The following information and opinions are provided courtesy of Wells Fargo Bank, NA.

MARKET UPDATE

U.S. Debt Loses its AAA Rating: What Does the Downgrade Mean for Investors?

Wells Fargo Wealth Management Investment Strategy Team *August 7, 2011*

1. Why did the Standard & Poor's credit rating agency decide to downgrade U.S. sovereign debt and keep the U.S. on a "negative credit watch," and are the other bond rating agencies likely to follow its example?

Last week U.S. politicians reached a deal, just ahead of the August 2, 2011 deadline, to raise the government's debt limit in order to avoid a default. Congress agreed to raise the debt limit by $900 billion and, in return, decided to cut government spending by $917 billion over a decade by capping discretionary programs through 2021. The spending reduction plan was back-loaded:

- Most of the cuts will materialize after 2016.
- The reduction for next year will amount to only $21 billion.
- In addition to the $917 billion in spending cuts, a special 12-member (six Democrats and six Republicans, three from each chamber) congressional committee will have to find ways to save an additional $1.5 trillion.
- Finding this $1.5 trillion in cuts will raise the debt limit by another $1.5 trillion, which will do away with the need to raise debt until 2013.
- If the committee fails to produce a plan for reducing spending by at least $1.2 trillion by the end of the year, then automatic spending cuts—which include a reduction in Medicare spending, but no cuts in social spending, Medicaid, federal employees pay and benefits for veterans—will come into effect.

In spite of this deal, Standard & Poor's (S&P) cut the U.S. debt rating by a single notch from AAA to AA+ for the first time in over 70 years, citing the failure of lawmakers to sufficiently reduce spending to bring down the record deficit. S&P has stated that for the U.S. to maintain its Triple A status, it had wanted to see a plan that would reduce the deficit by $4 trillion over the next 10 years. The plan that was passed only included $2.1 to $2.4 trillion in spending cuts, and therefore, fell short of S&P's expectations, triggering the downgrade.

S&P is also keeping the outlook for U.S. debt at "negative credit watch," stating that "the fiscal consolidation plan that Congress and the Administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government's medium term dynamics." S&P

has raised concerns that it has become less confident that Congress will be able to end the Bush Era tax cuts and deal with entitlement reform.

Our View: The other two primary bond rating agencies, Moody's Investor Services and Fitch Rating, are unlikely to follow S&P's lead, at least in the near-term. Both agencies affirmed the Triple A status of the U.S. on August 2 after President Obama signed the Budget Control Act into law. The decision by S&P to downgrade its U.S. rating has created a split-rated universe on the sovereign debt rating.

2. What has been the history of sovereign debt downgrades and what impact has this had on interest rates?

In our view, it is unlikely that S&P's decision to downgrade U.S. sovereign debt will precipitate a significant Treasury sell-off. Furthermore, we believe that it is likely to have a minimal impact on interest rates levels for the foreseeable future.

Dr. Brian Jacobson from Wells Fargo Advantage Funds recently looked at the effects of other sovereign debt downgrades from a Triple A rating. In the 1990s and 2000s, countries including Japan, Canada, Ireland, Italy, Portugal, Belgium, and Spain were all downgraded from Triple A to a lower status. His study compared the yields of three-month government bills and 10-year government notes relative to those of U.S. yields 100 days before and 100 days after the downgrades. The results were mixed. For example, following the rating agencies' downgrade of Canadian sovereign debt in 1994, the yield on the country's three-month bill declined 0.28 percentage points, while its 10-year note rose 0.36 percentage points. In the case of Japan's 2002 downgrade, the yield on the three-month bill increased by 0.24 percentage points, while its 10-year note rose 0.89 percentage points.

A recent study conducted by J.P. Morgan reached similar conclusions. It determined that government bond yields barely changed in prior instances in which sovereign debt was downgraded from Triple A. Since 1998 there have been five countries (Ireland, Spain, Belgium, Japan, and Italy) that have been downgraded from Triple A to Double A. During the week following the subsequent downgrade, the average bond yield increased only .02 percentage points. The actual ranges were from -0.18 percentage points to positive 0.33 percentage points. In addition, non-Triple A rated countries that experienced a downgrade saw their yields increase by an average of a mere .05 percent, leading us to conclude that we are unlikely to see much of an impact on interest rates as a result of S&P's U.S. downgrade decision.

