WELLS FARGO ADVISORS

2010 Midyear Economic and Market Outlook

The bumpy road continues…

Contents

Executive summary

- Our economic and market outlook hasn't changed significantly from the 2010 Outlook report, "A bumpy road to recovery" published earlier this year. Although we have adjusted some of our targets modestly, we still expect a bumpy road to recovery. We look for economic growth to be slower than normal and average 2.8% in the four quarters of 2010.
- We expect U.S. Consumer Price Index (CPI) inflation to be 2.0% in the 12 months ending December 2010. Inflation is likely to remain low, as net lending is still depressed and there is a lot of excess capacity in the economy keeping wage-and-price inflation low.
- We started this year anticipating the dollar could strengthen modestly. The dollar rallied, but more than we anticipated. We now recommend a slight underweight to developed equity markets and a slight overweight to emerging equity markets until it is clear whether European policymakers will take all necessary steps to support the euro and avoid a recession.
- We remain positive but cautious on the equity markets. Equities are likely to be volatile as the markets work off the excesses of the 80% rally from the March 2009 low to the April 2010 high. The S&P 500 hit our original year-end target of 1175-1200 in early April. More recently, we reduced our year-end target slightly to 1100-1140, given the weakness in foreign markets and volatile U.S. markets.
- We continue to favor cyclically sensitive sectors such as Industrials, Materials and Telecom Services. However, these sectors could be under pressure during market weakness. Nonetheless, we believe long-term investors should use pullbacks to build positions in these sectors in anticipation of a stronger market in 2011.
- In taxable fixed income markets, we continue to recommend investors overweight the corporate bond sector. The recent widening of spreads presents an attractive opportunity to increase exposure and bring portfolios up to an overweight allocation.
- Municipal bonds continue to offer attractive value, especially since tax rates are likely to increase next year. We recommend investors focus on general-obligation and essential-purpose revenue debt.

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Forecasts and targets

	2010	2011
S&P 500 — Target	1100-1140 range*	1200-1220 range†
S&P 500 Earnings Per Share Estimate (EPS)	$79	$89
Real Gross Domestic Product (GDP) ‡	2.8%	2.3%
10-year U.S. Treasury Note	3.00% - 4.00%	3.50% - 4.50%

* Year-end 2010 target
† 12-month target (mid 2010 to mid 2011)
‡ As of June 23, 2010. Fourth quarter to fourth quarter growth rate (mid 2010 to mid 2011)
Past performance is not an indication of future results. An index is not managed and is unavailable for direct investment. There can be no assurance that any of the target objectives will be met.

Is the economic recovery likely to continue? What could derail the economic recovery and cause a double-dip recession?

"We believe the economic recovery is likely to continue, although growth is slower than normal for this phase of the economic cycle. Nevertheless, the preconditions for an economic recovery are still in place. We continue to believe that the risk of a double-dip recession is less than 20%."

We believe the economic recovery is likely to continue, although growth is slower than normal for this phase of the economic cycle. Nevertheless, the preconditions for an economic recovery are still in place:

- Monetary policy is still accommodative.
- The credit markets are functioning more normally.
- Companies are hiring again.
- Businesses are rebuilding depleted inventories.
- Consumers are spending cautiously.
- Companies have resumed capital spending that was postponed during the recession.

The sector benefiting most and leading the way is manufacturing. Moreover, the upturn in manufacturing is widespread rather than isolated in just a few industries. Unfortunately, housing, the traditional leader in previous recoveries, is still depressed and lagging well behind other sectors.

High unemployment and mortgage foreclosures are major headwinds for the economy, preventing a normal strong economic rebound. However, consumer spending can still increase as consumer confidence improves. Of course, spending would increase faster if unemployment and foreclosures were lower.

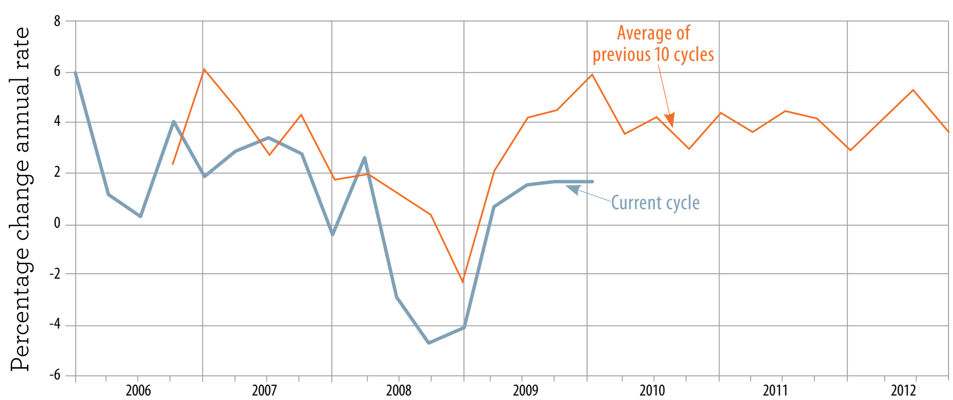
One of the main themes this year is that investors need to be flexible. So, what could cause us to change our outlook? A sharp event-driven spike in oil prices (to $125 per barrel) or a dramatic, disorderly decline in the euro (below 1.10 dollars per euro) would be significant signals that our outlook may be wrong. Similarly, a larger than expected correction in the U.S. equity market or a downturn in the U.S. leading economic indicator index would suggest that the outlook has deteriorated more than we anticipated.

The greatest threat to continued economic recovery would be some unexpected event that depresses confidence, causing consumers and businesses to reduce spending. Unanticipated events can occur at any time. However, we continue to believe that the risk of a double-dip recession is less than 20%.

Figure 1

Growth rate of inflation-adjusted final sales

This cycle vs. average of previous 10 cycles



Source: Haver Analytics, Wells Fargo Advisors

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Will higher taxes next year and/or the mid-term Congressional election impact the economic recovery?

"We expect higher taxes will dampen economic growth but not stop it. We look for personal taxes as a percent of personal income to increase from just under 9% currently to 11% in 2011 and to 12% in 2012, putting the tax burden at about the middle of the range for the past few decades."

"Unfortunately, the upcoming Congressional elections are likely to be very contentious. Therefore, we look for the elections to add to the volatility of the markets during the next several months."

Tax cuts

The Bush tax cuts are set to expire in January 2011. We expect higher taxes will dampen economic growth but not stop it. Taxes are now low relative to income; an increase in taxes from this level would not hurt the economy as much as a similar tax hike would if taxes were already high. More important, our work suggests that taxes alone cannot predict what the economy will do. For example, if taxes go up when corporate profits are declining, the economy is likely to falter. However, if taxes go up when corporate profits are rising, as we expect next year, the economy can still expand.

It is also important to remember that some of the tax cuts may not expire. President Obama has created a National Commission on Fiscal Responsibility and Reform to make recommendations on taxes and policies to achieve fiscal sustainability over the long run. The President appears to favor keeping tax rates low for low- and moderate-income families. Consequently, taxes may not go up as much as the end of the Bush tax cuts would indicate, and the economy may not suffer as much as some investors fear. We look for personal taxes as a percent of personal income to increase from just under 9% currently to 11% in 2011 and to 12% in 2012, putting the tax burden at about the middle of the range for the past few decades.

