WELLS CAPITAL MANAGEMENT

Economic and Market Perspective UPDATE

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September 13, 2013

Where's the Juice ... for Economic Growth?

Most conventional U.S. policies have recently turned, or are about to turn, restrictive for economic growth. Mortgage rates have surged by almost 1.25% since May, the government sequester has produced a significant tightening in fiscal policy, and the Federal Reserve seems poised to soon begin tapering its quantitative easing program. This rather abrupt change in policy leaves many questioning why the pace of economic growth should improve in the coming year. Indeed, the economic policy mix already adopted or about to be employed could arguably be expected to slow the economic recovery.

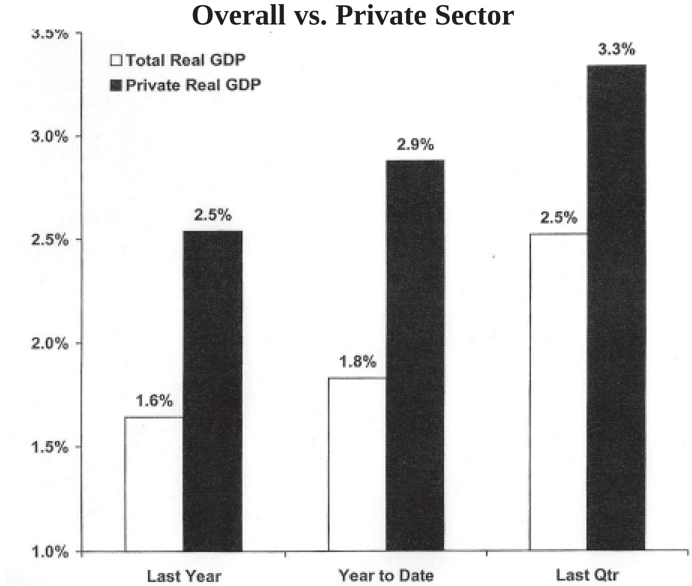
So, as we begin to ponder 2014, the question is "Where's the juice ... for economic growth?"

Throughout, the speed of the contemporary recovery has been constrained by aging demographics. Because of anemic growth in the working age population, at its best, annual real GDP growth may fail to reach even 4% during this recovery. However, despite real growth of only 1.8% so far in 2013, economic growth may reach about 3% in the coming year. Indeed, the private sector grew 2.9% in the first half of this year. Moreover, although traditional policies have become more restrictive, they remain more conducive to economic growth than widely appreciated. Finally, several unconventional and unrecognized forces have emerged which are poised to begin "juicing" economic activity.

Private sector already growing at 3%

So far in 2013, aggregate real GDP growth has increased at a paltry 1.8% pace obscuring a much healthier 2.9% rise in private sector economic growth (Chart 1). Indeed, in the latest quarter, private activity rose at a 3.3% annualized pace!

Chart 1
U.S. Real GDP Growth
Overall vs. Private Sector



Economic growth may surpass expectations in the coming year because outside of the government sector, the economy is already growing much faster than widely appreciated. Private sector growth should accelerate towards 3.5% and combined with a slower contraction in the public sector, overall real GDP should improve to one of its best annual growth rates of the recovery around 3%.

Conventional economic policies?

Both fiscal and monetary policies are turning restrictive. Aided by sequester, fiscal deficit spending as a percent of GDP (Chart 2), has contracted by almost 3 percentage points in the last 12 months. The U.S. mortgage rate (Chart 3) has risen by about 1.25% since May. Finally, the Federal Reserve seems poised to soon begin tapering its quantitative easing program. Many expect the U.S. recovery to struggle in the coming year as the lagged impact of these tightening policies weigh on economic growth. However, current economic policy may be less restrictive than it appears.

Chart 2
U.S. Government Deficit as a Percent of Nominal GDP*
*Trailing 4-Quarter Deficit Sum as a Percent of Current Quarterly GDP
Shaded areas represent recessions.

