WELLS CAPITAL MANAGEMENT

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Between a Rock and a Hard Place?

There is an increasingly narrow window for a sustained rally in the U.S. stock market. At this point, economic growth could easily prove either too weak or too strong. If economic growth remains tepid, sales will likely prove insufficient to drive satisfying earnings growth. Alternatively, since the economy is now near full employment, should economic growth accelerate, cost-push profit margin pressures will likely worsen.

The hope for significant new highs in the stock market seems to rest increasingly upon achieving a "Goldilocks" environment for the economy. That is, not too hot nor too cold. Solid economic growth without inflationary/overheat consequence. However, Goldilocks stock markets (think 1960s and late 1990s) are typically the product of significant and sustained advances in productivity, something sorely missing in the contemporary recovery.

So, is the stock market currently caught between a rock (too hot) and a hard place (too cold)?

Maximum profit margins and full employment

Charts 1 and 2 illustrate the challenge currently faced by the U.S. stock market. Corporate profit margins are near all-time record highs and the unemployment rate is nearing a level traditionally approaching full employment.

As shown in Chart 1, the profit gains during this recovery are mainly explained by significant improvement in profit margins. Like the economy itself, sales growth has remained subpar but companies have been able to compensate by chronically expanding margins. Now, however, with profit margins near post-war highs, earnings performance will be much more closely tied to sales results. Thus, should sales growth remain punk, earnings results will prove increasingly disappointing, particularly when investors are paying a market price/earnings multiple of about 19 times trailing earnings.

Conversely, should economic growth strengthen (which we believe is already happening), Chart 2 suggests the stock market may struggle with broadening overheat pressures. Employment is growing about 1% faster than the labor force causing the unemployment rate to fall about 1% a year. This was fine when the unemployment rate was still north of 6% but is now more problematic as the unemployment rate heads toward 5%. Already, wage indicators are showing signs of acceleration. Cost-push pressures could erode profit margins keeping earnings gains tepid even if sales results improve. Moreover, higher inflation expectations would push yields higher and quicken the Fed's exit strategy adding pressure to a highly-valued stock market.

