Wells Capital Management

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Economic and Market Perspective

May 1, 2015

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Despite Weak U.S. Growth … Overheat Pressures are Mounting

Many believe the economy needs to grow much faster before it is at risk of overheating. Indeed, because of the first-quarter slowdown in the U.S. economy, the Fed and most investors now expect interest rates will not be rising until late this year at the earliest. But, with the economy nearing full employment, even remarkably modest growth could aggravate resource pressures, cost-push problems, interest rates, and the speed and magnitude by which the Fed may be forced to calibrate its exit strategy. While we do not believe the U.S. economy faces an imminent period of runaway inflation, we do recognize increasing signs of "overheat pressures" building throughout the economy. Should these pressures continue to intensify, "good news becoming bad news" may increasingly dominate the mindset of both the Fed and the financial markets during the second half of this year.

What follows is a short pictorial (I hope you like charts!) highlighting just how much and how quickly the sand under the feet of investors and policy officials is changing.

U.S. economic momentum has been BAD, but since late March, is starting to improve.

Whether due to temporary port closings, inclement weather, or more fundamental catalysts, weak economic momentum has dominated the landscape so far this year. However, since March 23, the U.S. economic surprise index has been rising suggesting a majority of economic reports are again outpacing expectations. While weak economic momentum probably played a significant role in shaping mindsets and altering economic behaviors this year (e.g., fostered a belief in disinflationary trends, pushed back Fed tightening expectations, reduced concerns about an imminent rise in very low bond yields, reduced anxieties surrounding the potential for price/earnings multiple erosion, caused a scaling back or cancellation of capital spending plans, or produced a more cautious consumer), the trend change illustrated in Exhibit 1 is likely to make the character of the economy and the financial markets very different in upcoming months. We expect a spring thaw and the lagged impact of much lower mortgage yields and energy prices to keep the surprise index rising for the next several months.

Exhibit 1:
Citigroup U.S. Economic Surprise Index

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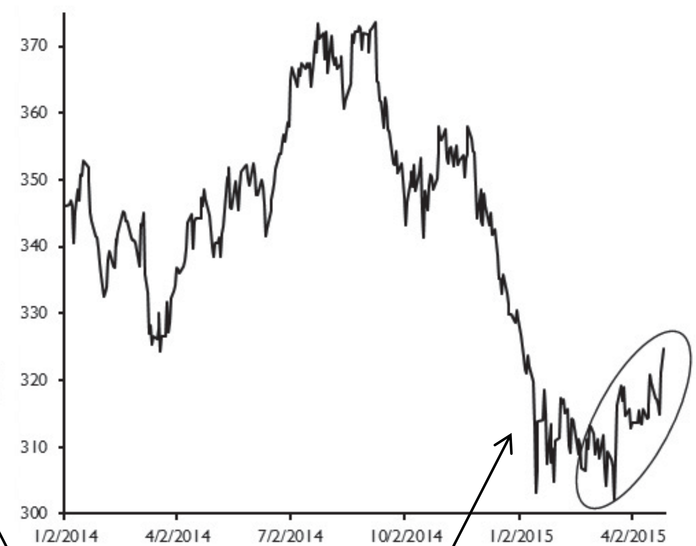
Commodity prices are no longer deflationary!!!

The collapse in commodity prices since last summer helped to exacerbate fears of a global deflationary spiral. Like the economic surprise index, this is another major trend which has recently changed. As shown below, both energy and non-energy commodity prices are rising again after a prolonged and significant decline. In contrast to how lower commodity prices helped keep consumer and producer price reports from becoming problematic last year, the recent increases in commodity prices may serve to worsen inflation reports in the months ahead.

Exhibit 2:

WTI Spot Crude oil price

S&P GSCI Industrial Commodity Price Index



Commodity Prices Are No Longer DEFLATIONARY!!

Has the U.S. dollar peaked???

The biggest and most sustained rise in the value of the U.S. dollar in more than 15 years dominated the economic and financial market landscape since last summer. As this exhibit shows, however, the dollar may be in the process of peaking. In recent months, it has experienced its largest and longest consolidation period since it first began rising last June. Against major world currencies, the U.S. dollar has been flat for about two months and against emerging world currencies, it has recently fallen back to where it first was in early December. The strong upward trend in the U.S. dollar since last summer was primarily responsible for the collapse in commodity prices (shown in Exhibit 2). Few currently anticipate that the U.S. dollar is in the process of peaking. For this reason, thinking among both policy officials and investors would likely change abruptly should recent dollar weakness persist and extend pushing commodity prices higher, aggravating overall inflation concerns and forcing additional scrutiny of the Fed's exit strategy. That is, could the deflationary force of a strong U.S. dollar in 2014 become an inflationary weak dollar force this year? Is the Fed prepared for such an outcome? Are bond or stock investors?