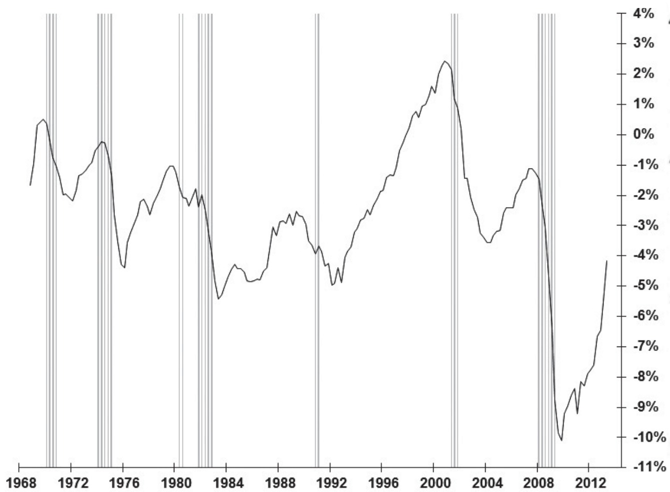
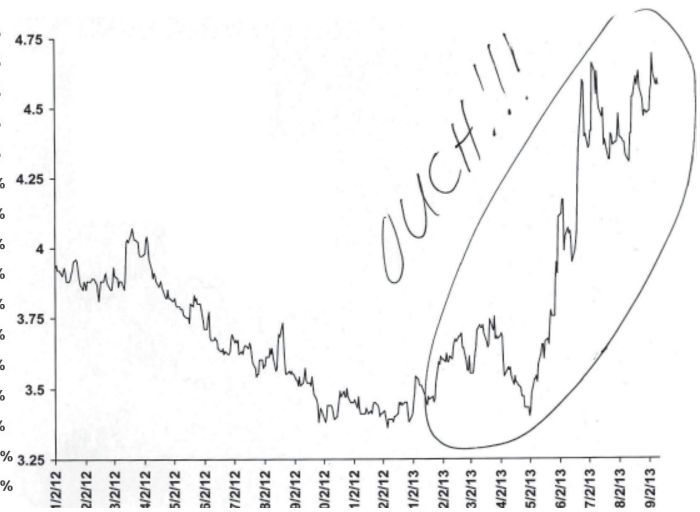


Chart 3
U.S. Average Home Mortgage 30-Year Fixed Rate



First, most of the negative impact from sequester is ending. A significant portion of the improvement in the federal deficit during the last year is a temporary result of sequester, which should be reversed in the coming year. Consequently, fiscal policy should be more accommodative in the coming year.

Second, although mortgage activity has recently slowed because long-term interest rates have increased, we suspect the ultimate impact of higher mortgage rates will be surprisingly mild. Unlike past recoveries, the recent rise in yields primarily represents a repricing from “artificially low” levels predicated on Armageddon scenarios which never materialized. Resetting mortgage rates at levels which, in retrospect, they never should have fallen below, hardly seems as damaging to the economy as the normal cyclical rise due to robust economic growth or rising inflation fears. Moreover, homebuyer affordability remains near all-time record highs, the household debt service burden is at an all-time record low, pent-up demand for houses has seldom been stronger, and the continuous decline in the unemployment rate has kept buyer confidence healthy.

Finally, although the Fed will soon begin to taper its quantitative easing (QE) program, the economic fallout should be minimal. The QE program had little impact on the conventional channels of monetary policy—money supply and loan growth. Despite wild swings in the last few years in QE growth, annual growth in the M2 money supply has remained in a tight range while loan growth has experienced only a slow but steady revival. Neither has shown much sensitivity to Fed actions in recent years and appear mostly impervious to QE policies. Why should an economy, which was mostly nonresponsive to explosive QE injections, be harmed much when they end?

Juice for the economy!

There are several forces which should help juice economic growth in the coming years.

First, a positive fallout from a rise in long-term yields without a corresponding rise in short-term rates is a steepening yield curve. As illustrated in Chart 4, although not a perfect relationship, a steepening in the yield curve has often preceded faster economic growth. A steeper curve tends to boost profits in the financial industry and encourage lending activities. It is also suggestive of broader economic confidence as more participants believe stronger economic growth will lead to higher yields. At a minimum, the impact of higher mortgage rates and Fed tapering should be lessened by a steeper yield curve.

Second, the most important monetary influence in the next several years will not likely be higher yields or slower monetary growth rates. Rather, changes in money velocity (Chart 5) should prove the most potent monetary stimulus for economic growth. Velocity has mostly declined for years. However, every economic recovery since at least 1960 has experienced a period of rising velocity (generally later in the cycle). Since confidence measures have now recovered to a five-year high, velocity should begin rising soon boosting both the money supply and loan growth despite rising interest rates and Fed tapering.