Mid-term election

Unfortunately, the upcoming Congressional elections are likely to be very contentious. As we said at the beginning of 2010, we believe this election season will be unsettling for the markets, with both parties highlighting the negative aspects of their opponents' views. This negative rhetoric could make the economy look bad at a time when investors are already nervous about other problems. Therefore, we look for the elections to add to the volatility of the markets during the next several months. If it looks like the election outcome could lead to a more balanced approach to policymaking with both major parties sharing power, the equity market may view this situation more favorably than an extreme situation in which one party is in control of both the Congress and the White House.

How will problems in Europe affect the global economic recovery?

"Several factors are working against a new European recession. Such measures during the next 12 months should reduce the negative effects of government austerity measures and, ultimately, reduce the amount of any European economic spillover into the rest of the world."

Europe appeared irresolute in the face of its sovereign debt problems and raised fears that the common currency union may fail, or at least suffer a new recession. If Europe fails to implement corrective policies, if the policies fail, or if government austerity measures across Europe curtail household and business spending, a new recession could develop that could slow global economic growth through two channels. First, Europe is an important trade partner for the United States and China. A new European recession could cut Europe's purchases of U.S. and Chinese goods, thereby spreading the economic slowdown. In terms of the banking system, a more intense financial crisis could raise financing costs for banks or could lead banks to mistrust loan collateral and limit lending. Alternatively, a recession could hurt banking business by increasing defaults and cutting loan demand. Insolvency among European banks could cause losses for banks with European banking exposure in other countries.

However, several factors are working against a new European recession. The austerity measures come at a time when European household and business inventory restocking

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are gaining momentum and giving the economy a tailwind. In addition, evidence from past financial crises in other countries indicates that measures to increase liquidity in the economy can significantly reduce the economic drag from austerity measures. Interest rates are already low, and the European Central Bank has further bolstered liquidity through the unprecedented step of lending directly into the economy. Such measures during the next 12 months should greatly reduce the negative effects of government austerity measures and, ultimately, reduce the amount of any European economic spillover into the rest of the world.

Which is a greater risk: inflation or deflation? Are inflation expectations increasing or decreasing?

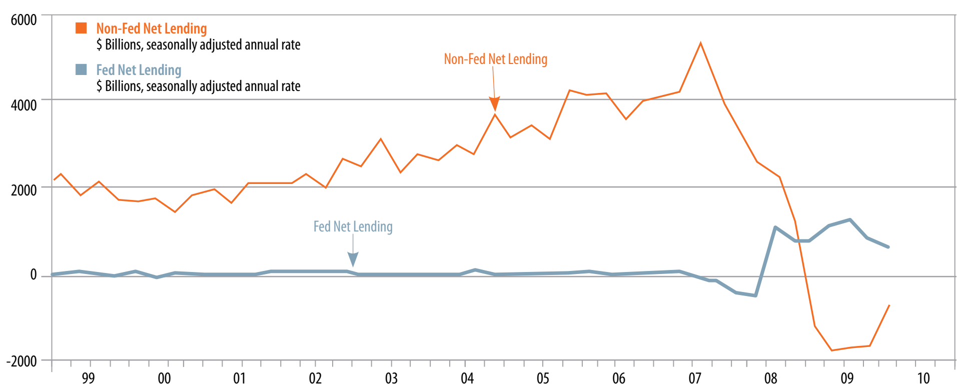
"The most recent figures on lending and debt repayment show inflation risks remain low. We currently forecast inflation to be at 2.0% for year-end 2010. Longer-term, we expect CPI inflation to average 2.5% over the next 10 to 15 years."

Investors frequently worry about inflation because rising prices erode the purchasing power of wealth. Investors also worry about inflation because the U.S. dollar is a fiat currency (not backed by any tangible asset). The dollar only has value because the U.S. government declares it to be legal tender for payment of debts. The dollar's true value is determined by its supply and demand. If the government ever abandoned monetary restraint and pumped more money than the public wanted to hold, the value of the dollar would drop and inflation would increase.

A year ago, most investors were only worried about inflation, not deflation, because the Federal Reserve was pumping a lot of money into the markets in order to stabilize the financial system and boost economic growth. The value of the dollar was dropping last year, and money growth was accelerating rapidly. Today, many investors are concerned that the European debt crisis could put global economic growth at risk. More importantly, the value of the U.S. dollar has increased as the euro has fallen, and U.S. money supply growth has slowed significantly. Consequently, inflation risks have lessened. The slowdown in money growth reduces investor concerns that the Fed is printing too much money and allows the Fed to hold interest rates at a low level longer. Concerns about deflation have increased because of European sovereign debt problems; however, we believe moderate inflation is more likely than deflation over the next several years.

History shows that inflation is usually caused by consumers and businesses using credit to spend more than they earn. However, the most recent figures on lending and debt repayment show inflation risks remain low. In fact, net lending, which includes new loans less debt paid off or written off as uncollectable, has been negative for five consecutive quarters (as of March 2010). This is not inflationary. We currently forecast inflation to be at 2.0% for year-end 2010. Longer term, we expect CPI inflation to average 2.5% over the next 10 to 15 years.

Figure 2: Net-lending



Source: Haver Analytics, Federal Reserve

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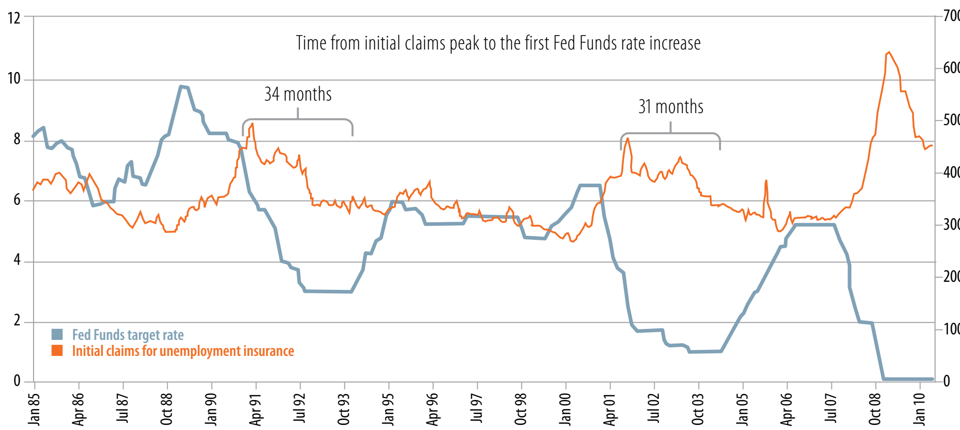
What is our current outlook on interest rates? When do we think the Fed will begin to raise rates?

"The combination of high unemployment, low inflation and the more recent financial market turbulence caused by the European sovereign debt crisis provide the Fed with plenty of leeway to keep short-term interest rates near zero percent for the remainder of the year."