Exhibit 3:
U.S. Major Currency World Index (DXY)

MSCI Emerging Market Currency Index
Part of MSCI Emerging Currency Basket in U.S. dollars

Is the U.S. Finally Peaking??
Could it Become An INFLATIONARY FORCE??

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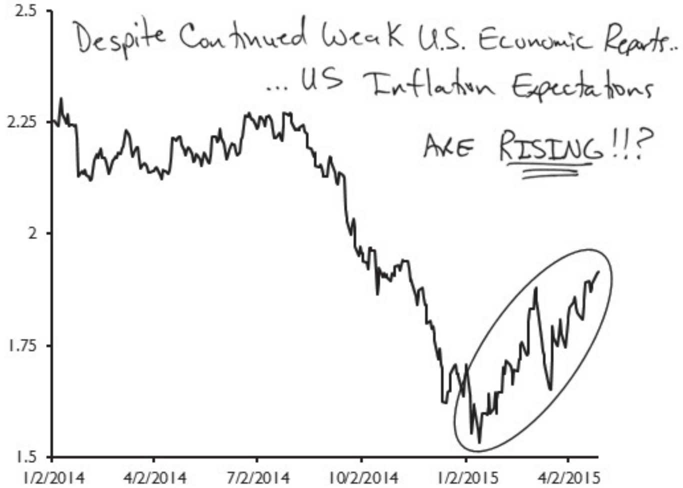
U.S. inflation expectations are already RISING!

This chart provides a market measure of U.S. inflation expectations. It is calculated by subtracting the real yield of the 10-year inflation linked Treasury bond from the yield on the nominal 10-year Treasury bond. The result is the implied inflation rate imbedded in the 10-year Treasury yield. Since early January, the 10-year inflation rate expectation has risen by about 40 basis points from about 1.5% to about 1.9%. It is interesting that measurable inflation expectations imbedded in the prices of investable assets suggest inflation anxieties have been rising most of this year despite continued weakness in many economic reports. If inflation expectations are already moving higher, what may happen to inflation fears if economic growth accelerates (and if the unemployment rate declines toward 5% while wage inflation rises and the U.S. dollar drops) in the months ahead?

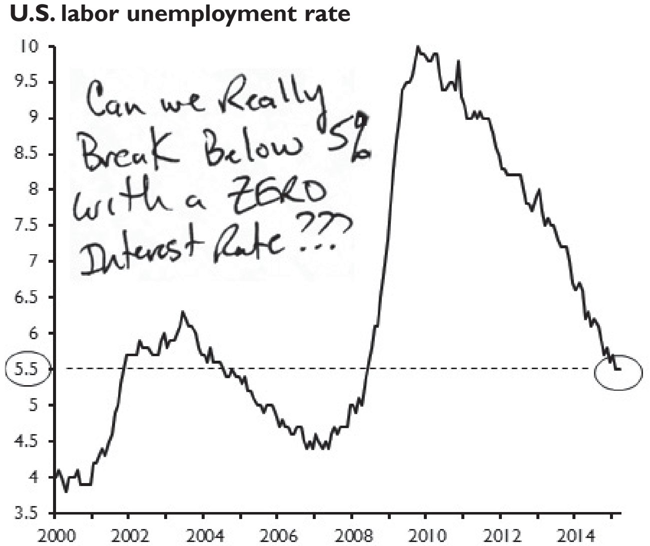
Exhibit 4:
U.S. bond investor inflation expectations
U.S. 10-year Treasury breakeven yield index



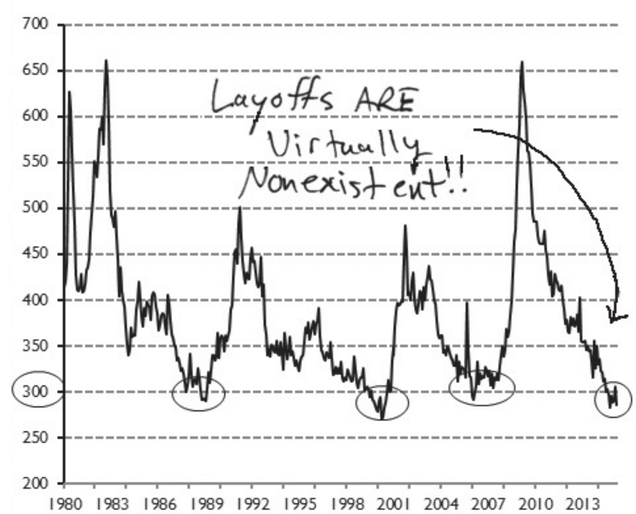
U.S. labor market is near full employment!??