Chart 4
Annual Real GDP Growth vs.
U.S. Treasury Yield Curve

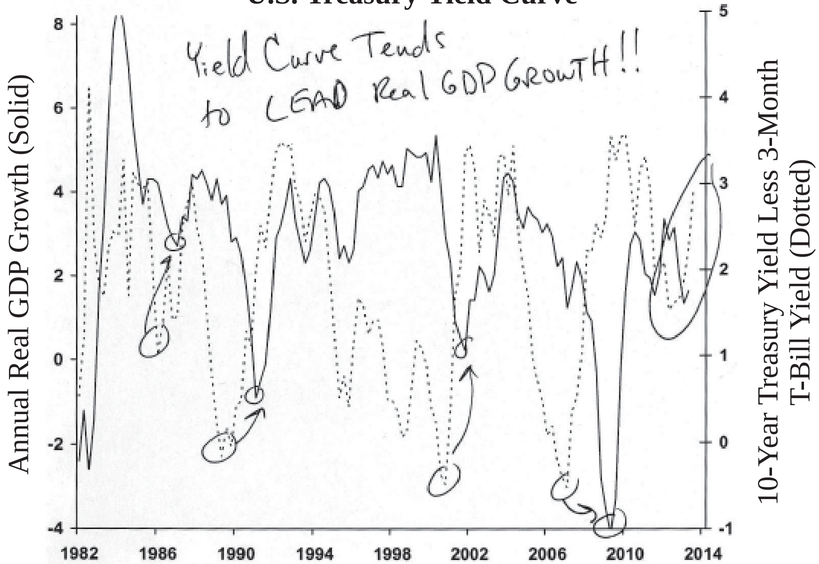
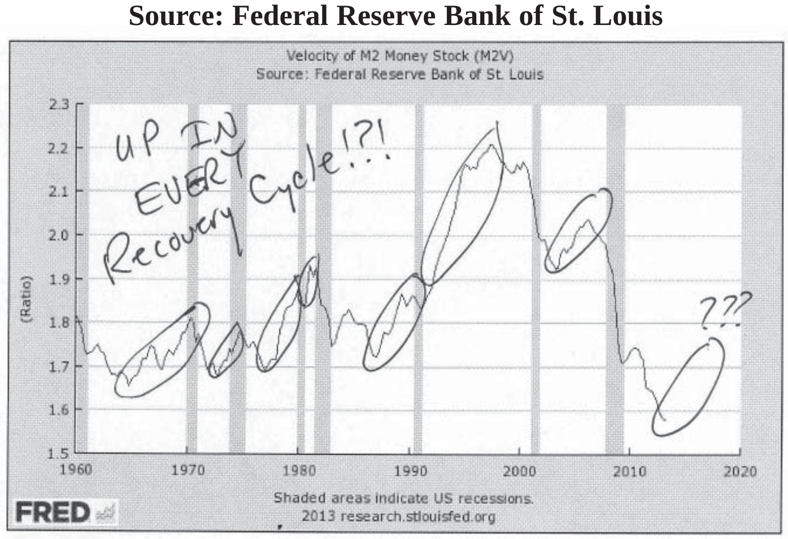


Chart 5
Velocity of M2 Money Stock (M2V)
Source: Federal Reserve Bank of St. Louis



Third, undoubtedly, compromised balance sheets have held back this recovery since the recession ended in 2009. However, after years of slow but steady improvements including debt liquidations, asset price recoveries, slower debt accumulation, improved savings rates, and massive liquidity injections, balance sheets across the economy are much healthier and may soon become a "force for growth." Banks are no longer hanging by a thread. Indeed, the lending industry is perhaps the best capitalized, most liquid, and possesses the greatest potential loan capacity at any time in the post-war era. Corporate America is basking in the aftermath of one of the best profit revivals of any post-war recovery, are enjoying near record-setting operating margins, have low debt ratios and, as shown by Chart 6, have considerable excess cash flow reserves yet to be converted into capital spending. Although several individuals are still struggling with debt loads, aggregately, U.S. household balance sheets have also been remarkably repaired. After suffering a post-war record decline in net worth of almost 25% during the 2008 collapse, household net worth (Chart 7) is now back to a new record high of almost $71 trillion (that is, households have $71 trillion "free and clear" of all debt and liabilities which amounts to 6.2 times current annual consumption expenditures!!!). Moreover, while the household debt service burden (Chart 8) was at a record high in 2007, today it is back to a record low! While balance sheet concerns most certainly curtailed both lender and borrower propensities in recent years, much stronger and more liquid balance sheets may now provide a foundation for a multi-year period of stronger economic growth.