"The U.S. Treasury will need to continue selling large amounts of debt on a regular basis to fund the U.S. debt and future budget deficits over the foreseeable future. We see a strong likelihood that investors may face a period of higher interest rates in the next two to five years."

We continue to believe that the Fed will keep the benchmark federal funds target rate (the interest rate at which banks lend to other member banks) unchanged at 0% to 0.25% through the remainder of 2010 and into early 2011. High unemployment, low inflation and the more recent financial market turbulence caused by the European sovereign debt crisis provide the Fed with plenty of leeway to keep short-term interest rates near zero percent for the remainder of the year. We believe the most recent recession probably ended in the summer of 2009 when initial jobless claims peaked. In past cycles, the Fed kept rates at low levels well past the official end of the recession, as we experienced slow job recoveries (see Figure 3). Thus far, this cycle has also been slow to see job creation. During the past two recessions, the Fed waited more than 30 months to begin raising interest rates after initial unemployment claims peaked. During this cycle, initial claims peaked in May 2009. If this cycle follows the pattern of previous cycles, the Fed may not begin to raise short-term rates until the second half of 2011.

Figure 3



Source: Haver Analytics

While we are not concerned about significantly higher rates in the next six to 12 months, investors purchasing longer dated bonds face an investment horizon in which we could potentially face a period of significantly higher yields, which could negatively impact bond prices. The U.S. Treasury will need to continue selling large amounts of debt on a regular basis to fund the U.S. debt and future budget deficits in the foreseeable future. As global economies improve and risk aversion abates, market participants may demand higher yields to buy and hold U.S. Treasury debt, which is a particular concern with more than 50% of Treasury securities currently held by foreign investors. We see a strong likelihood that investors may face a period of higher interest rates in the next two to five years.

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Is the dollar likely to rally further?

"The U.S. dollar has been in a long-term decline, dating back to the 1970s, reflecting the effects of globalization. We see this trend intact against a broad group of currencies, though cyclical factors may boost the dollar against a few major currencies in the coming 12 months."

The U.S. dollar has been in a long-term decline, dating back to the 1970s, reflecting the effects of globalization, as other countries gain access to world markets and compete successfully against U.S. companies. We see this trend intact against a broad group of currencies, though cyclical factors may boost the dollar against a few major currencies in the coming 12 months.

The dollar's strength in 2010 focused almost exclusively in the euro. We believe the greenback may gain further in the year ahead against the common European currency and other major currencies. During the next 12 months, several trends lead us to expect the euro to remain weak. First, we think the U.S. economy will outgain its European counterparts, boosting the dollar. Moreover, the debt crisis should keep European interest rates low, even as U.S. rates edge higher. Similarly, stronger economic growth and rising interest rate differentials may push the greenback higher against the Japanese yen and the British pound in the year ahead.

By contrast, we believe the same comparisons align for a broad dollar decline against the currencies of the developed commodity exporters (such as Canada and Australia), Asia and Latin America. In the year ahead, the economies and interest rates of these regions should move to the detriment of the dollar. One reason U.S. interest rates may not rise as quickly against these Asian and Latin American rates is that U.S. households and businesses are still paying down debt, which may leave credit demand weak in the coming year. The emerging Asian and Latin American economies are not weighed down by the same debt burden, and are enjoying strong domestic spending gains.

Currency performance is an important part of the investor's international investment return, and makes differentiation an important consideration. Basically, an investor should look for currencies with prospects to appreciate against the dollar. As the local currency rises against the dollar, that gain is added to the investor's return on the stock or bond; as the local currency falls and the dollar gains, the loss reduces the investor's total return on the overseas investment. Moreover, our outlook indicates that currency performance may be more differentiated than in the past, with the implication that investors should select the foreign currency as carefully as they do their stocks and bonds. We find attractive the currencies of our preferred countries. (See page 8 for a list of our preferred countries.)

Will the euro fail as a common currency?

The euro zone is unlikely to break up and the euro fail as a currency — either during the next 12 months or in the longer term — though the euro's fate depends on how the member countries assess the costs and benefits of the union. The euro zone's members benefit from low interest rates, increased trade among members, competition and larger financial markets for each member state. One cost of the common currency is that the one-size-fits-all interest rate policy prevents the member countries from managing their economies through interest rate changes. Lacking this lever over their economies, the weaker members of the currency union have relied on their government deficits to boost economic performance.

Another structural problem is that the efficiency gains of the strongest country can encourage borrowing by the weaker members. Germany has improved its efficiency and global competitiveness during the past 10 years, which has helped control inflation in the union's largest economy and enabled policymakers to keep the union's interest rate low. Meanwhile, the less efficient members (Spain, Portugal and Greece) have not attained the same efficiency gains but, instead, have used the low interest rates to boost their spending. Thus, the weaker members have tended to accumulate large

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"A euro zone collapse seems to us neither imminent nor inevitable, as long as the euro zone leadership successfully addresses the union's weaknesses. Meanwhile, the firming European economic recovery, low inflation and ample liquidity should support the euro."

national debt. These disadvantages were on display, as the debt crisis of the union's smallest country (Greece) caused a currency crisis for all the members. These costs and benefits have been well-known since the euro's inception, but the crisis illustrated the need for credible and coordinated reforms to enforce fiscal discipline and close the competitiveness gap with Germany.

A euro zone collapse seems to us neither imminent nor inevitable, as long as the euro zone leadership successfully addresses the union's weaknesses. The euro has not collapsed. Despite falling 25% from its 2008 peak of $1.60, the euro is well above its previous cycle low, near $0.82 in 2001. Meanwhile, the firming European economic recovery, low inflation and ample liquidity should support the euro. For the coming year and beyond, the large overall benefit of the currency union gives the leadership strong incentive to institute important reforms. Nevertheless, as policymakers try new measures, some additional financial market volatility in Europe is likely.

Figure 4

Value of the euro

Source: Federal Reserve Board/Haver Analytics

Past performance is not an indication of future results

From an investment standpoint, euro zone uncertainties may persist, but the continent offers no better example of our differentiation theme. The euro zone's investment prospects appear weak, but countries outside the euro zone are attractive. All the Scandinavian countries bear watching. In particular, Sweden and Norway appear set for above-trend economic growth with solid trade surpluses, low inflation and debt. Even within the euro zone, Germany looks attractive, notably for its positioning to exploit the euro's decline in its strong export sector.

Which countries are likely to be strongest and offer the best international investment opportunities?

An important theme in our current outlook is country differentiation. In 2009, many equity markets rose sharply together as the global economic recovery began to develop. Today, the global expansion continues and has good prospects for the next 12 months, but differences between countries are proving to be increasingly important. Therefore, we expect the next 12 months to reward those investors who select countries as carefully as they do individual bonds or equities.

