



# Perspective

## Economic and Market

December 9, 2014

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### Holiday Hodgepodge

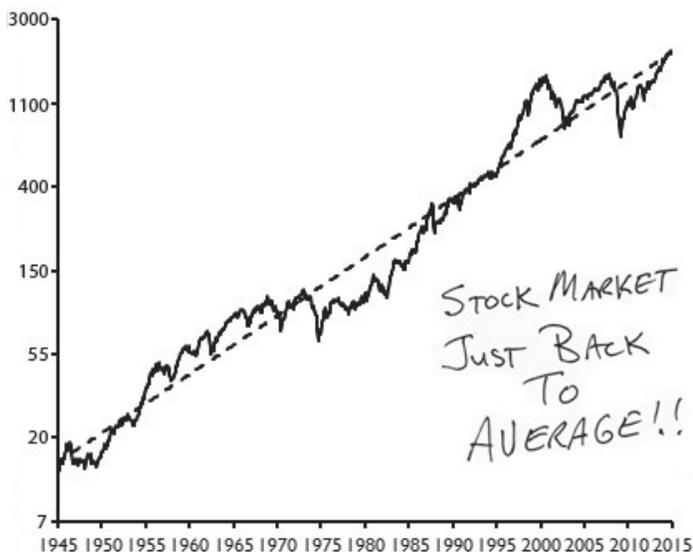
It's the holiday season. What follows is a hodgepodge of holiday investment thinking to be enjoyed with good cheer and a warm beverage (preferably a Hot Tottie)!

#### I. Stock market is back to average!

The S&P 500 Stock Price Index has risen more than 2.5 times from its low in early 2009. Despite this amazing rally, however, the stock market has only returned to "average" by post-war standards! Chart 1 illustrates the U.S. stock market compared to its trendline average. On average, during the last 70 years, the U.S. stock market has risen about 7% a year (i.e., the slope of the trendline). Actually, it has oscillated about this long-term trend, sometimes significantly below (e.g., 1950, 1974, or 2009) and other times far above (e.g., 1957, 1966, 1972, and 2000), but always returning to its underlying pace of about 7% annualized. Chart 2 explains why the long-term trend of the stock market is about 7%. Because, not surprisingly, stock prices simply follow the long-term sustainable growth in corporate earnings (i.e., the slope of the dotted line in Chart 2 is also about 7%).

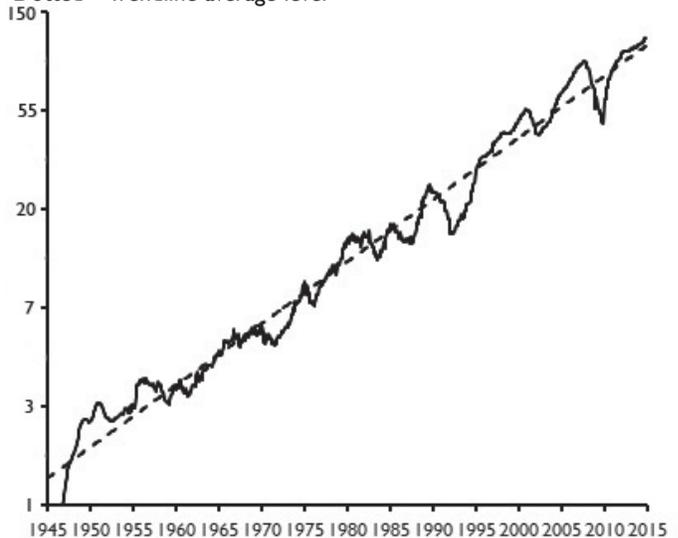
**Chart 1: S&P 500 Stock Price Index versus trendline average, natural log scale**

Solid—S&P 500 Composite Stock Price Index  
Dotted—Trendline average level



**Chart 2: S&P 500 trailing earnings per share versus trendline average, natural log scale**

Solid—S&P 500 trailing 12-month earnings per share  
Dotted—Trendline average level



A few observations. First, corporate earnings performance has been very normal in this recovery. Earnings quickly recovered back above trendline and have since sustained at a trendline growth rate. Second, as shown in Chart 1, the stock market is no longer cheap. The low risk/high return segment of this investment cycle is probably over. Third, nor is the stock market yet excessively expensive. Historically, investors have enjoyed average to spectacular returns (e.g., mid-1950s, early 1990s, or late 1990s) from similar average valuation positions. Finally, historically, from average valuations, the stock market does possess risk (e.g., the Nifty Fifty collapse in the early 1970s and the violent 1987 crash both occurred from an average valuation).