Our View: Although there may not be any immediate impact on Treasury prices, our investment strategy continues to underweight U.S. Treasurys, and this downgrade reinforces that asset allocation view. In addition, we continue to recommend full global diversification in fixed income *allocations. Utilizing both developed and emerging market fixed income investments provides economic diversification, currency diversification, and exposure to economic growth rates and interest rates higher than are available in the U.S. Given the recent U.S. downgrade, along with the continued longer-term fiscal uncertainty faced by many developed market economies, it is likely that the flow of fixed income funds globally may increasingly be directed towards emerging market countries as investors seek alternative opportunities.*

3. What is the potential impact to U.S. corporation bonds from this downgrade?

Many corporate issuers that have an underlying rating below Triple A and down the rating scale have been borrowing at some of the lowest interest rate levels in decades. In our view, their ability to borrow at such low rates is unlikely to change following S&P's decision to downgrade U.S. sovereign debt.

Today, there are only four U.S. companies that carry a Triple A rating. These companies are Automatic Data Processing, Johnson and Johnson, Microsoft and Exxon Mobil. They will not lose their Triple A rating status as a result of the S&P downgrade of U.S. sovereign debt.

Standard & Poor's released a report in July highlighting that, under its current rating framework, there are 107 corporate or local government entities that bear a higher rating than the sovereign credit of the nation where they're currently located.

Our View: Volatility has remained relatively subdued in the investment-grade corporate bond market up to this point, while the high-yield segment has increased in volatility over prior weeks. The S&P debt downgrade and continued credit challenges facing the U.S. likely will put upward pressure on interest rates over the intermediate to long term. We continue to see value for investors in high-grade financials and industrial bonds as a way to enhance yield while reducing duration to protect fixed income portfolios from future rising interest rates within the corporate fixed income market.

4. What does the downgrade mean for holders of state and local government bonds?

It is likely that the long-term effect of the U.S. debt downgrade could be slightly negative for municipal bonds as a result of a decline in federal support toward state and local governments. The sectors most affected by the downgrade are likely to be pre-refunded bonds backed by escrows of U.S. Treasurys or Government Sponsored Enterprise (GSE) debt. Today, approximately five percent or $150 billion of municipals are prefunded with Treasury or Agency Collateral.

Moody's recently placed 177 top-rated municipal issuers on review for possible downgrade. This change affects 162 local governments in 31 states, 14 housing finance programs and one university, all of which have high exposure to Federal Funding. Also, five states—Virginia, Tennessee, South Carolina, Maryland and New Mexico—currently receive significant funding support from the Federal Government. Per Moody's recent report, municipal bonds issued by these five states are the most vulnerable to a potential downgrade as a result of the U.S. sovereign credit issues. Diversification away from these issuers may be prudent in light of the downgrade.

Our View: *We continue to recommend that investors look to essential service revenue bonds and high-quality general obligation (GO) bonds that have sufficient financial cushion built into their funding sources. We would look to reduce exposure in pre-refunded municipal bonds or states and local governments that rely on significant federal funding sources given further possible rating downgrades. While the recently passed Budget Control Act lays out a framework for future increases in the debt ceiling, reducing the overall trajectory and growth rate of the deficit will be vitally important for municipalities that rely on significant amounts of federal funding in their budgets.*

5. What action will foreign holders of U.S. Treasurys likely take based on this downgrade?

Today, U.S. Treasury holdings are as follows: Foreign entities (46 percent); Federal Reserve (14 percent); U.S. households (10 percent); Private Pension & Public Retirement Funds (nine percent); Banks, Insurance Companies, State and Local Governments (13 percent); and Money Market Mutual Funds (seven percent).

Our View: It would be very unlikely that foreign central banks, who make up almost half all Treasury holdings, would be large sellers, as the U.S. government debt market remains the largest and most liquid market in the world. These governments are well aware that any large-scale sell-off is likely to reduce the value of their existing holdings, through falling prices as well as a result of a further decline in the value of the dollar. Moreover, the downgrade will not have any effect on the government's ability to repay principal or interest as the rating still maintains a "prime" rating at AA+. Therefore, it is unlikely that the downgrade would precipitate a significant Treasury sell-off and, as mentioned previously, may have a minimal immediate impact on interest rates levels.

Moreover, with the U.K. economy remaining very weak, much of the Eurozone dealing with continued sovereign debt challenges, and the limited availability of Japanese government debt for foreigner purchase, there remains a lack of alternative opportunities to U.S. Treasurys. As a result, at least in the short term, demand likely will remain strong from overseas foreign central *banks. During the last week of July, there were Treasury auctions of two, five, and seven year notes totaling $99 billion dollars. Foreign Central Banks purchased 35 percent of these bonds, up from 30 percent in the month of June.*

6. What actions will be taken by large pension funds and other large holders of U.S. Treasurys?

Concerns that many insurance companies, pension funds, banks and mutual funds currently need to be in AAA rated securities have been widely discussed in the media. However, an ability to hold Treasurys and Agency securities is based on the average rating of the three major debt rating services of S&P, Moody's and Fitch. As long as Fitch and Moody's keep their Triple A ratings, as they have previously both reaffirmed on August 2, this requirement is still met at the Triple A rating level.