One important differentiation theme has been whether a given country has issues with debt. Britain, Japan and the euro zone (with the notable exception of Germany) are experiencing subpar expansions, in part because these countries are trying to reduce their debt burdens. Meanwhile, the Scandinavian countries and many emerging market

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economies have rebounded faster, as they have more manageable debt levels. Another basis for differentiation has been strong international trade positions, especially trade ties to China's fast-growing economy. We have been recommending Australia, Canada, Brazil, India and Mexico — in part for their relatively low debt levels, but also because each is an important trading partner with China as well as with broader Asia.

"An important theme in our outlook is country differentiation. Based on the two themes of low debt and strong trade orientation, we find Germany, Sweden, Norway, Malaysia, Singapore and Chile attractive."

Based on these two themes, we also find Germany, Sweden, Norway, Malaysia, Singapore and Chile attractive. All six countries have strong government financial fundamentals, with low deficits and debt. In particular, Chile's strong financial position has enabled a strong recovery from the February 2010 earthquake. In addition, all avoided the speculative real estate excesses of the past decade. Finally, all are strong global exporters: Sweden and Germany in high-tech manufactures, Norway and Chile in natural resources, and Malaysia and Singapore in varied products closely tied to Europe and China.

Attractive Countries	
Developed Markets	Emerging Markets
Australia	Brazil
Canada	Chile
Germany	India
Norway	Malaysia
Singapore	Mexico
Sweden	

For more detail on countries we find attractive, please ask your Financial Advisor for a copy of our monthly publication titled, "International Strategy Snapshots."

Where do the risks lie in the international markets?

"Geopolitical disputes remain a risk for international markets. Financial risks remain as well, but we think major policy mistakes are unlikely. Policy risk in China should also remain a market concern, but China's economy should avoid a recession."

Geopolitical disputes remain a risk for international markets. Tensions in the Middle East remain high as Iran continues to pursue a nuclear capability. A military action against Iran and a subsequent retaliation likely would include significant destruction, instability and commodity price spikes. Although that probability seems small right now, this confrontation is fluid and could escalate quickly. Such a scenario would likely be negative for the dollar and financial markets, but positive for other commodity markets.

Meanwhile, tension has also built in Western Asia, where Taliban and Al Qaeda elements operating in Afghanistan, Pakistan and India are trying to destabilize these governments in order to break the cooperation these countries give the U.S. military's anti-terror operations in Afghanistan. The military conflict could spill over from Afghanistan, but we think that risk is currently low and may be declining in the near-term, as Pakistan has scored military success against the terrorists and has improved communication with India in the past year. We do not expect a broader military conflict in this region, but a significant terrorist provocation could push international financial markets and the dollar lower. Nevertheless, negotiations are proceeding to grant significant concessions to the Afghan Taliban ahead of the planned U.S. troop withdrawal. The Taliban could pose a long-term risk to regional stability if the Taliban re-emerges as a regional power.

The Korean peninsula is another source of uncertainty. The sinking of a South Korean naval vessel in March 2010 led the two Koreas to cut communication with each other. China and the United States, as the principal allies of North and South Korea, respectively, seem determined to avert a deliberate war. However, the break in

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communication between the two Koreas means that any new confrontation may escalate quickly. We expect additional verbal sparring, which may also trigger some volatility for Korean financial markets.

In addition, financial risks remain, as well, in the euro zone and in Eastern Europe. A new wave of sovereign credit worries could arise if European governments fail to take decisive action to control deficits and debt. Alternatively, countries that withdraw monetary stimulus too quickly risk pulling away important support for economies that must work through difficult belt-tightening measures. We think major policy mistakes are unlikely, but disagreements and dissension among politicians remain possible and may generate renewed financial market volatility.

Policy risk in China should also remain a market concern during the coming year. Beijing is trying to curb real estate speculation without hurting the rest of the economy. Measures taken early in 2010 appear to be reining in property price inflation, but the second half of 2010 should reveal how much the rest of China's economy slows. We see enough sources of strength that China's economy should avoid a recession.

Why does the rally in commodities during the past year appear to be cooling off? Looking ahead, which commodities are likely to be strongest?

Commodity markets take long-term support from strong generational trends in urbanization, population growth and global trade, all of which increase commodity demand. In addition, years of underinvestment and geological constraints may leave commodity supplies struggling to keep pace with future demand. Many commodity prices take additional support from the U.S. dollar's long-term decline, which cheapens commodity prices in the currencies of the commodity-buying countries. Moreover, during the next 12 months, the ongoing global economic expansion should help support commodity markets.

"During the next 12 months, the ongoing global economic expansion should help support commodity markets. Our attractive commodities include industrial commodities – crude oil, platinum, palladium and copper."

Even though commodities have considerable long-term support, the cyclical rally stalled in early 2010. The slowdown came as the U.S. dollar surged higher, responding to worries about European debt and China's policies to moderate its property market. Policymakers should need the next three months to implement the policies and measure their early track for success. We expect commodity prices to stabilize during that interval, and then resume the rally, once China and Europe demonstrate control of their respective issues. There is a small probability that markets may turn defensive if policymakers fail to launch credible plans, or if the early results indicate that the policies are failing.

Our attractive commodities include industrial commodities — crude oil, platinum palladium and copper. These commodity markets corrected in mid 2010; but, if our outlook for policy in Europe and China is correct, we expect these commodities to resume their rallies. If our policy outlook proves incorrect, we would expect to review our commodity recommendations with an eye towards more defensive positions.

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Attractive	Neutral	Unattractive
Platinum	Gold	Natural Gas
Palladium		Silver
Copper		Aluminum
Crude oil		

Buying gold, silver, platinum or palladium allows for a source of diversification for those sophisticated persons who wish to add precious metals to their portfolios and who are prepared to assume the risks inherent in the bullion market. Any bullion or coin purchase represents a transaction in a non-income-producing commodity and is highly speculative. Therefore precious metals should not represent a significant portion of an individual's portfolio.

For more details on commodities we find attractive, please ask your Financial Advisor for a copy of our monthly publication titled "Commodities Snapshot."

From both a fundamental and technical perspective, can the stock market continue to advance after rising more than 80% between the March 2009 lows and April 2010 highs?

Fundamental perspective

Early this year, we published expectations for continued economic recovery in 2010; however, we cautioned that recovery would be accompanied by a volatile stock market offering muted returns. Equity markets rarely move linearly. They tend to make sharp moves as investor expectations swing from overly pessimistic or overly optimistic stances back toward reality. This is typical human behavior, and the dramatic move in stocks through late April 2010 is similar to other historical periods when world economies re-emerged from recessions simultaneously. At the start of the year, we were targeting a range of 1175 to 1200 for the S&P 500, representing a more muted 5.4% to 7.6% increase during calendar 2010. Some signs suggested that the high for the year could potentially emerge by midyear. The first quarter of this year offered the easiest earnings comparisons versus the recession's trough earnings (first quarter 2009). While we started the year with an earnings projection of $76 for 2010, we also stated at the time that there was potential upside to our earnings expectations of $3 to $4 for 2010 and 2011. We recently increased our earnings estimates for 2010 to $79 from $76, and to $89 from $86 for 2011.