In the last 50 years, the U.S. unemployment rate has only been less than it is today about one-third of the time and it has only been below 5% one-quarter of the time. Moreover, as shown below, nobody is being laid off anymore. Layoffs (proxied by initial jobless claims) typically do not ever get much lower than 300K and they have essentially been at or below this level since last summer! Even though overall economic growth remains modest by historical standards, for the first time in this recovery, the job market is getting tight. In the last year, total household employment has risen by about 1.6% while the labor force has grown only by about 0.5% leading to a drop in the unemployment rate of 1.1% (from 6.6% to 5.5%). If this pace of job creation continues in the next year, the U.S. economy will have one the lower unemployment rates of the postwar era. Having unemployment claims decline from about 350K to 300K while the unemployment rate drops from about 6.5% to 5.5% (essentially what occurred in the last year) might not create significant cost-push pressures. However, the same pace of the growth in the next year will not likely be achieved without aggravating resource market concerns.

Exhibit 5:
U.S. labor unemployment rate



U.S. initial jobless claims
Four-week moving average, monthly data



Resource Pressures Could Intensify... Since US Job Market Has TIGHTENED!!?

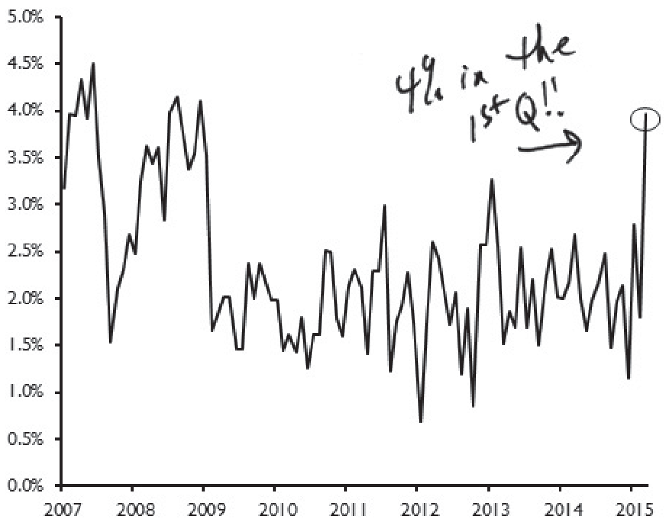
Evidence of rising wage Inflation is already fairly pronounced!

Average hourly earnings rose at the fastest pace of this recovery in the first quarter at about a 4% annualized rate. The U.S. employment cost index rose at its quickest pace in the last three quarters since 2008. Data collected by the Automatic Data Processing company (ADP) suggests private payroll compensation has jumped to its fastest pace of the recovery during the last year (not shown in Exhibit 6). Finally, the NFIB Small Business Compensation Plans Index has risen substantially in the last 12 months suggesting wage pressures are also becoming more visible among small companies. Although still widely perceived as not yet problematic, wage inflation is already rising. Isn't this how it always seems to work? Initially, most don't see a problem even though evidence mounts that an issue is developing. Then, usually suddenly, the problem becomes widely recognized and most wonder how it got so bad so fast.

Exhibit 6:

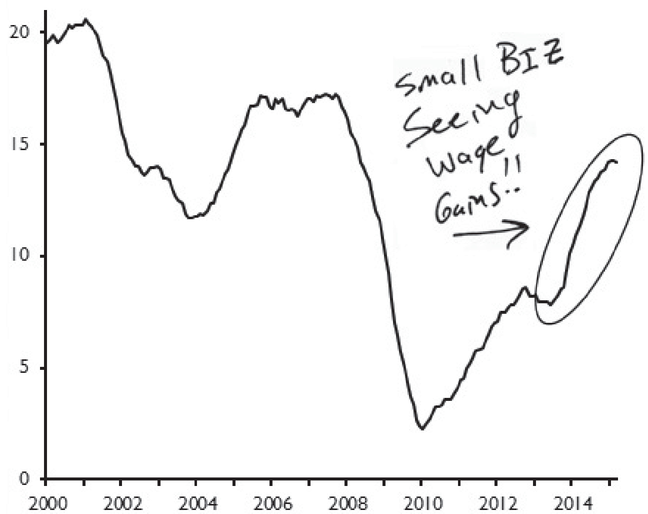
U.S. wage inflation—First quarter 2015

Annualized



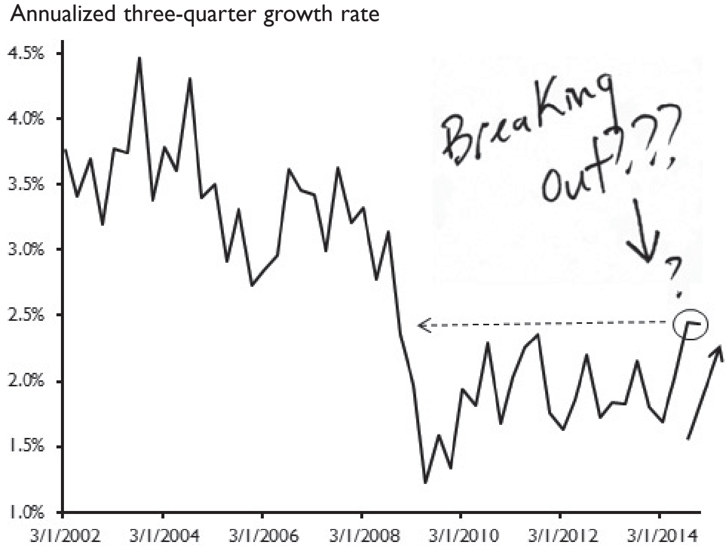
NFIB Small Business Compensation Plans Index

12-month moving average



U.S. Employment Cost Index

Annualized three-quarter growth rate

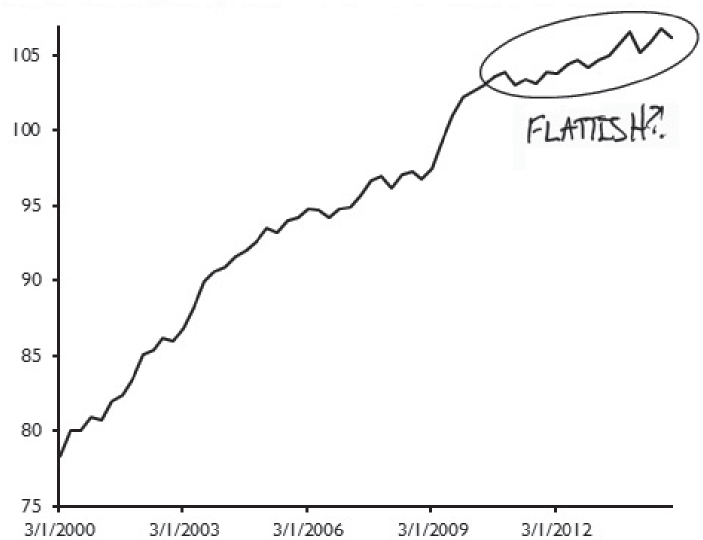


No labor supply and no productivity = wage pressures!?

The U.S. labor force rose by less than 0.5% in the last year while productivity declined by about 0.4%! A slow growing, unproductive labor supply with an economy nearing full employment sounds like a disaster for wage and profit margin pressures should aggregate demand growth improve even incrementally. Layoffs are so low because companies are running lean and mean with no ability to lay off additional staff. The supply of new potential laborers is becoming constrained as the economy reaches full employment and productivity is punk. How will companies meet additional demands without raising wages?

Cost-Push Pressures May Surprise Many Because Productivity IS So WEAK?!?

Exhibit 7:
U.S. Productivity Index



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Two added inflationary forces that could aggravate overheat concerns?!?

Much of this recovery has been buffeted by two major disinflationary forces that may finally be changing. First, the housing cycle in this recovery has been absolutely unique in the postwar experience. Home prices typically rose during almost all recoveries adding early and often to inflationary pressures. As shown below however, home prices fell until 2013 in this recovery and after a nice recovery bounce took another pause during much of 2014. However, home prices have again started to rise in recent months. They bottomed last August and have since risen at a robust annualized pace of about 9.2%! Moreover, throughout much of the postwar era, borrowing grew faster than overall gross domestic product (GDP) growth as most recoveries were augmented by leverage. Often, this leverage resulted in aggregate demand outpacing supply and leading to frequent inflationary outcomes. However, as shown below, in the current recovery, bank lending was virtually absent in the early years of the recovery and only grew in line with overall GDP between 2011 and 2013. It has only been in the last year, for the first time in this recovery, leverage has been rising faster than overall GDP growth. Are both housing and leverage finally returning to their traditional "inflationary" roles here in the current recovery just as it nears full employment and wage pressures are emerging?