Additionally, many institutional investors such as pension funds, banks, insurance companies, and mutual funds have language in their investment policy statements that states that all government issued securities such as "Treasury or Agency securities" meet their minimum holding requirements.

Our View: We see very little impact on institutional Treasury holdings as a result of the actions of S&P.

7. Does this rating change impact our view of the U.S. Dollar?

The U.S. Dollar likely will continue to be the predominant global currency for the foreseeable future, but there are clear indications that investors and central banks are looking for ways to reduce their concentrated risk to this single sovereign currency. According to the International Monetary Fund, the U.S. Dollar currently represents 60.7 percent of the world's currency reserves vs. 26.6 percent for the euro—the next closest world reserve currency. While the U.S. Dollar remains the dominant global currency, global growth likely will continue to come from the emerging market consumer. The U.S. economy today accounts for 20 percent of global Gross Domestic Product (GDP) and this percentage likely will fall over the next several decades. The diminishing role of the U.S. economy, elevated debt levels, and slower domestic growth than many other global economies only further validates our strong global focus in portfolios.

Our View: We have been recommending dollar diversification in our investment strategy for years. The dollar has been on a long-term decline and currency diversification has benefited investors. While a short-term increase in interest rates could help the U.S. Dollar valuation on *global currency markets in the near term, we continue to believe that the U.S. Dollar is likely to decline in value on a trade-weighted basis over the long term.*

8. Is S&P's decision to downgrade U.S. sovereign debt already factored into the market?

The downgrade has been widely anticipated and has occurred after similar downgrades at smaller rating agencies. The market will most likely not be surprised, but may initially react negatively now that the S&P downgrade is a reality. As a result, it will most likely be another factor contributing to elevated volatility levels in the capital markets. The Chicago Board Options Exchange Volatility Index (VIX) has soared from 17 to 38 in recent weeks. While we don't expect volatility to spike significantly above current levels, the downgrade along with other global economic concerns will most likely mean that investors need to be prepared for elevated volatility levels for some time.

Conversely, it is worth noting that the split rating (S&P at AA+ and Moody's and Fitch at Triple A) also may play into market psychology. As we noted in our answer to question one, a split rating defaults to the higher rating.

Our View: For many months we have been recommending a reduction in Treasury holdings and suggesting, instead, other income-generating investments. Our international focus in all asset classes will position us for this eventuality. Our investment strategy, that includes diversification across four asset groups globally, as well as disciplined rebalancing, is designed to help manage portfolios through volatility.

9. Does this rating downgrade change our economic outlook for the U.S. economy?

The U. S. economy is greater than the rating of its government's debt. Of the 50+ economic indicators we monitor each month, only two, the Federal Funds rate and Treasury budget, have a direct connection that could be effected by this downgrade. We recently made a revision to our 2011 forecast for U.S. economic growth, lowering it to 2.0 percent. This downward revision was based on the economic performance of the first half of 2011. The downgrade of U.S. sovereign debt is a measure of the fiscal standing of the U.S. Government, which is dramatically different than the fiscal standing of U.S. corporations. Our economic view will continue to be shaped by all aspects of the U.S. economy.

Our View: As we expect the global GDP to continue to grow at twice the growth rate of the U.S. economy, we continue to strongly recommend full globalization of investment strategies. This recommendation includes international exposure to developed and emerging economies in fixed *income, equities, real assets, and complementary strategies. Our strategic asset allocation is positioned for this global opportunity, and we continue to support that view.*

10. What are the longer-term ramifications for the downgrade on the stock market?

As we noted in the answer to question eight, while S&P's decision may be a contributing factor to some additional volatility in the very near-term, if history is any guide, much of the downgrade may have already been discounted by the market. The major question is, however, what the longer-term ramifications of the downgrade will be on corporate earnings and investor confidence. Few other major developed countries with a developed stock market have experienced a credit rating downgrade. Two notable examples are Canada in June of 1994 and Japan in February of 2001. The Canadian market reaction was relatively muted, and after a brief correction, continued its long-term bull-market rally. The Japanese downgrade was also met with little reaction in the weeks immediately following the announcement. Stock prices were only modestly lower (less than two percent) during the 30 days after the announcement. This was followed by an upward spike in prices, with the Nikkei reaching a high in May of 2001. Unfortunately, that high was short lived and was followed by 4 ½ years of poor performance!