For more than a year, we have been comparing the current market recovery to the recoveries from the 1973-1974 and the 1981-1982 recessions. While the fundamentals of those two recessions were different than the current environment, they did exhibit similar swift and dramatic swings in investor expectations. Unlike the market recovery following the 1990-1991 recession, most of the world is now recovering together. After a first strong market up leg such as we just experienced, it is not unusual to go through a period of more muted returns. We believe the second half of 2010 will represent such a period. In Figure 5, we have plotted the trajectory of the two strongest cyclical market up legs of the past seven cycles (in blue and red) alongside that of the most recent initial market recovery (in black). Generally, by the second year of recovery, "Street" earnings estimates have at least recovered to more realistic levels. Investors and the markets have started to consider the likelihood of a multi-year recovery as opposed to a continued recession.

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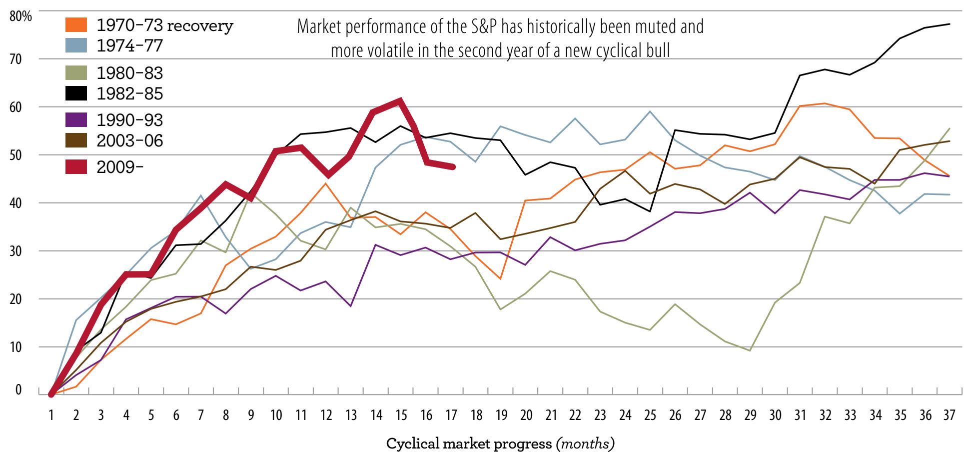
Figure 5



Source: Fact set, Baseline, Wells Fargo

Past performance is not an indication of future results. An index is not managed and is unavailable for direct investment.

"The second year of recovery tends to be more vulnerable to negative news. Most frequently, the dynamic first up leg of a cyclical recovery is followed by a multi-quarter period of volatility and more corrections. But, investors must be mindful that this volatility is normal, and we continue to believe we are in the early stages of a multi-year economic recovery."

"While we believe the stock market is now working through a transition, we also believe the second up leg of this cyclical bull market should begin to form in early 2011. Continuous economic recovery should push the S&P 500 back above the 1200 level on a more sustainable basis by the middle of next year. We have adjusted our year-end target for the S&P 500 to the 1100-1140 range."

In the second year of recovery, investors often begin to anticipate the potential for monetary tightening in some parts of the world and, eventually, within the United States. Additionally, as is true now, investors wrestle in the second year of market recovery with ongoing positive signs of economic growth versus less favorable lagging indicators from the previous recession. Today, investors continue to focus on the 9.7% unemployment rate as well as on some of the tremors or aftershocks of the recession. The sovereign debt issues in a number of countries in Europe represent lagging aftershocks that are more difficult for investors to digest with an elevated stock market. The second year of recovery tends to be more vulnerable to negative news. Most frequently, the dynamic first up leg of a cyclical recovery is followed by a multi-quarter period of volatility and more corrections. But, investors must be mindful that this volatility is normal, and we continue to believe we are in the early stages of a multi-year economic recovery.

Nonetheless, given the fact that earnings comparisons should continue positive through the balance of the year, but offer smaller upward surprises than during the past few quarters, we have adjusted our year-end target for the S&P 500 to the 1100-1140 range from our previous 1175-1200 range. Stocks already reached the 1220 area in April. Our adjustment represents roughly a 5%-6% reduction from our previous target range. Again, while we believe the stock market is now working through a transition, we also believe the second up leg of this cyclical bull market should begin to form in early 2011. We expect the S&P 500 will remain quite volatile this year, with the potential for lower lows and perhaps even rallies toward the April highs. Continuing economic recovery should push the S&P 500 back above the 1200 level on a more sustainable basis by the middle of next year.

Technical perspective

In our opinion, the stock market can continue to advance after its more than 80% rally. However, we believe the probability is low that the stock market will make much upside progress during the second half of 2010. Performance of the average stock has been even stronger than that of the market-cap weighted indices. The Value Line Arithmetic Composite (an index made up of 1700 stocks that equally weights each of its components) rose 170% between March 2009 and April 2010. The NYSE cumulative advance/decline line (a measure of whether most stocks are going up or down) rose to its December 2007 level by the end of April 2010. These sharp rises are characteristic of the early stages of a new bull market. But, in our opinion, this initial dynamic phase of the bull market is now winding down.

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During the March 2009 through April 2010 time period, the stock market recovered from very depressed levels. The rising tide floated all boats and resulted in outperformance by low-priced and small- to mid-cap stocks. Now, the large March 2009 to April 2010 advance is the dominant factor in the marketplace. We believe it has resulted in increasingly nervous and fatigued investors and is the primary cause of the recent sharp market swings in both directions. The news backdrop from Europe to China to the Gulf of Mexico oil spill is acting as a catalyst to exaggerate the swings. We believe these conditions will likely keep the stock market range-bound over the next several months.

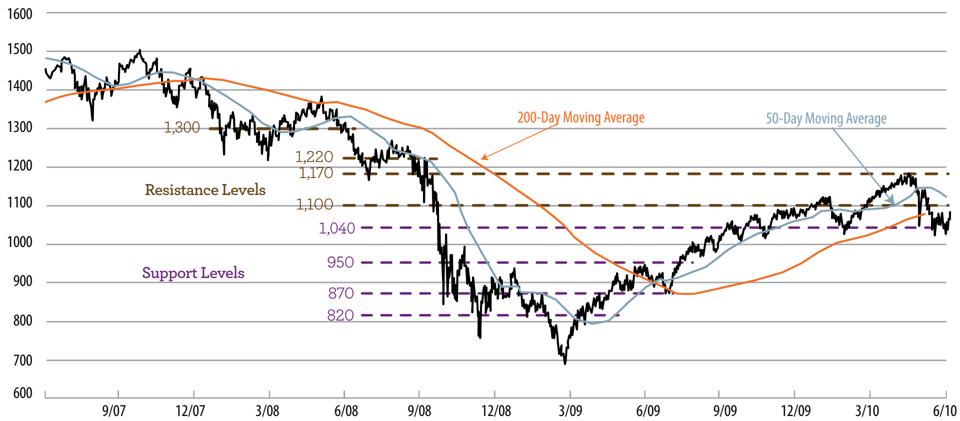
Investors faced many obstacles in the first half of the year: the uncertainty of healthcare and financial industry reform, spending increases, proposed tax hikes, slow reconfirmation of Fed Chairman Ben Bernanke, "contagion" fears re-emerging as the European debt crisis accelerated, the CBOE Volatility Index (VIX) falling to its 30-year historical average level (a sign of investor complacency), and Goldman Sach's SEC fraud charge. Any one of these events had the ability to derail the bull market, but only resulted in benign, stock-market pullbacks relative to the large advance since early 2009 — which underlines the fact that in strong bull markets, momentum is not easily broken and the "buy the dip" investor mindset is still alive. These conditions resulted in a very resilient stock market during the first half of the year and should continue to prevent a sustained decline (greater than the 20% area) during the second half of the year, provided that our economic and market outlook is accurate. Many individual investors have retained a healthy skepticism and never returned to the equity market since the bull market inception in 2009. This is evidenced by subdued equity fund inflows and the small percentage of equity funds that have returned to 401(k) plans since exiting in 2007 and 2008. The upside to this skepticism is it has served to help the market climb the proverbial "wall of worry" and has kept stock market declines in check.