There have been only two other times in post-war history when the stock market finally reached trendline after languishing far below average for several years. As shown in Chart 1, the 1950s-1960s bull market finally reached trendline in the mid-1950s and the 1980s-1990s bull market reached trendline in the early 1990s. Both bull markets rose nearly as much after reaching trendline than they did recovering to trendline. Therefore, since today's stock market seems similarly positioned (i.e., it has just returned to average), if history is any guide, this bull market could last considerably longer and rise significantly more.

## 2. Yield curve drives retail stocks?

The fate of retail stocks may be much more sensitive to the interest-rate cycle than investors appreciate. Chart 3 overlays the relative price of retail stocks with the U.S. yield curve. Although far from a perfect relationship, the shape and movement in the yield curve has tended to lead the relative performance of retail stocks. Retail stocks have been among the best performers in the stock market since the 2008 crisis. This may be primarily because the yield curve has persistently remained remarkably positively sloped. However, if the Fed finally begins raising the federal funds rate next year, retail stocks could struggle as the yield curve flattens.

**Chart 3: S&P 500 retail sector versus U.S. yield curve**

Left scale—S&P 500 retail stocks sector relative price, natural log scale (Solid)  
 Right scale—U.S. yield curve: 10-year Treasury less federal funds rate (Dotted)



## 3. Time to overweight eurozone stocks?

A primary reason we think eurozone stocks may outperform U.S. stocks in the coming year is because the eurozone has so much more room for relative economic improvement. Chart 4 compares the relative performance of the eurozone stock market with the relative performance of its job market. Throughout the 1990s, the U.S. unemployment rate improved steadily relative to the unemployment rate in the eurozone (i.e., the dotted line declined) and the U.S. stock market significantly and consistently outpaced. By contrast, during much of the 2000s, the U.S. unemployment rate rose relative to the eurozone unemployment rate and eurozone stocks mostly outperformed the U.S. stock market. Since the 2008 crisis, eurozone economic performance has trailed the U.S. and the U.S. stock market has again dominated.

Currently, the eurozone unemployment rate is almost 6% higher than it is in the U.S. This is almost as wide of a disparity as existed in the late 1990s right before the eurozone stock market began a prolonged period of outpacing the U.S. stock market. The eurozone economy does not have to perform better than the U.S. for eurozone stocks to outpace U.S. stocks. It is likely eurozone economic growth will remain subpar compared to the U.S. However, the eurozone only has to “close the gap” relative to U.S. economic performance. As shown in Chart 4, although the eurozone unemployment rate will remain above the U.S. unemployment rate for the foreseeable future, its spread to the U.S. unemployment rate is likely to soon begin diminishing.

In many ways, the current attractiveness of the eurozone stock market is because its economy is performing so poorly. Will it likely perform worse than it already has, particularly when policy officials in the region are now supporting improved performance? In the next few years, improvement in the eurozone unemployment rate will likely exceed further improvements in the U.S. unemployment rate. And, if the dotted line does begin to rise, eurozone stocks should again outpace the U.S. stock market.

**Chart 4: Relative price of eurozone to U.S. stock market versus relative U.S. less eurozone unemployment rate**

Left scale—Relative price of eurozone to U.S. stock market (Solid)  
 Right scale—U.S. unemployment rate less eurozone unemployment rate (Dotted)



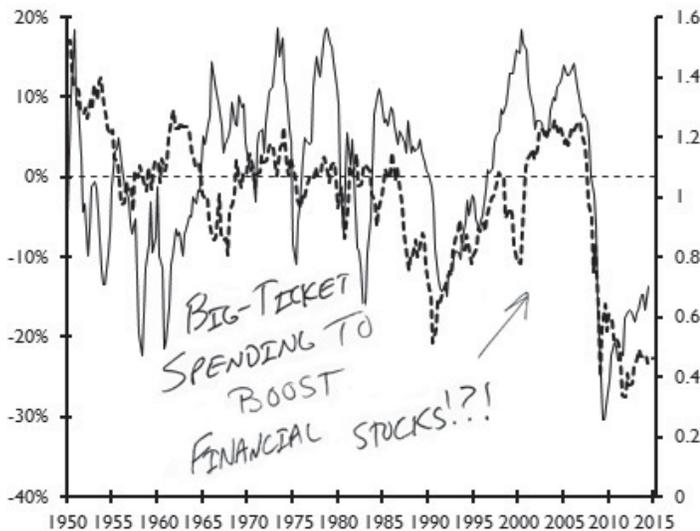
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## 4. Pent-up demand good for financial stocks!