Chart 6
U.S. Corporate Net Cash Flow to Capital Spending Ratio

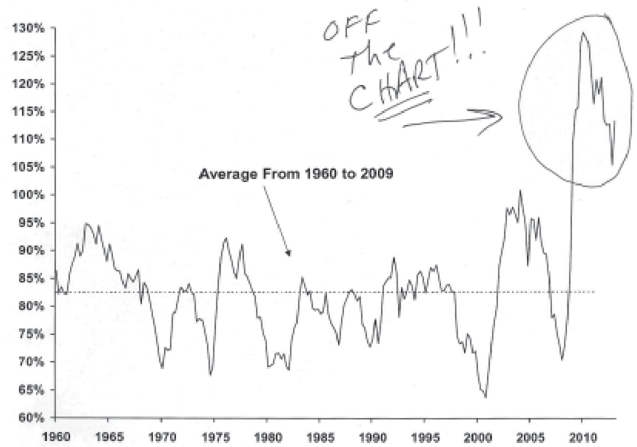


Chart 7
U.S. Household Net Worth
Trillions of U.S. Dollars

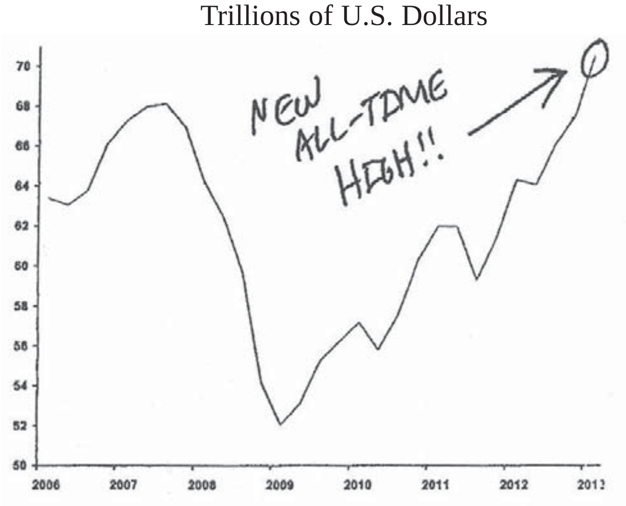
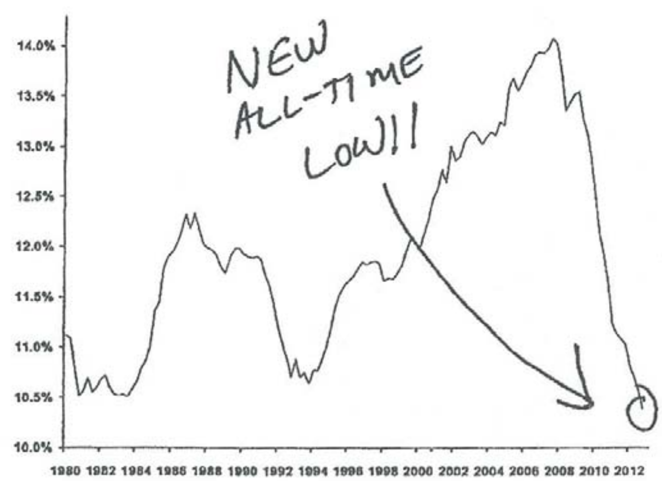


Chart 8
U.S. Household Debt Service Burden

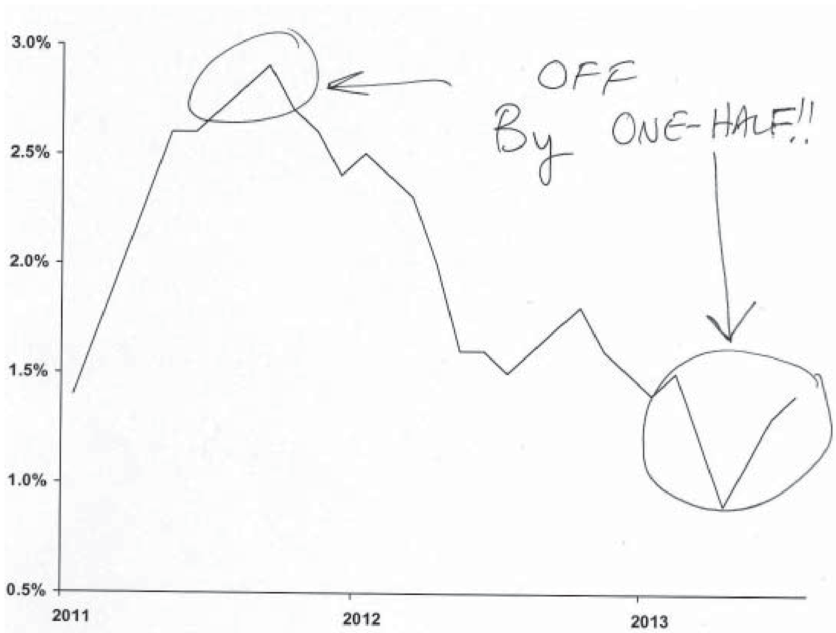


Fourth, despite rising mortgage yields, housing activity is likely to remain far healthier and continue to contribute more to overall economic growth than most appreciate. Although home affordability (Chart 9) has recently declined, it remains astonishingly above the range of affordability which existed for almost 40 years between 1970 and 2009. During this time, the affordability index averaged about 116 compared to its current level of almost 169. Prices are much lower than a few years ago, incomes are higher, mortgage rates are still extremely low by historic standards, and pent-up demand is considerable since housing was at the epicenter of the 2008 recession. Consequently, despite rising mortgage rates, housing will likely remain an outsized source of growth for the U.S. economy.

Chart 9
Homebuyer Affordability Composite Index*
***Source: National Association of Realtors and ISI Group LLC**

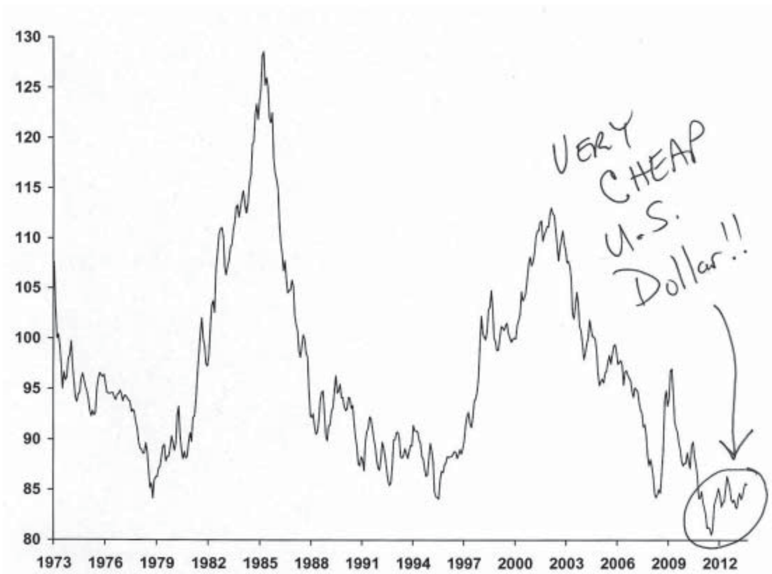
Fifth, the lack of inflation in this recovery is stretching consumer budgets by boosting real purchasing power. The annual rate of PCE consumer inflation (Chart 10) was almost 3% in mid-2011, but has since fallen in half. Nominal household income can grow 1.5% slower today compared to what it did a couple years ago and still produce a similar growth in real consumption (due to the stimulative power of lower price inflation).