Our View: Currently our major concern is the impact of any further slowing in economic activity on corporate earnings. Our forecasts are currently calling for a 10 percent gain in earnings for 2012, which would value the current stock market at an average P/E multiple of 11x, far below normal levels. If earnings forecasts begin to slow in a meaningful way, however, we will need to reassess these forecasts and our market targets.

Will we experience the same type of poor performance that plagued the Japanese market for much of the last decade? Given the major differences between our two countries in terms of demographic makeup, corporate earnings diversification and history of innovation, we believe that any concerns of a prolonged period of malaise are exaggerated. However, the level of uncertainty that currently pervades the marketplace is a significant headwind and we likely will need some form of catalyst to reignite investor confidence. Therefore, patience will be necessary as attractive valuations likely will be met with skepticism until such time as proof of earnings growth and confidence in our economic system returns.

All data for this Market Update sourced from Bloomberg Finance, LLP, unless otherwise noted.

we cannot guarantee their accuracy or completeness. Opinions represent Wells Fargo Wealth Management's opinion as of the date of this report and are for general information purposes only. Wells Fargo Wealth Management does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

Asset allocation and diversification do not assure or guarantee better performance and cannot eliminate the risk of investment losses.

Past performance does not indicate future results. The value or income associated with a security may fluctuate. There is always the potential for loss as well as gain. Investments discussed in this presentation are not insured by the Federal Deposit Insurance Corporation and may be unsuitable for some investors depending on their specific investment objectives and financial position.

This report is not an offer to buy or sell, or a solicitation of an offer to buy or sell the securities or strategies mentioned. The investments discussed or recommended in the presentation may be unsuitable for some investors depending on their specific investment objectives and financial position.

Some alternative investments and complementary strategies may be available to pre-qualified investors only.

Some real assets may be available to pre-qualified investors only.

Fixed income securities are subject to availability and market fluctuation. These securities may be worth less than the original cost upon redemption. Certain high-yield/high-risk bonds carry particular market risks and may experience greater volatility in market value than investment grade corporate bonds. Government bonds and Treasury bills are guaranteed by the U.S. government and, if held to maturity, offer a fixed rate of return and fixed principal value. Interest from certain municipal bonds may be subject to state and/or local taxes and in some instances, the alternative minimum tax.

S and P Bond ratings definitions: AAA'—Extremely strong capacity to meet financial commitments. It is the highest Rating. 'AA'—Very strong capacity to meet financial commitments. It is the second highest rating. 'A'—Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances. 'BBB'—Adequate capacity to meet financial commitments, but more subject to adverse economic conditions. 'BBB-'—Considered lowest investment grade by market participants. 'BB+'—Considered highest speculative grade by market participants. 'BB'—Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions. 'B'—More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments. 'CCC'—Currently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments. 'CC'—Currently highly vulnerable. 'C'—Currently highly vulnerable obligations and other defined circumstances. 'D'—Payment default on financial commitments. Nonrated means no rating available.

Investing in foreign securities presents certain risks that may not be present in domestic securities. For example, investments in foreign and emerging markets present special risks, including currency fluctuation, the potential for diplomatic and potential instability, regulatory and liquidity risks, foreign taxation and differences in auditing and other financial standards.

Indexes represent securities widely held by investors. You cannot invest directly in an index. 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.

Wells Fargo and Company and its affiliates do not provide Legal advice. Please consult your legal advisors to determine how this information may apply to your own situation. Whether any planned tax result is realized by you depends on the specific facts of your own situation at the time your taxes are prepared.

Wells Fargo affiliates may be paid a referral fee in relation to clients referred to Wells Fargo Bank, N.A.

Wells Fargo Bank, N.A. offers various advisory and fiduciary products and services. Financial Advisors of Wells Fargo Advisors, LLC, a separate non-bank affiliate, may refer clients to the bank for an ongoing or one-time fee. The role of the Financial Advisor with respect to bank products and services is limited to referral and relationship management services. The Bank is responsible for the day-to-day management of the account and for providing investment advice, investment management services and wealth management services to clients. The Financial Advisor does not provide investment advice or brokerage services to Bank Accounts.

Wells Fargo Advisors is the trade name used by two separate registered broker-dealers: Wells Fargo Advisors, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, non-bank affiliates of Wells Fargo & Company.

Investment Products: ▶ NOT FDIC Insured ▶ NO Bank Guarantee ▶ MAY Lose Value