Rapid swings in momentum and investor sentiment have now become the norm and not the exception, especially since the late April highs. May was one of the worst performing months in stock market history. The month included two declines of 1,000 DJIA points in eight trading days or less, a five-trading-day advance of more than 1,000 points and a three-day advance of more than 500 points. Investor confusion and light volume added to this volatility. Low volume has been cited as a worrisome factor, and we agree it must be monitored closely. What low volume has meant to this point, however, is that sellers have not been motivated to exit because pullbacks have been relatively mild. Buyers have been reluctant to make large commitments to stocks, a positive as it reflects healthy skepticism. The light volume could become a problem if it serves as a catalyst for heavier selling as major index resistance levels are approached, but not surpassed. (See Figure 6 for current major resistance and support levels for the S&P 500.)

Figure 6

S&P 500 Composite Index

3-year chart



Source: Bloomberg

Past performance is not an indication of future results. An index is not managed and is unavailable for direct investment.

The recent rapid market swings have made it difficult for investors to regain their "sea legs." The volatility caused by the European debt crisis has resulted in safe-haven assets rising (U.S. dollar, treasury prices, and gold) while "risk" assets (Euro currency and stock markets) have been falling. The message of these markets is that investors have a low degree of confidence in the steps taken by European authorities. Investors are hyper-sensitive to another meltdown (similar to the U.S. meltdown in 2007 and 2008) and the potential negative implications for the recovering worldwide economy. The debt crisis will take some time to work through and therefore increases the odds that the U.S. equity market remains range-bound for the next several months. Historically, the May to October period represents the weakest six months of the year; therefore, seasonality is currently working against equities. Another headwind for equities is the historical tendency for stocks to behave sluggishly as investors begin to discount a new cycle of U.S. Fed interest rate hikes. We expect investor anticipation of Fed hikes to begin by this fall. Furthermore, there is added uncertainty in the short term surrounding the economy's ability to continue growing without the temporary massive government support plans that have been removed.

What sectors and investment styles should lead the way as the economy continues to expand?

We note that S&P 500 revenues have increased by 5.4% since the trough of the recession. This is in line with, or ahead of, progress from the recoveries after the prior two recessions (1990 to 1991 and 2001). Operating earnings have increased 59% since the first quarter of 2009, and margins have increased from 5.7% to 8.2% in the first quarter of 2010 (versus a long-term average operating margin of 6.7%). The more cyclically sensitive sectors are already showing higher than long-term average operating margins (including the Industrial, Consumer Discretionary, Technology, Materials and Energy sectors). Overall, large U.S. corporations are carrying healthy balance sheets and generating strong cash flows. From here, ongoing growth will require more transition from government spending to the U.S. consumer. In addition, earnings growth will be less dependent on margin expansion and more on continued revenue growth here and abroad.

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"In our opinion, most cyclically sensitive sectors' earnings growth rates will outperform those of defensive sectors through this year and next. We currently recommend investors overweight the Industrials, Materials, and Telecommunicatons sectors. We believe investors should use general market retrenchments as opportunities to accumulate more cyclically-sensitive small- and mid-cap stocks versus large-cap stocks, and value-oriented versus growth-oriented stocks."

Since late April, the more defensive sectors of the market have outperformed others by declining less as the market has pulled back. The sectors that outperformed during the most recent correction are the same sectors that materially underperformed the S&P 500 during the initial up leg of the cyclical bull market. Specifically, the Consumer Staples, Health Care and Utilities sectors have underperformed the S&P 500 by 28, 29 and 32 percentage points, respectively, since March 2, 2009. These three sectors recently outperformed the S&P 500 by 6, 5 and 5 percentage points during the recent pullback. Based upon history and our belief that we are not headed for a double-dip recession, it is very early in this economic recovery for these three sectors to outperform the general market for an extended period of time. It is premature, in our opinion, to expect that deep cyclically sensitive sectors like Industrials, Consumer Discretionary, Financials, Materials and Energy will not have another period of outperformance during this economic recovery. In our opinion, most cyclically sensitive sectors' earnings growth rates will outperform those of defensive sectors through this year and next.

We recommend investors with nine-month or longer investment time horizons use periods of market weakness this year to accumulate stock positions within segments of the economy that traditionally benefit from multi-year economic recoveries. We do not suggest focusing upon economic weakness and the defensively-oriented stocks, but rather upon the potential for cyclical growth ahead and the accumulation of companies whose fortunes should strengthen as the global economic recovery continues into 2011. We currently recommend investors overweight the Industrial, Materials and Telecommunications sectors. At this stage of the recovery, our sector underweight recommendations remain the defensive Consumer Staples and Health Care sectors. Note that due to current valuations and attractive yields, we recently upgraded the defensive Utilities sector to evenweight from underweight. Utilities represent less than 4% of the total market cap of the S&P 500. In the international markets, investors with a three- to six-month investment horizon should underweight developed country equities and overweight emerging market equities during this anticipated period of volatility.

	Guidance	S&P 500
Overweight		
Industrials	14%	10.5%
Materials	7%	3.5%
Telecommunications	5%	2.9%
Evenweight		
Consumer discretionary	11%	10.4%
Energy	11%	11.0%
Financials	16%	16.2%
Information technology	17%	19.0%
Utilities	3%	3.7%
Underweight		
Consumer staples	8%	11.2%
Health Care	8%	11.7%

Past performance is not an indication of future results. An index is not managed and is unavailable for direct investment.

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We believe investors should use general market retrenchments as opportunities (relative to their investment objectives) to accumulate small-cap and mid-cap stocks versus large-cap stocks, and value-oriented versus growth-oriented stocks. As economic growth continues to broaden across industries and regions, the opportunities for smaller and more domestically focused U.S. companies should accelerate. At the same time, we are seeing opportunities and better value in cyclically-oriented issues on market pullbacks. We believe defensive issues will most likely lag, once again, as investors look beyond 2010 into a period of multi-year cyclical economic growth.

What is our outlook for the fixed income markets?