Chart 10
PCE Consumer Price Annual Inflation Rate



Sixth, the real (adjusted for relative product prices) broad U.S. dollar index (Chart 11) remains remarkably cheap. In 2000, this index was above 110 and it was near 130 in the middle-1980s. By contrast, today, the U.S. is cheaply priced to many around the globe since the real broad dollar index is at an all-time record low between 80 and 85! In the last couple years, international economic growth has been fairly anemic with many major economies experiencing slow recoveries or even renewed contractions. Being an attractively priced economy in a weak global recovery does not pay many dividends. However, with both Japan and Europe recently returning to positive growth and with the emerging world economic recovery finally showing signs of reacceleration, a low U.S. dollar may prove a more significant boost for U.S. manufacturing growth in the next few years.

Chart 11
U.S. Real Broad Trade-Weighted U.S. Dollar Index



Seventh, a surprising consequence from the surge in oil prices leading up to the 2008 crisis is that it put the U.S. on a path towards energy independence. For almost three decades after President Carter wore a sweater by the fireplace as he spoke of an energy shortage, no president would allow the price of oil to rise under their watch. However, the recent surge in oil prices to about $100 has unleashed animal spirits in the domestic oil industry. The U.S. rig count has exploded almost seven-fold since 2009. Moreover, U.S. oil production has been rising steadily (Chart 12) and U.S. net imports of crude oil (Chart 13) have persistently declinined for the first time since 1980! That is, by allowing free market prices to clear the marketplace, after struggling for decades with energy shortages and paying dearly for imported oil, the U.S. is headed toward energy independence. How big will the dividend from energy independence prove and how much will the cumulative cost savings stimulate future economic growth? We often consider the economic impact of monetary and fiscal policies, but the biggest accommodative economic policy of the next several years may be from a major forthcoming energy independence dividend!