Chart 5 compares U.S. big-ticket spending (business investment spending, housing outlays, and consumer durable goods purchases) to the relative performance of financial stocks. The solid line in this chart is the percent by which real U.S. big-ticket spending is above or below its trendline average. When the solid line is above zero, it illustrates periods of big-ticket spending saturation whereas readings below zero indicate periods of rising pent-up demands. The 2008 crisis produced the largest U.S. big-ticket pent-up demand in post-war history. While big-ticket spending has recovered some in recent years, it is still about 15% below trendline levels suggesting pent-up demand remains considerable.

**Chart 5: U.S. Pent-up demand versus relative financial stock performance**

Left scale—U.S. big-ticket spending (total investment outlays plus consumer spending on durable goods) as a percent of its trendline average (Solid)  
 Right scale—S&P 500 financials sector relative price\*, natural log scale (Dotted)

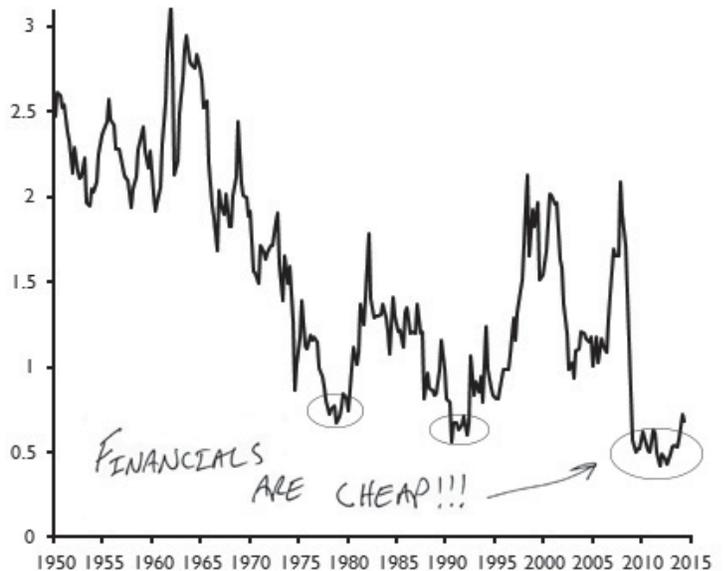


\*S&P 500 financials sector index estimated from financial industry sectors between 1950 and 1990, and then is the current S&P 500 Financials Sector Index after 1990.

Movements in big-ticket spending have been closely associated with the relative performance of financial stocks especially since 1970. Moreover, as shown in Chart 6, financial stocks currently trade at one of their lowest price/earnings multiples of the post-war era. Want to participate in a further recovery of the U.S. housing industry from the depths of its worst post-war recession and also the aging fleet of U.S. autos? Financial stocks may be the play.

**Chart 6: S&P 500 financial sector price/earnings multiple\***

\*Ratio of S&P 500 Financials Stock Price Index (same as used in Chart 5) divided by total domestic financial industry profits from the GDP accounts.



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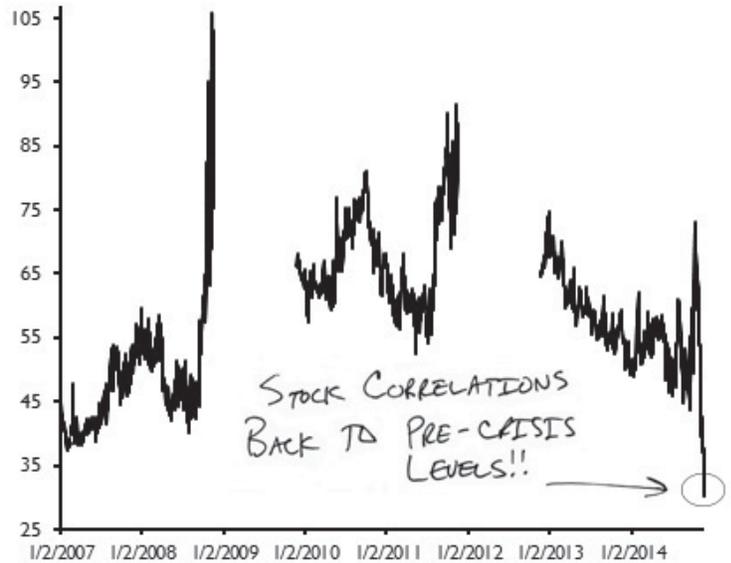
## 5. It's stock picking time again!?!