"In the second half of 2010, we believe fixed income investors will continue to face a low interest rate environment and a steep yield curve. For the second half of 2010, we are lowering our yield range on the benchmark 10-year Treasury to 3.00%-4.00% with a year-end target in the 3.75% area."

In the second half of 2010, we believe fixed income investors will continue to face a low interest rate environment and a steep yield curve (short-term rates significantly lower than longer-term rates). We think the Federal Reserve will keep short-term rates low through 2010, which in turn will likely keep a lid on longer-term benchmark rates. At the beginning of 2010, we felt the benchmark 10-year Treasury yield was likely to trade in a range between 3.25% to 4.50%, and in the first half of the year, the 10-year Treasury saw a yield high of 3.99% and a yield low of 3.16%. For the second half of 2010, we are lowering our yield range on the benchmark 10-year Treasury to 3.00% to 4.00% with a year-end target in the 3.75% area.

This type of rate environment may require investors to make choices or trade-offs in their fixed income portfolio. While short-term, high-quality fixed income securities can provide preservation of capital and liquidity, it comes at a cost: little-to-no yield or return. To achieve incremental yield or return, fixed income investors will face the decision of either extending their time horizon (longer maturities) or lowering their quality parameters (lower quality bonds), or some combination of both. In the current environment, we believe a little of each is acceptable. However, we caution investors from becoming too aggressive in long-duration securities or below investment-grade bonds.

Where do we see opportunities in the fixed income markets?

As we look into the second half of 2010, we believe the more credit-sensitive markets offer the best relative value for fixed income investors. We recommend overweight positions in investment-grade corporate and municipal bonds, as well as a slight overweight to high-yield securities. We recommend a slight underweight to Treasury securities, and an underweight to agency securities and mortgage-backed securities.

ASG fixed income sector allocation recommendations

Overweight	Slight overweight	Neutral weight	Slight Underweight	Underweight	Duration
Corporate Bonds	High Yield		U.S. Treasuries	Mortgage Backed	Slightly short
Municipal Bonds		Emerging Markets		Agency Securities	

Investment-grade corporate bonds and high-yield securities

Investment-grade corporate bonds and high-yield securities still offer valuations above their longer-term historical averages, and corporate credit trends have improved with the economic recovery. U.S. companies are well into the deleveraging process, which

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"As we look into the second half of 2010, we believe the more credit-sensitive markets offer the best relative value for fixed income investors. We recommend overweight positions in investment-grade corporate bonds and municipal bonds, as well as a slight overweight to high-yield securities."

has strengthened their balance sheets, with corporate profitability and earnings also showing improvement. In addition, we think the high-yield market will continue to be supported by rapidly falling default rates, a steadily improving economy and low interest rates, creating investor demand for securities that provide incremental yield. According to Moody's Investors Service (Moody's), high-yield default rates peaked in the fourth quarter of 2009 and are forecasted to drop sharply over the coming year. Moody's is calling for default rates to drop from the recent 9.5% level in April 2010 to 3.0% by the end of this year; then to 2.3% a year from now.

Municipal bonds

We continue to like valuations in the municipal sector and see some interesting dynamics supporting the municipal market. First, looming tax rate increases are expected to increase investor demand for tax-exempt income in the coming years. Beginning in 2011 (unless Congress takes action), the Bush-era tax cuts will be phased out increasing the top bracket on ordinary income to 39.6% from its current 35%. Dividends, which have enjoyed a top tax rate of just 15%, will revert to being taxed at ordinary rates. Finally, beginning in 2013, individuals earning more than $200,000 or couples earning more than $250,000 will pay a 3.8% Medicare tax on all investment income, which includes taxable interest, dividends and capital gains.

Secondly, the supply of tax-exempt bonds is being reduced by the Build America Bond program, which allows municipal bond issuers to issue taxable bonds in which the interest payments are subsidized by the federal government. The overall impact has been to reduce the supply of new issue tax-exempt municipal bonds, particularly in the longer-term maturities. While state and local governments are addressing their budgetary constraints with a combination of expenditure cuts and tax increases, many issuers have turned to the Build America Bond program to help reduce their financing costs. This new financing program is having a profound impact on both the primary and secondary markets for tax-exempt bonds.

While state and local municipal issuers have been facing unprecedented budget problems due to prolonged and significant declines in their municipal tax revenue sources, we continue to believe the primary risk will be ratings downgrades rather than actual default risk. We continue to favor single "A" rated or better general-obligation and essential-service revenue bonds in all maturity ranges.

How should long-term investors be positioning portfolios?

Investors need to clearly define the risk they are willing to take and invest accordingly. In addition, investors need to recognize that markets may not help grow wealth as much as they did in the past.

The U.S. economy continues to face many years of deleveraging as consumers and businesses restrain spending in order to reduce their debts. In addition, governments are likely to raise taxes in order to reduce deficits. This means that economic growth and asset returns may be less than many investors are accustomed to seeing.

U.S. equity markets have recovered sharply from the lows during the deep 2008-2009 recession. Looking ahead, equity returns are likely to be more modest than during the first leg of the stock market's recovery. In fact, as the economy transitions from recovery to expansion, economic growth is likely to moderate. Consequently, returns are also likely to be modest. We recommend investors with nine-month or longer investment time horizons use periods of market weakness this year to accumulate stock positions

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within segments of the economy that should benefit from a multi-year economic recovery. We suggest focusing on companies whose fortunes should strengthen as the global economic recovery continues into 2011. We are currently recommending an overweight in the Industrial, Materials and Telecom Services industry sectors. Our underweight recommendations remain the defensive Consumer Staples and Health sectors.

We believe investors should use market weakness as opportunities (relative to their investment objectives) to accumulate smaller and mid-cap stocks versus large-cap stocks as well as value-oriented versus growth-oriented stocks. As the economy continues to grow, the opportunities for smaller and more domestically focused U.S. companies should expand as well. At the same time, we believe less cyclically dependent growth companies' stocks will lag as investors look beyond 2010.

"Bottom line, we believe the road to economic recovery is likely to continue; however, it will most likely be a bumpy ride."

As for fixed income, we recommend overweight positions in investment-grade corporate and municipal bonds, as well as a slight overweight to high-yield securities. We continue to favor single "A" rated or better general-obligation and essential-service revenue bonds in all maturity ranges.

On the international side, we have been recommending Australia, Canada, Brazil, India, and Mexico — in part for their relatively low debt levels, but also because each is an important trading partner with China as well as with broader Asia. Based on these two themes, we also find Germany, Norway, Sweden, Malaysia, Singapore, and Chile attractive. Our attractive commodities include industrial commodities — crude oil, platinum, palladium, and copper. These commodity markets corrected in mid 2010; but, if our outlook for policy in Europe and China is correct, we expect these commodities to begin to rally further.

Bottom line, we believe the road to economic recovery is likely to continue; however, it will most likely be a bumpy ride.