Chart 12
U.S. Oil Production
Million Barrels Per Day
12 Month Moving Average

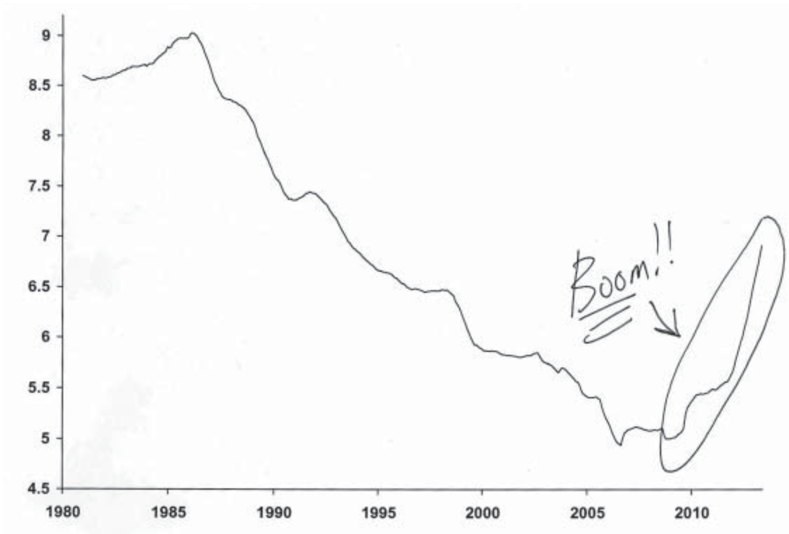
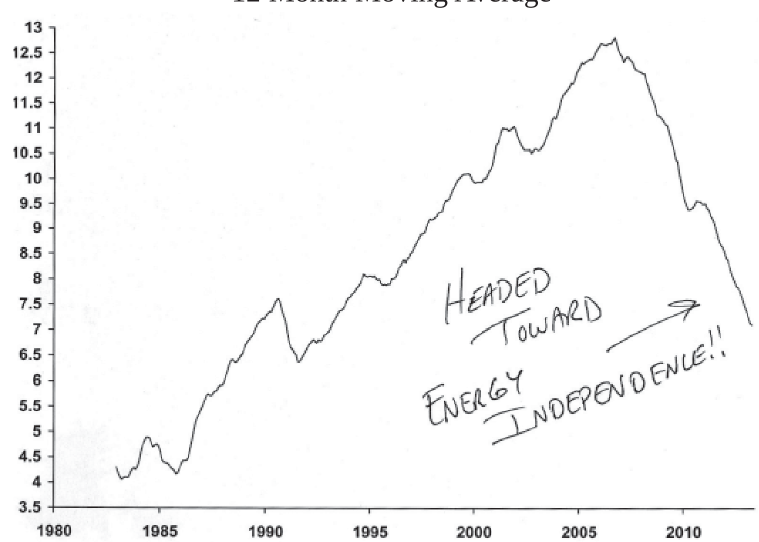
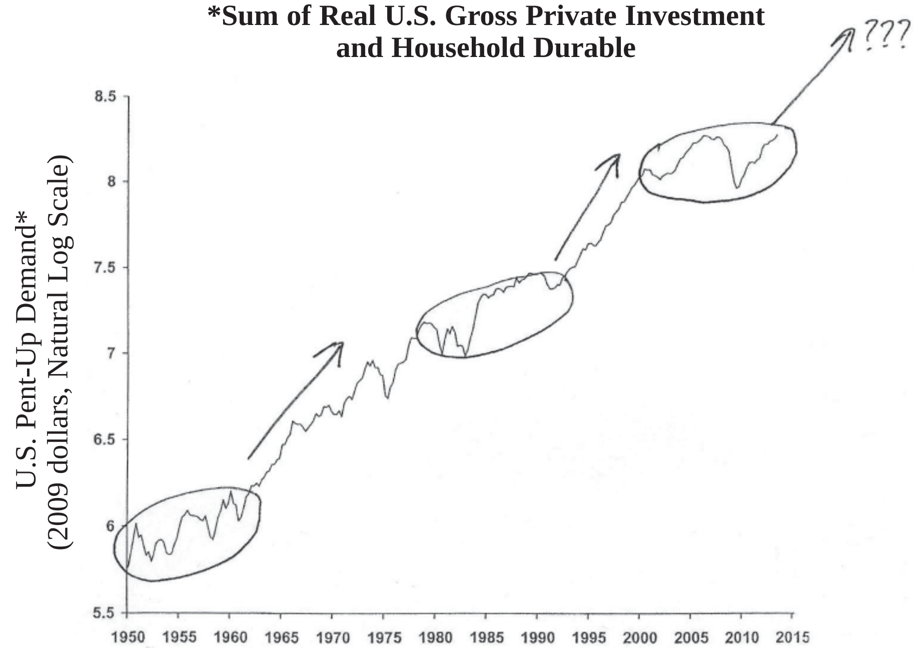


Chart 13
U.S. Net Imports of Crude Oil
Million Barrels Per Day
12 Month Moving Average



Eighth, severe recessions often produce silver linings for the next recovery and one of the biggest is they tend to create significant "pent-up demands." The lost decade comprising the 2000 and 2008 recessions may have produced the largest pent-up demands of the post-war era. Chart 14 illustrates total private sector big-ticket spending (business investment, housing and household durable goods) which is often postponed during difficult economic times. Since WWII, we have experienced three major periods when pent-up demands rose as big-ticket spending was paused—the 1950s, the 1980s, and since 2000. After both the 1950s and 1980s, the economic recoveries of the following decade were juiced by a catch-up in big-ticket spending. From Chart 14, pent-up demands created since 2000 might be the largest ever. In both the 1950s and 1980s, even though big-ticket spending slowed, it still rose mildly during the decade. Since 2000, however, big-ticket spending has almost flatlined. Moreover, real estate price points have been significantly lowered, interest rates for these financeable items have never been lower, and balance sheets and liquidity have returned to health. Fiscal tightening may be chronic during the rest of this recovery, but "big-ticket spending" stimulus may more than offset a contractionary fiscal policy.

Chart 14
U.S. Pent-Up Demand
***Sum of Real U.S. Gross Private Investment**
and Household Durable