The 2008 crisis produced a “risk-on, risk-off” investor mindset causing stocks to be perceived as a homogenous asset class rather than a market of individual stocks. The correlation among the daily movements in individual stock prices has been abnormally strong throughout this recovery. Discriminating between individual company characteristics or divergent valuations is not very fruitful if stock prices are persistently established and dominated by events (e.g., a second depression or a U.S. government bankruptcy) related primarily to the overall asset class. It has been tough for stock pickers in a stock market which has not distinguished much among individual stocks.

However, as shown in Chart 7, stock picking may finally be coming back into vogue. This data from Bloomberg and the CBOE obviously has some missing values. In late 2008, the correlation among S&P 500 stock prices spiked and has since remained elevated. The correlation among stock prices is closely related to investor confidence and the VIX volatility index. Both correlations and volatility have remained high throughout this recovery because confidence was so shaken by the last recession. More recently, however, confidence in the economy and the stock market has improved. Consequently, both the VIX volatility index and stock correlations have trended lower. Indeed, as shown in the chart, the correlation among S&P 500 stocks has collapsed to its lowest level since before the 2008 crisis! Because the psychological damage produced by the 2008 crisis continues to fade, we expect stock correlations to remain lower in the balance of this recovery. Although asset allocation decisions dominated investment success so far in this recovery, perhaps stock picking is about to take center stage?

**Chart 7: CBOE S&P 500 Implied Stock Price Correlation Index\***

\*Data is from Bloomberg and CBOE. Obviously, there are missing observations in 2009 and again in 2012.



## 6. Is stock market more yield sensitive than perceived?

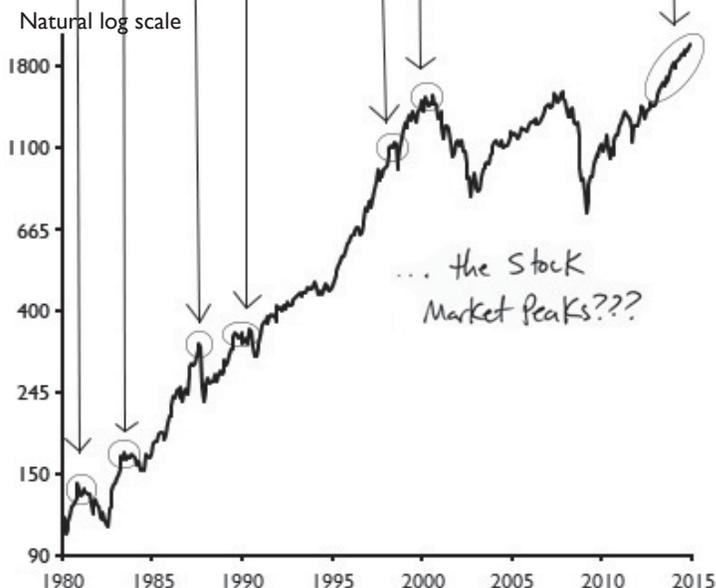
The stock market often does okay in the face of rising yields. Historically, it is not rising yields per se which causes trouble for the stock market. Rather, it has typically struggled only when stock and bond yields part company. Specifically, when the bond yield rises while the stock yield declines. Chart 8 overlays the 10-year Treasury bond yield and the S&P 500 earnings yield (inverse of the trailing 12-month price/earnings multiple). Since 1980, each major instance when bond yields rose while stock yields declined is highlighted and related to the stock market in Chart 9. As shown, between 1980 and 2000, there were six significant examples when bond yields rose while stock yields fell and each was resolved by a significant correction in the stock market.