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Economic and the Market Forecast *as of 6/18/10*

		2009 Year end	2010 Latest	2010 Year End Forecast
Real GDP	*rolling 4 quarters*	0.1%	2.5%[1]	2.8%
Real GDP	*latest quarter % chg. ann. rate*		3.0%[1]	
Unemployment	*end of period/latest*	10.0%	9.7%[2]	9.8%
CPI Inflation	*rolling 12-months*	2.7%	2.0%[2]	2.0%
Federal Deficit	*rolling 12-months*	$1.47 tril.	$1.36 tril.[2]	$1.6 tril.
Existing Home Sales (SAAR*)	*end of period/latest*	5.4 mil.	5.8 mil.[3]	5.8 mil.
Total Vehicle Sales (SAAR*)	*end of period/latest*	11.2 mil.	11.6 mil.[2]	12.0 mil.
Oil Prices	*end of period/latest*	$79.36	$77.18	$90.00
Target Federal Funds Rate	*end of period/latest*	0.12%	0.12%	0.0-0.25%
10-Yr. Treasury	*end of period/latest*	3.84%	3.22%	3.75%
30-Yr. Treasury	*end of period/latest*	4.64%	4.14%	4.50%
MSCI EAFE Index	*end of period/latest*	1580.77	1419.16	1550
MSCI Emerging Markets Index	*end of period/latest*	989.47	953.48	1050
S&P 500	*end of period/latest*	115.10	1117.50	1100-1140
S&P Operating Earnings	*trailing 4 quarters*	$65.27/shr	$72.01/shr[1]	$79/shr
S&P 500 price/earnings	*trailing 4 quarters oper. earn.*	17.08	15.52[1]	14.18

***SAAR** - Seasonally adjusted annual rate

1 = data as of first quarter 2010
2 = data as of May 2010
3 = data as of April 2010

Current ASG Strategy *as of 6/22/10*

Major Markets	Recommended Weighting
U.S. Large-Cap Stocks	neutral
U.S. Mid-Cap Stocks	over
U.S. Small-Cap Stocks	neutral
Growth Stocks	neutral
Value Stocks	neutral
Foreign Developed-Country Stocks	under
Emerging Market Stocks	over
Dollar	neutral
Commodities	neutral
Short-term IG† Bonds	neutral
Inter.-term IG† Bonds	over
Long-term IG† Bonds	under
Speculative Grade Bonds	neutral
REITs	neutral

Sectors	Percent of S&P	Guidance
Consumer Discretionary	10.4	even
Consumer Staples	11.2	under
Energy	11.0	even
Financial	16.2	even
Health Care	11.7	under
Industrials	10.5	over
Information Technology	19.0	even
Materials	3.5	over
Telecommunication Services	2.9	over
Utilities	3.7	even

†**IG** - Investment grade - treasuries, agency securities, mortgage-backed securities, corporate bonds and municipal bonds.

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Definitions

The CBOE (Chicago Board Options Exchange) Volatility Index (VIX) shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking and is calculated from both calls and puts. The VIX is a widely used measure of market risk and is often referred to as the "investor fear gauge".

The Dow Jones Industrial Average is based on 30 major companies weighted by price.

The S&P 500 Index consists of 500 industrial, financial, utility and transportation companies with market capitalizations of $3 billion or more.

New York Stock Exchange Composite Index measures all common stocks listed on the New York Stock Exchange and four subgroup indexes: industrial, transportation, utility and finance. The index tracks the change in the market value of NYSE common stocks, and is adjusted to eliminate the effects of new listings and delistings.

MSCI EAFE Index: Compiled by Morgan Stanley Capital International (MSCI), the Morgan Stanley Europe, Australasia and Far East Index is a value-weighted index of the equity performance of major foreign markets. In effect, it is a non-American world index of over 1000 stocks.

MSCI Emerging Market Index: Created by MSCI and designed to measure equity market performance in global emerging markets.

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living. Merrill Lynch High Yield Master II Index tracks the performance of U.S. dollar denominated below investment-grade corporate debt publicly issued in the U.S. domestic market.

Merrill Lynch Corporate Master Bond Index reflects investment-grade bonds with average maturities of at least one year.

Standard & Poor's Rating Agency (S&P) is a financial services company that rates stocks and corporate and municipal bonds according to risk profiles.

Moody's Investors Service (Moody's) is an independent, unaffiliated research company that rates fixed income securities. Moody's assigns ratings on the basis of risk and the borrower's ability to make interest payments.

Short-term Fixed Income: Fixed income instruments that mature in one to six years.

Intermediate-Term Fixed Income: Fixed Income instruments that mature in six to 12 years.

Long-Term Fixed Income: Fixed Income instruments whose maturities are greater than 12 years.

High Yield: Non-investment grade fixed income securities (rated Ba1 or lower by Moody's and/or BB+ or lower by S&P). These investments are considered to be speculative and are subject to a higher degree of risk.

International: Financial markets in developed economies outside of the U.S.

Emerging Markets: Financial markets in countries with developing economies. These markets are typically immature compared to those of the world's major financial centers but are becoming increasingly sophisticated and integrated into international markets; they provide potentially higher returns but are intensely volatile.

REITs: Real estate investment trusts (REITs) trade on the major exchanges and invest in real estate directly, either through properties or mortgages.

Large-Cap Growth: Stocks that have a market cap greater than $6 billion and a price-to-book ratio greater than 2.15.

Large-Cap Value: Stocks that have a market cap greater than $6 billion and a price-to-book ratio less than or equal to 2.15.

Mid-Cap Growth: Stocks that have a market cap between $1.2 - $6 billion and a price-to-book ratio greater than 2.15.

Mid-Cap Value: Stocks that have a market cap between $1.2 - $6 billion and a price-to-book ratio less than or equal to 2.15.

Small-Cap Growth: Stocks that have a market cap less than $1.2 billion and a price-to-book ratio greater than 2.15.

Commodities: Basic goods used in commerce that are generally interchangeable with other commodities of the same type. Commodities are most often used as inputs in the production of other goods or services.

Analyst Certification: The analyst who is primarily responsible for commentary on any subject company/companies and securities in this report has represented that the commentary accurately reflects that analyst's personal views. The analyst further certifies that he/she receives no compensation that is directly or indirectly related to the specific recommendation or views contained within this report.

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Important disclaimers

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Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility.

The prices of small and mid-cap company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Dividends can be increased, decreased or totally eliminated at any point without notice.

While stocks generally have a greater potential return than government bonds and treasury bills, they involve a higher degree of risk. Government bonds and treasury bills, unlike stocks, are guaranteed as to payment of principal and interest by the U.S. Government if held to maturity. Although treasuries are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate inversely to a change in interest rates.

High-yield bonds, also known as junk bonds, are subject to greater risk of loss of principal and interest, including default risk, than higher-rated bonds. The prices of these bonds may be volatile , and they are generally only suitable for aggressive investors.

Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Investments that are concentrated in a specific sector or industry may be subject to a higher degree of market risk than investments that are more diversified.

Buying commodities allows for a source of diversification for those sophisticated persons who wish to add commodities to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any purchase represents a transaction in a non-income-producing commodity and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.

There are special risks associated with an investment in real estate, including credit risk, interest rate fluctuations and the impact of varied economic conditions. Distributions from REIT investments are taxed at the owner's tax bracket.

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