Chart 1: U.S. corporate profit margin

U.S. corporate profits as a percent of nominal GDP

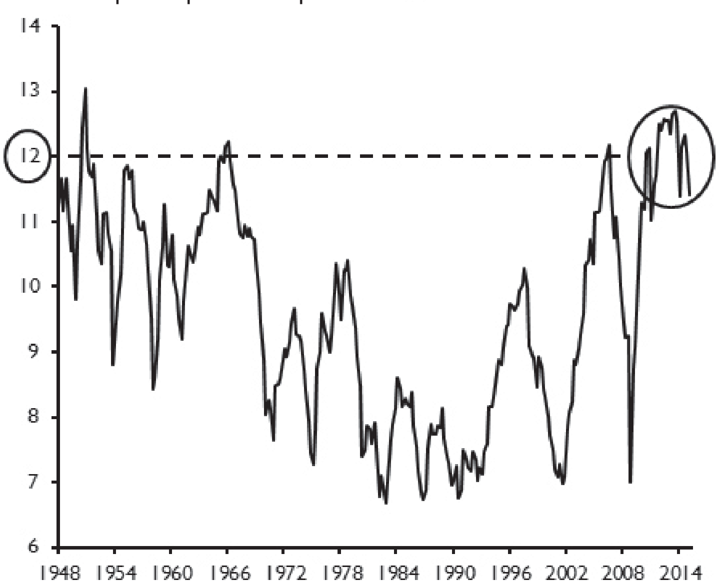
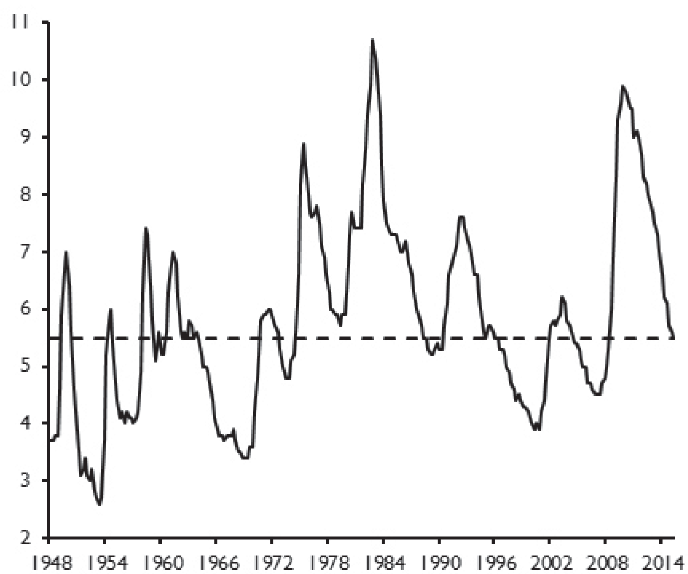
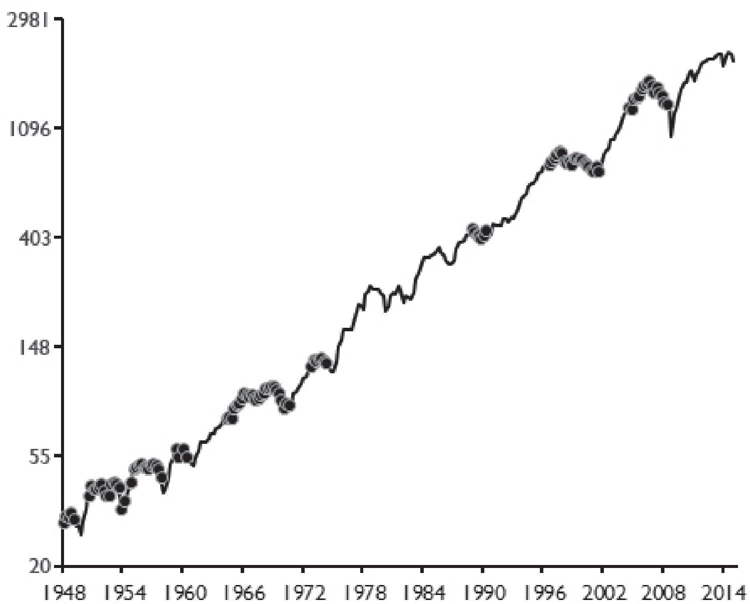


Chart 2: U.S. labor unemployment rate



As shown in Chart 3, corporate profits have often struggled once the unemployment rate falls below 5.5%. The black dots show all quarters when the unemployment rate was below 5.5%. Historically, while earnings have occasionally continued to rise briefly (e.g., a couple years in the mid-1960s and again for a couple years in the mid-2000s), once a 5.5% unemployment rate is breached, earnings growth has typically soon stalled.

Chart 3: U.S. corporate profits
With IVA and CCA adjustments, natural log scale
Black dots show all quarters when the U.S. unemployment rate was below 5.5%