Since the early 2000s, bond yields have mostly declined and stock yields have mostly increased. However, in the last couple years, bond yields and stock yields have again begun to part company. Since 2012, the stock yield has steadily declined from about 8.3% to about 5.5%. Meanwhile, the 10-year bond yield bottomed in 2012 at about 1.4%, rose significantly to about 3% by the end of 2013, and has subsequently declined to about 2.25%. Although the 10-year bond yield has declined this year, so has the stock yield. We think the stock market may struggle and prove more vulnerable than most now appreciate should yields begin rising again. Stock yields have mostly moved inversely relative to bond yields for the last couple years. As these charts suggest, since the stock yield has continued to decline, should bond yields rise again, the stock market may face a period of turbulence.

**Chart 8: 10-year Treasury yield versus S&P 500 earnings yield**



**Chart 9: S&P 500 Stock Price Index**



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## 7. Commodity prices are probably range-bound???

Many believe the recent decline in commodity prices reflects significant global economic weakness. However, much of the recent weakness is due to energy prices. The S&P GS overall commodity price index has declined by about 28% from its summer high. For perspective though, the non-energy S&P GS commodity price index is unchanged since year-end as is the S&P GS industrials commodity price index.

While commodity prices have weakened in the last few years, this year's weakness seems mostly related to the energy market. The dramatic surge in oil prices leading up to the 2008 crisis ultimately produced a seven-fold ballooning in the U.S. domestic rig count. We believe the lack of response in U.S. oil prices to intensifying geopolitical tensions earlier this year and the large decline in oil prices since summer mostly reflects a growing recognition of newfound U.S. energy independence. That is, perhaps greater U.S. supply capabilities have caused oil prices to react differently in this recovery cycle and recent energy price declines do not necessarily reflect slowing economic growth. As shown in Chart 10, outside of the energy industry, commodity prices have not been excessively weak. Non-energy commodity prices have only declined about 12% from summer highs and are flat since year-end.

Historically, commodity prices have exhibited long periods of trendless oscillations interrupted by periodic surges. As shown in Chart 10, after being trendless during the 1960s, commodity prices surged in the early 1970s (the OPEC era) before establishing a new trading range which lasted for almost 30 years until the 2000s. Then, the introduction of emerging world economies produced another generational surge in commodity prices last decade. Between 1970 and 1975, non-energy commodity prices doubled before returning to range-bound trading. Similarly, between 2004 and 2008, they again doubled and are now most likely in the early stages of another prolonged sideways trading range.

Chart 10: S&P GSCI Non-energy Commodity Price Index  
Natural log scale

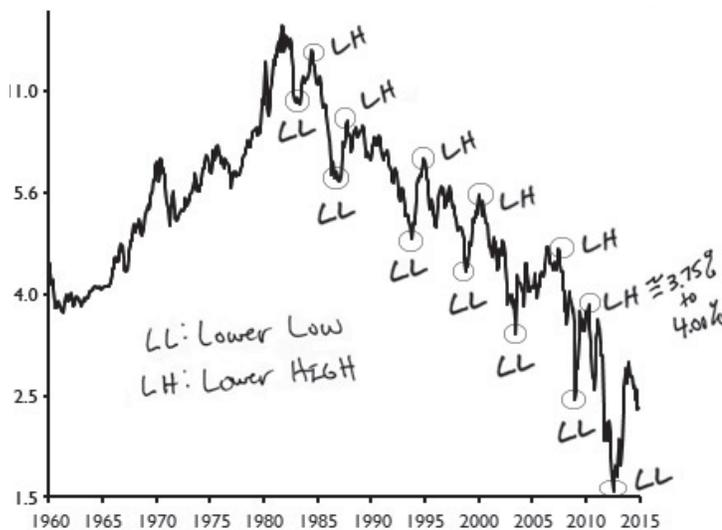


Finally, the weakness in commodity prices since 2010 may not be irregular. Historically, commodity prices have often trended lower during recoveries. Even in the high inflation, late 1970s economic recovery, commodity prices mostly declined until 1978. Similarly, they declined during much of the 1980s expansion and during both the early and later years of the 1990s economic recovery. We think many are inferring too much about current weakness in commodity prices. Our guess is recent declines in commodity prices reflects a range-bound marketplace (one which may be nearing the lower end of its trading range) rather than suggesting imminent economic weakness. Indeed, commodity prices were similarly weak in 1977, 1986, and 1993 just before “overheating fears” began dominating the financial markets in 1978-1979, 1987, and 1994.

