Wells Capital Management

Economic and Market Perspective

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A cascade of change?

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Investors continue to weigh whether the most recent stock market rally signals the end of a correction or whether it simply represents a temporary respite from an unfolding bear market? However, forthcoming changes in the financial markets are likely much more dramatic than simply a stock market in search of a bottom.

Until now, the premise of this bull market has been the ability to grow without aggravating inflation or interest rate pressures. Growth has simply soaked up unemployed resources and the financial markets have been driven primarily by a culture of disinflation, persistent policy accommodation, chronically falling yields, and rising price-earnings valuations. In the last year, however, as the U.S. economy has returned close to full employment, the premise underlying the financial markets is changing. Improved economic growth is no longer universally positive. At full employment, if the recovery perseveres as we expect, it will likely aggravate cost-push pressures, lift both wage and core consumer price inflation, and require higher interest rates.

As the character of the recovery is altered by full employment, investors should anticipate a cascade of change during the next phase of this bull market. If the stock market has finally bottomed, expect significant changes in global, capitalization and sector leadership and perhaps major trend changes in commodity prices, bond yields, and the U.S. dollar.

Commodity prices, core inflation, and the unemployment rate

Exhibit 1 illustrates that the economic recovery may be undergoing significant change. Since 1970, whenever commodity prices bottomed while the unemployment rate was below 6%, the annual rate of core consumer price inflation accelerated.

As shown, commodity prices and core inflation have been either flat or falling during most of the last five years. However, in the last year, as the U.S. unemployment rate has declined below 6%, the core rate of consumer price inflation has started to rise again. This recent pickup in inflation may become even more pronounced if commodity prices soon bottom. As these charts suggest, since the economy has returned close to full employment, the balance of this recovery will likely be characterized by more pronounced inflationary overtones. That is, the fallout from continued economic growth will now likely be far different than it has been so far in this recovery. While we do not believe the economy is en route to runaway inflation, the rest of this recovery will likely be characterized by stronger commodity prices, higher wage inflation, consumer price inflation, and interest rates.

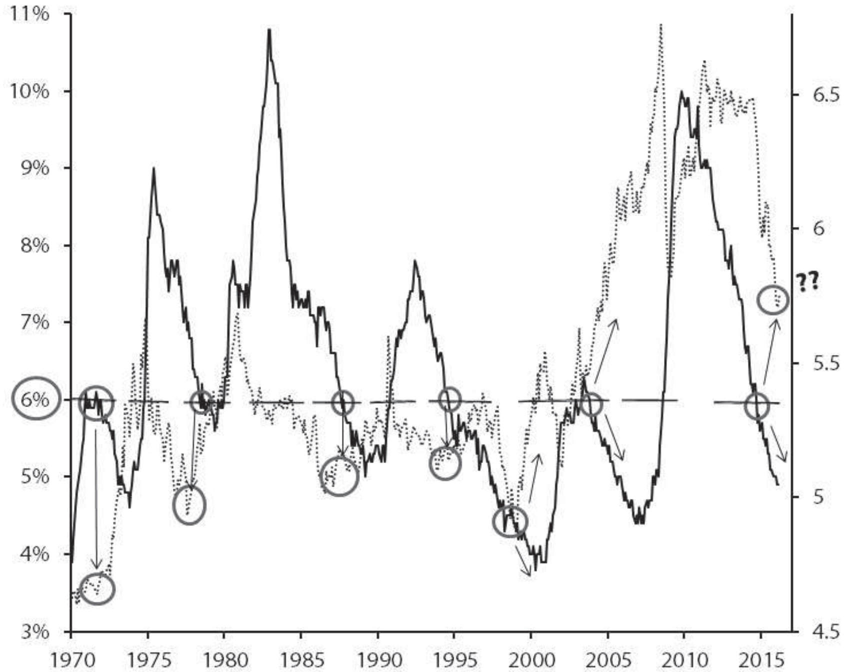
Consequently, the recent period of financial market turbulence is probably more than just a stock market in search of a bottom. Rather, it may be marking considerable changes in both the character and leadership of the financial markets. Here are just a few potential shifts investors may want to monitor.

Exhibit 1: Commodity prices, core inflation, and unemployment

Chart 1

Commodity prices, core inflation, and unemployment

*Solid (left scale) — U.S. unemployment rates
Dotted (right scale) — S&P GCSI Spot Commodity Price Index, natural log scale.