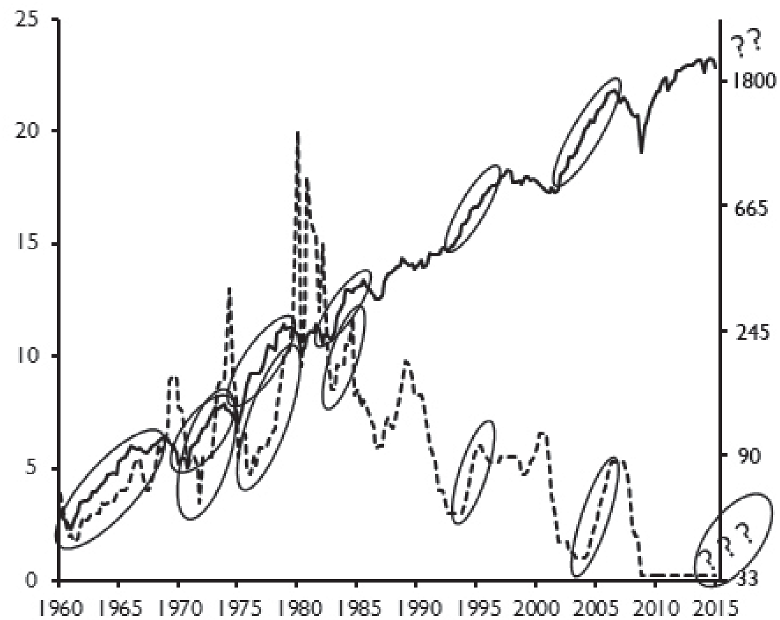
Did the Fed miss its earnings exit ramp?

As it attempts to discover a Goldilocks growth rate for the economy, the stock market already seems to be struggling with challenges presented by record profit margins and full employment. Additionally, it imminently faces the first Fed tightening move of the recovery, an event which often produces investor indigestion.

Of the many unique aspects characterizing contemporary monetary policy, one which may prove very important for the stock market is "how long" the Fed has waited to begin the tightening process. Our concern is not that by waiting so long, the Fed is behind the curve (although that also is possible). Rather, by waiting too long to start the process, the Fed has allowed its traditional exit ramp (i.e., raising interest rates against strong gains in corporate profits) to expire. Consequently, the Fed is now about to begin the process of raising interest rates without its traditional buffer of recovering profitability.

Chart 4 illustrates when the Fed has initiated tightening, the economy and the stock market have conventionally been shielded against rising interest rates because the profit cycle is usually still in the early stages of recovering from the previous recession. It overlays corporate profits with the federal funds interest rate and initial tightening cycles are highlighted for each economic recovery. In every case since 1960, monetary tightening began when profits were still in an early stage of their recovery. Therefore, the impact of higher interest rates was typically mitigated by rapid profit growth resulting from solid recovery gains in both profit margins and sales.

Chart 4: U.S. corporate profits versus federal funds interest rate
Left scale—10-year U.S. Treasury bond yield (Dotted)
Right scale—U.S. corporate profits, natural log scale (Solid)



This buffer is simply unavailable today because the profit cycle is much more mature. Although profits are likely to continue growing in the next few years, even under the most optimistic assumptions, earnings growth will not be as dramatic as it was earlier in this recovery. The Fed's exit ramp, which normally buffers the impact of its early tightening moves, has already expired.

Many point to numerous examples when the stock market did well even though interest rates rose. However, most of these historic cases were when higher rates were being buffered by solid earnings gains. Because the Fed has waited so long this time to begin the process, the impact of interest-rate hikes once they do finally come, will not be as cushioned as they have in past recoveries.

The road to Goldilocks!??