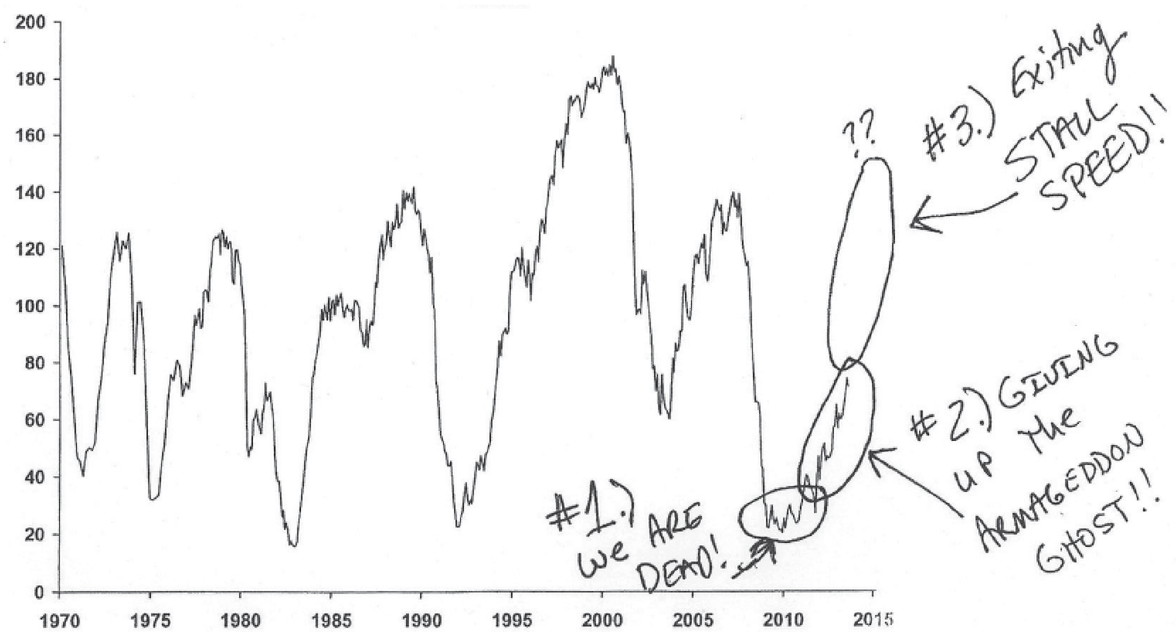
Ninth, the U.S. and global economic recoveries appear to be entering a period of synchronization which should keep overall growth stronger and less vulnerable to external shocks. For the first time, the U.S. recovery is enjoying simultaneous expansions in both the manufacturing industry and the services sector (i.e., the ISM surveys for both are above the 50 expansion level), much improved housing activity, rising home prices, and a steadily falling unemployment rate. The U.S. recovery is still growing slowly, but its performance is much "broader" helping to boost and maintain confidence in the future. International economic growth has also broadened and become more synchronized. For this first time since early in this recovery, the U.S., Europe, and Japan are all growing at the same time! Moreover, the newly-adopted policy regimes of Abenomics and Draghinomics make it likely these recoveries will persist and strengthen. Finally, recent reports from China and other emerging economies suggest the long-awaited bottom in the emerging recovery cycle is at hand. In 2014, the global recovery should prove broader, more synchronized and should be firing on more cylinders than ever.

The biggest economic juicer? ... Confidence revival!

Changes in confidence have probably been the most important influence underlying both the financial markets and the economic recovery and it will likely continue to be of primary importance in shaping the character of the recovery in 2014.

U.S. confidence collapsed near post-war lows after the 2008 crisis and until late last year remained mired at these levels. Due to the severity of the 2008 shock, the cultural mindset of Americans has only improved slowly. Indeed, we suspect U.S. confidence is only part way through what may prove a three-stage cycle of revival (illustrated in Chart 15).

Chart 15
Conference Board Consumer Confidence
Present Situation Index



Stage 1 is best described as a widespread attitude of “We are Dead.” In the immediate emotion of the 2008 stock market collapse and panicky policy official responses thereafter, the national mindset was frozen with fear. A consensus felt problems were numerous, overwhelming, and unsolvable. The adopted simile that 2008 was like the Great Depression ensured paralyzing fears would hold back any attempt at recovery. As illustrated by Chart 15, this stage of confidence would last until late 2012. During this time, the national mindset would worry over several potential Armageddon stories keeping the economic recovery from gearing (e.g., widespread municipal bond defaults, another bank failure, a secondary housing recession, a run on the U.S. government, a euro zone breakup, the fiscal cliff, etc.).

During the last year, however, confidence surged to its highest level in five years as it finally moved to stage 2—”Giving up the Armageddon Ghost.” Most still believe the economy is growing too slowly and that the country still faces formidable challenges. However, most also seem to finally accept that the recovery will sustain and no longer greatly fear being derailed again by an imminent calamitous event. Emboldened by this new outlook, economic activity has broadened considerably in the last year—the unemployment rate has experienced a sustained a decline, the labor force has been rising for the first time in the recovery, housing activity has finally emerged, home prices have increased again, bank loans have risen slowly but steadily, profits have continued to beat expectations, household net worths have been fully restored, and private sector real GDP growth has improved to almost 3% in 2013. The financial markets have also been completely repriced reflecting an “Armageddon-free” confidence in the future—the S&P 500 price-earnings (PE) multiple rose 3 points in the last year, the 10-year Treasury bond yield has increased close to 3%, and junk bond yield spreads recently reached new lows for the recovery. As U.S. confidence moved from stage 1 to stage 2, it had a huge impact on both the economic recovery and the financial markets.

We suspect confidence could jump to stage 3 next year perhaps waking “animal spirits” for the first time in this recovery. We coin stage 3 of the confidence cycle as “Exiting Stall Speed.” Historically, when real economic growth has declined below 2%, the recovery has stalled into another recession. While most today no longer fear an imminent economic calamity (as they did until the last year), they are still highly troubled by how slow the recovery is growing and fear it simply cannot seem to exit the “stall speed” of about 2% real GDP growth.

