</sup> Bloomberg Finance LLP, June, 2011

global macroeconomic issues, such as the debt problems facing the European Union and political challenges in the Middle East.

### What can investors do?

The equity markets have rallied for two-straight years on improving economic activity and earnings growth, with the S&P 500 Index nearly doubling over that period. During the latest bull market run we have only experienced one correction (defined as a 10 percent decline in equity prices) and several mild pullbacks (similar to the drop in March). We believe a near-term correction is likely as the Federal Reserve considers a monetary exit strategy, the European Union deals with the peripheral country debt issues and manufacturers struggle with supply constraints.



Source: Bloomberg Financial, LLC, Ned Davis, 6/11

In April we suggested investors rebalance risk assets and reduce developed market equity exposure in favor of short term bonds. We believe this advice is still appropriate in today's uncertain market environment.

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