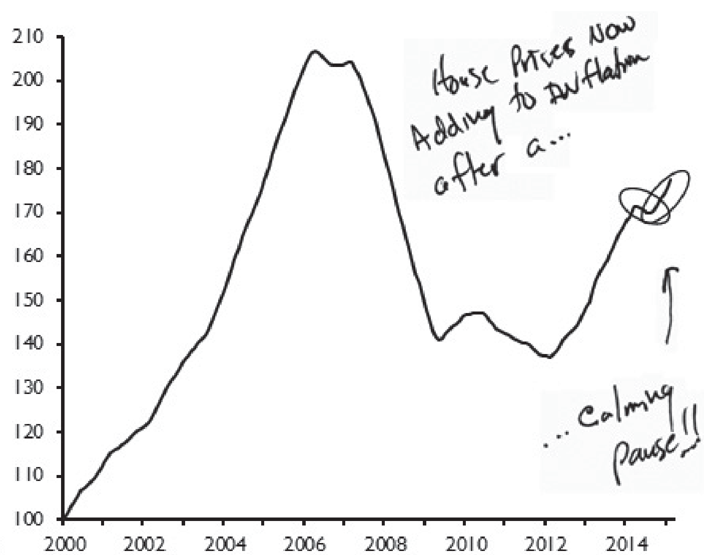
Exhibit 8:

U.S. bank lending velocity

Total U.S. bank loans divided by nominal GDP. Nominal GDP estimated for first quarter 2015.

U.S. Home Price Index

S&P/Case-Shiller Composite 20 Price Index



A Couple Trends which Could Exacerbate OVERHEAT Concerns??!

Summary

The weakest economic recovery in the postwar era has dulled concerns about potential overheating evidence. Indeed, few believe the economy could exhibit overheat characteristics when it is growing at such a subpar pace. However, we think a potential cocktail for "overheated anxieties" is being stirred.

What if:

• A spring thaw hits the U.S. economy and reports suddenly begin to regularly come in stronger than anticipated?

• The U.S. dollar surprisingly "tops" and declines in the balance of 2015 as growth in overseas economies bounce due to the lagged impact of falling energy prices, much lower bond yields, and weaker currencies? Consequently, the growth differential to the U.S. diminishes bringing a bid to foreign currencies and a sell to the U.S. dollar.

• Both energy and non-energy commodity prices simultaneously jump as the U.S. dollar weakens ending concerns about a deflationary spiral and heightening anxieties about whether the Fed is behind the curve?

• Inflationary expectations among investors (which are already rising) increase above 2% and head for 2.5% or 2.75%?

• The unemployment rate quickly drops below 5% destroying any rationale for the Fed to keep the funds rate at zero and raising questions about how high and how quickly it should be increased?

• Evidence of rising wages (which is already fairly pronounced) becomes obvious and wage inflation quickly blows through 2.5% heading for 3%?

• Productivity remains miserable providing no relief for companies facing cost-push pressures and no exit ramp for the Fed to lift interest rates against?

• Bank loans (which have quietly been rising solidly in the last year) accelerate even further while home prices spring higher with record low mortgage rates, full employment, and the millennials finally reaching the peak home formation age.

• Most overseas economies experience the first synchronized bounce (due to the lagged impact of a synchronized global economic policy stimulus (i.e., lower energy prices, lower bond yields, and lower currencies) in economic growth of the global recovery?

Again, we do not anticipate a major inflationary spiral. We are concerned, however, because a majority of mindsets seem to believe the slow-growing global economy is not at risk of overheat and consequently both the Fed and bond vigilantes can maintain very low yields for some time to come. Even those who anticipate the Fed will begin to raise interest rates this year, think the process will likely be methodical, well communicated, and largely uneventful. While a major inflationary spiral remains very unlikely, given the consensus mindset today, a significant "fear" by investors that the U.S. economy is overheating, inflation is rising and the Fed may be behind the curve does appear possible. These charts are a good reminder that the currently expected slow and steady exit of the Fed could actually quickly become a panicky exit!

Thanks for taking a Look!!