If economic growth does rise above stall speed next year, how much could the economy be boosted if confidence moves to stage 3? Could a move to stage 3 confidence finally get corporations to start using their considerable cash hoards and initiate a new capital spending cycle? Will it boost payrolls as business broadens staff to meet “future opportunities”? Will it unleash long postponed household big-ticket spending? Will lending firms see credit demands finally start to improve? Will money velocity finally accelerate? The key to this recovery has been “confidence” and perhaps we will finally reach third gear next year!

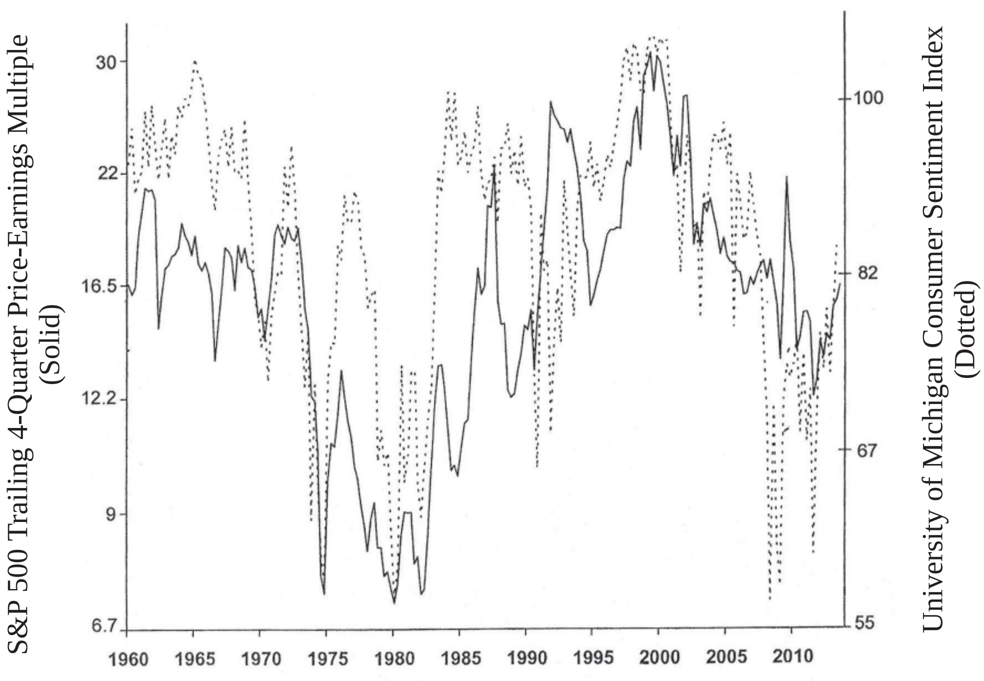
Third gear & the stock market

Reviving confidence has also been the primary catalyst behind the rising stock market in the last year. If confidence reaches stage 3, the stock market may enjoy another upward leg in 2014.

Chart 16 overlays the Consumer Confidence Index with the S&P 500 PE multiple (based on trailing 12-month earnings per share). Although not a perfect relationship, the PE multiple has been closely related to the level and changes in consumer confidence. Indeed, excluding the two times the PE multiple rose primarily because earnings declined (i.e., in 2001 and again in 2009), the last year has been the only time PE multiples have significantly increased since 2000! It is no coincidence, PEs finally expanded when confidence surged higher. Giving up the Armageddon ghost boosted the PE multiple in the last year by about three points from about 13 to about 16.

How much will valuations be increased by “Exiting Stall Speed”? Whether it happens in 2014 or later, should confidence eventually return to historic recovery peak levels (i.e., the dotted line in Chart 16 nears 100), the S&P 500 PE multiple could eventually improve to around 20 times. In our view, the primary opportunity in stocks over the next few years is not faster earnings growth, speedier real economic growth, or a “grand rotation” among investors from bonds towards stocks. While these will help shape how the stock market performs, the most important driver and indeed the opportunity for stock investors, will be whether and when confidence surges into stage 3! Next year?

Chart 16
S&P 500 Trailing PE vs. Consumer Confidence



Summary

Although monetary and fiscal policies have always helped shape the future character of the economy and the financial markets, they are not the only factors which matter, and frequently, are not even the most important.

Traditional economic policies are turning more restrictive and will likely remain a contrationary force during the rest of this recovery. However, despite policy officials starting to lean against the wind, there are still plenty of positive forces likely to boost economic activity and support the stock market as we look toward 2014 and beyond. Some should be of more immediate help (e.g., rising confidence, a more synchronized global recovery, a steeper yield curve, strong homebuyer affordability, and low inflation) while others may provide a backdrop of support for the next several years (e.g., rising monetary velocity, much improved balance sheets, excess cash reserves, strong and long postponed pent-up demands, a record-low real U.S. dollar, and potentially a massive energy independence dividend).

Due to these many expansionary forces, and despite conventional policies becoming less accommodating, we expect real GDP growth to rise and sustain next year above 3%. Most exciting, this economic performance may drive confidence higher into stage 3 where we may finally enjoy some "real animal economic and market spirits"!

Thanks for taking a Look!!