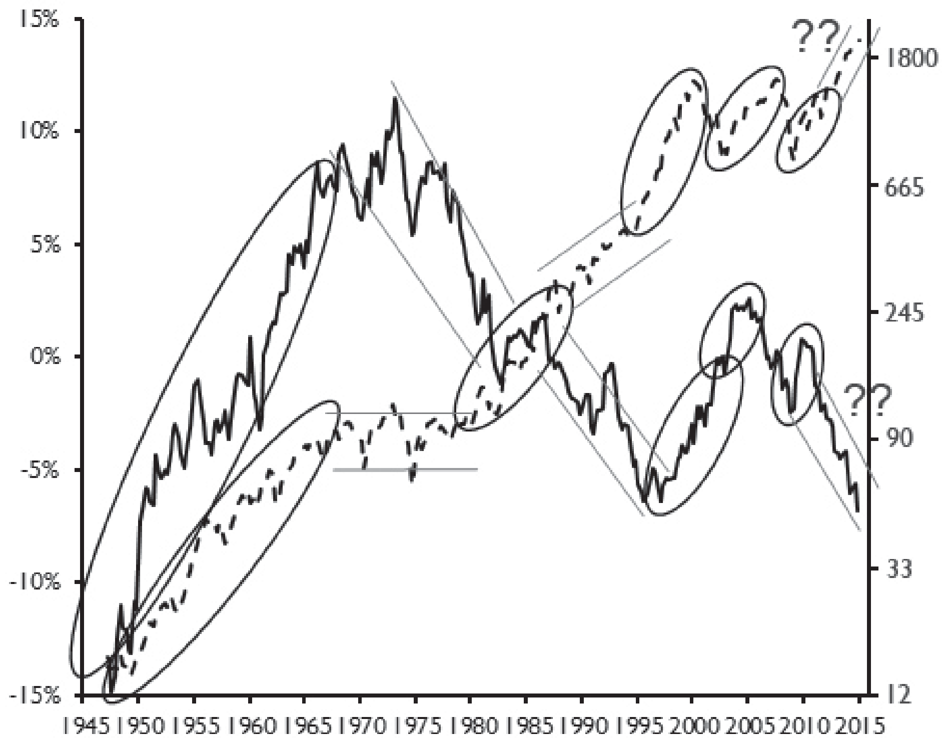
Nearing full employment with record high profit margins suggest there is probably only one road to a Goldilocks stock market: A revival in productivity.

Solid gains in productivity stretches the labor resource and keeps cost-push pressures manageable even when reaching full employment. It helps boost supply enough to meet rising demands so that cyclical inflation and interest-rate pressures can be mitigated. In short, healthy productivity elongates economic recoveries by acting as an elixir to an otherwise fully employed economy and consequently has been central to many sustained stock market advances.

Chart 5 illustrates a fairly close relationship between productivity and the stock market in the post-war era. The solid line is detrended U.S. productivity. When it rises (declines), productivity is growing faster (slower) than post-war norms. The dotted line is the S&P 500 Composite Stock Price Index. Historically, most major stock market runs have been associated with periods of above-average productivity gains. This was certainly true between WWII and the mid-1960s, the early 1980s run between 1982 to 1987, and again in the late 1990s.

There are two notable exceptions when productivity did poorly and the stock market still rose—during the first half of the 1990s and since about 2012 in the current recovery. However, during both of these periods, bond yields and interest rates were either flat or down most of the time. If the stock market is going to sustain a rally in the face of rising yields, this chart strongly suggests much healthier productivity gains must soon materialize.

Chart 5: Detrended productivity versus S&P 500 Stock Price Index
Left scale—Detrended U.S. Productivity Index (Solid)
Right scale—S&P 500 Stock Price Index, natural log scale (Dotted)



Summary and conclusions?

Substandard productivity growth has left the earnings cycle suspect in the immediate period. If sales growth remains punk, earnings will be disappointing since margin enhancements are mostly spent. Should sales growth bounce, however, earnings performance will likely be hampered by profit margin erosion. Essentially, without sufficient productivity gains, now that the economy is nearing full employment with maximal profit margins, it is getting very difficult for the economy to find a speed limit beneficial to the stock market.

Ultimately, we expect U.S. productivity to improve yet in this recovery, perhaps eventually restarting another buy and hold segment in the contemporary bull market. However, for a period, our guess is the stock market will struggle as it faces some challenges which have built up during its steady upward run in recent years (e.g., sentiment which has become a bit too calm, valuations which are a bit too extended, and an interest-rate structure which is much too low).

Better U.S. productivity results may yet bring a Goldilocks ending to the current bull market. However, productivity is currently a no show and as the economy nears full employment with maximum profit margins, investors should be prepared for a possible correction as the stock market temporarily finds itself between a rock and a hard place.

Thanks for taking a Look!!

Jim