## 8.A BIG bond technical to watch??!

Chart 11 illustrates the 10-year Treasury bond yield since 1960. From its peak yield more than 30 years ago in 1980, the U.S. Treasury yield has established a steady pattern of “lower lows” and “lower highs.” Most recently, the bond yield established a lower low in late 2008 at around 2%, rose to a lower high yield just shy of 4% in early 2010, and established another lower low yield just below 1.5% in 2012.

**Chart 11: U.S. 10-year Treasury bond yield**  
Natural log scale



Perhaps the bond yield set yet another lower high late last year when the yield reached about 3% at year-end 2013? However, our guess is the secular bull market in bonds ended with the last lower low yield in 2012 and the rise in the bond yield to 3% last year was the first step in a process of reconnecting the bond market to the economic recovery cycle. Ultimately, we expect the 10-year yield to rise above 4% in this recovery, and if it does, it will establish the first “higher high yield” in the U.S. bond market in more than three decades!

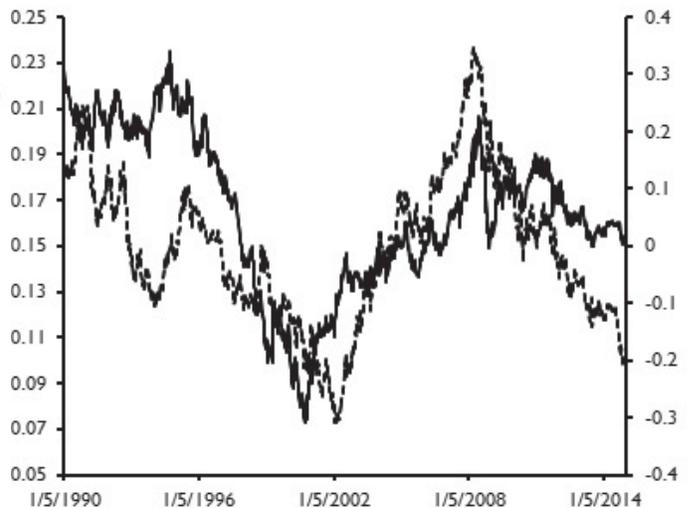
Currently hovering at only about 2.25%, it appears unlikely the bond yield will visit the 4% area anytime soon. However, investors should be aware of this important technical yield level, since even if it is approached, investor mindsets may be altered significantly. Could this possibly become a focus of the 2015 bond market? Twice already in this recovery, the 10-year bond yield has jumped significantly in a short period of time. Between October 2010 and February 2011, it rose from about 2.4% to 3.8%, and in three months last year it increased from about 1.6% to almost 3%. Consequently, it would not be outlandish if sometime next year, for the first time in over three decades, the 10-year bond yield traded close to a new “higher high yield”!

## 9. Buy some materials stocks??!

Chart 12 illustrates an indicator which has moved closely with the relative performance of materials stocks and which we expect will rise in the next year. As shown, materials stocks tend to do well when bank loans are strong and the U.S. dollar weakens. This year, bank loans have risen faster than any other time in this recovery. The problem for materials stocks has been a significant rise in the U.S. dollar. Looking into 2015, while we anticipate continue solid gains in bank lending, we also expect the U.S. dollar to weaken some. The combination should boost the loan/dollar ratio creating a favorable environment for materials stocks.

**Chart 12: Relative S&P 500 Materials Sector Price Performance versus loan/dollar indicator**

Left scale—S&P 500 Materials Sector Relative Price (Solid)  
Right scale—Ratio of U.S. bank loans divided by U.S. Dollar Index, Natural log scale (Dotted)

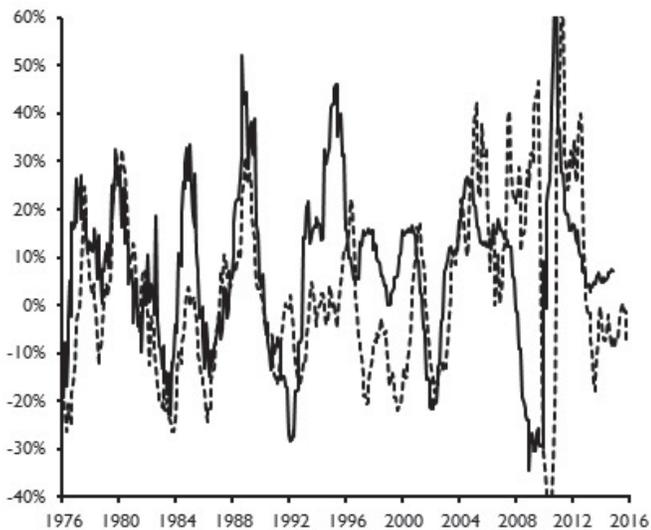


## 10. Don't expect too much from profits next year?

Wall Street expectations are for another solid upper single digit gain in corporate profits in 2015. Chart 13 illustrates a profit indicator which suggests Wall Street profit expectations may prove to be overly optimistic.

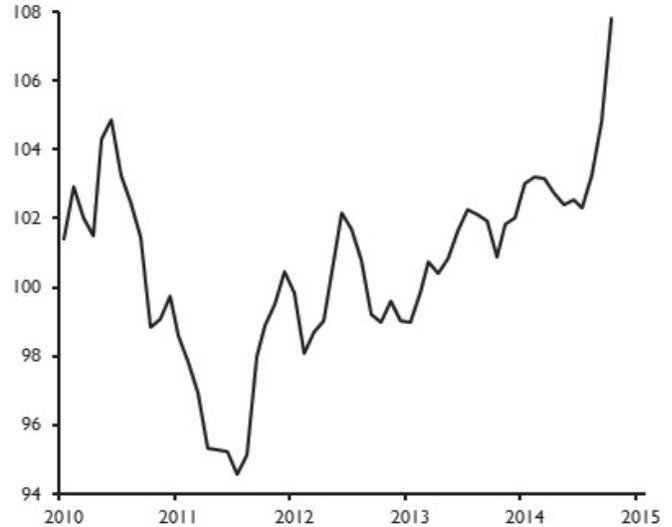
**Chart 13: S&P 500 earnings per share versus profit indicator, annual growth**

Solid—Annual growth in S&P 500 trailing 12-month earnings per share  
 Dotted—Annual growth in profit indicator (ratio of Core Crude Producer Price Index divided by U.S. Dollar Index). Lagged (pushed forward) by 12 months.

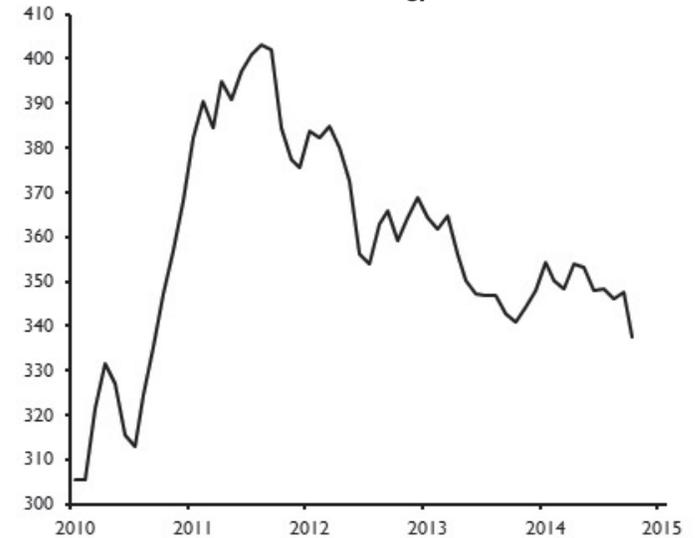


The indicator is the ratio of the core crude producer price index (Chart 15) divided by the U.S. dollar index (Chart 14). Historically, profit growth tends to accelerate about one year after producer prices rise relative to the U.S. dollar. Since the U.S. dollar has surged in the last year while producer prices have declined, this indicator currently suggests a mild decline in profits next year. Falling producer prices suggest corporations lack top-line pricing power and the strength of the U.S. dollar has reduced domestic competitiveness and worsened profit repatriation results. Although this profit model is hardly infallible, at least directionally (is profit growth likely to accelerate or weaken), it has proved fairly accurate a year in advance. Investors should remain conservative with profit forecasts for 2015.

**Chart 14: U.S. Trade-weighted Broad Dollar Index**



**Chart 15: Producer Price Index  
 Crude non-food materials less energy**



## Summary

Thanks for perusing a few economic and financial market concepts which may be useful to ponder as we enter the new year. We hope you found something interesting. Now, go put another log on the fire and pour yourself another Tottie! Happy Holidays!

*Thanks for taking a look!!*

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