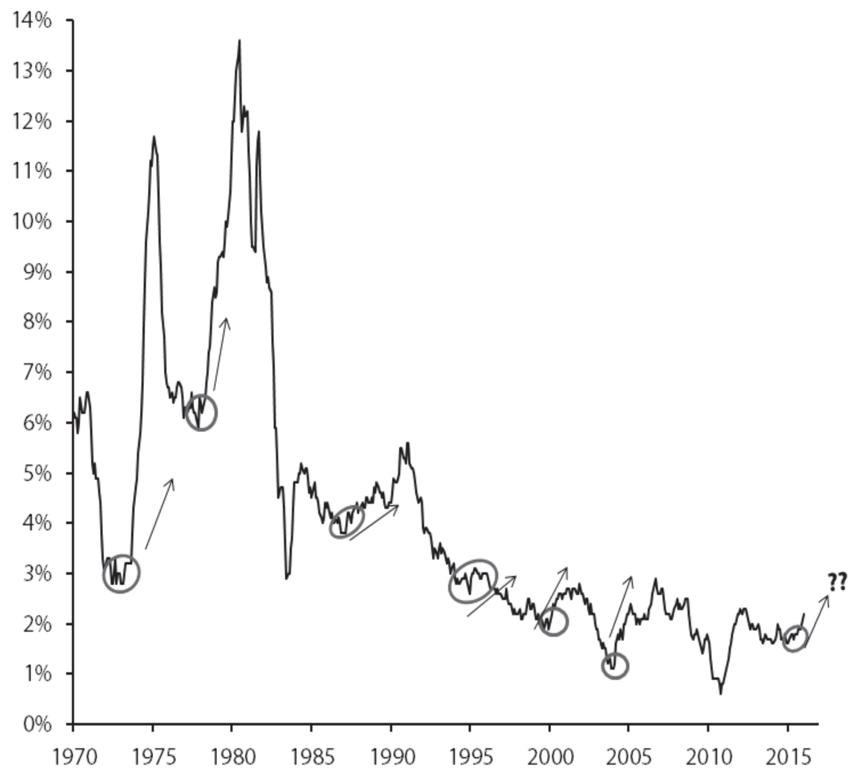


Once the Unemployment Rate Falls Below 6%...

... A Rise in Commodity Prices...

Chart 2

Core consumer price inflation rate



...typically aggravates CORE Consumer Inflation!?!

If commodity prices bottom, will the U.S. dollar peak?

If commodity prices are near a bottom, Exhibit 2 shows the U.S. dollar is also likely near a peak. Commodity prices and the U.S. dollar have been almost perfectly inversely correlated during the last 15 years. Since the beginning of 2011, the dollar has either trended sideways or strengthened while commodity prices have either been flat or weak.

If, as suggested by Exhibit 1, commodity prices do begin to rise for the first time since early 2011, Exhibit 2 suggests the U.S. dollar may similarly enter a period of protracted weakness. Commodity price strength and a weak U.S. dollar would represent a new and unexpected trend for most investors.

Are inflation expectations and bond yields finally poised to trend higher?

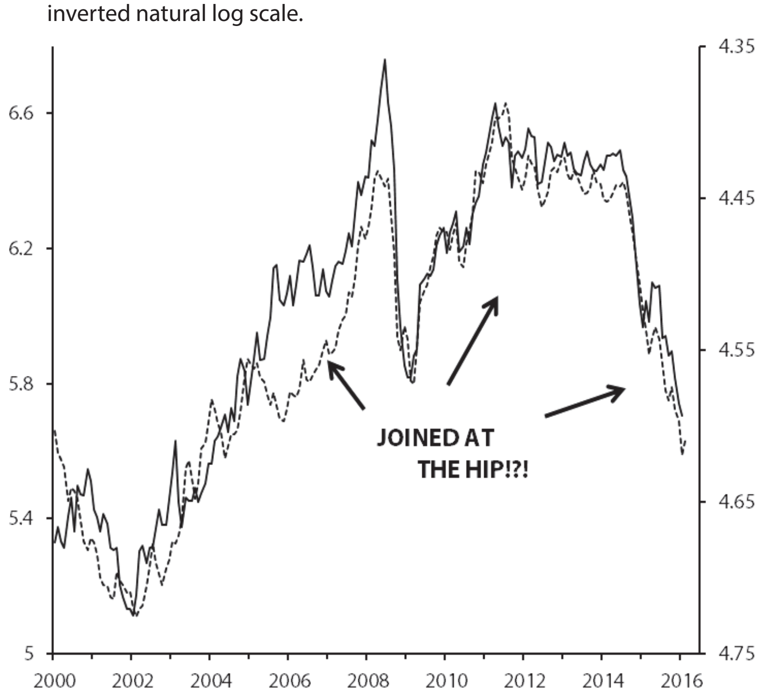
As Exhibit 3 illustrates, despite an uninterrupted seven-year expansion, both inflation expectations and bond yields have trended persistently lower. While both have had temporary cyclical spurts during this recovery (e.g., the 10-year bond yield rose significantly in both late-2010 and again in 2013), neither has trended higher on a sustained basis.

Exhibit 2: Commodity prices and U.S. dollar

Chart 3

Commodity prices vs. U.S. dollar

*Solid line (left scale) — S&P GCSI Spot Commodity Price Index, natural log scale.
Dotted (right scale) — U.S. Real Broad Trade-Weighted Dollar Index, inverted natural log scale.



Many core inflation measures and wages have accelerated in the last year. Annual core consumer price inflation has risen from 1.6% to 2.2%, the core personal consumption price deflator inflation rate has risen from 1.2% to 1.7%, the core consumer services inflation rate has risen from 2.5% to 3.0% and wage inflation (three-month moving average) has increased from 1.8% to 2.5%. Never in this recovery have core economic cost risen this much and this broadly. With the unemployment rate now below 5% and headed lower, if commodity prices do soon bottom and the U.S. dollar peaks, could inflation expectations and bond yields finally sustain a higher trend move?

New leadership for the stock market?

This bull market's leadership has been dominated by a few select investment themes including above average dividend payers (i.e., dividend aristocrats), consumer stock sectors over producer sectors, large capitalization stocks, and finally U.S. as opposed to international stocks. Exhibit 4 compares the relative performance of each of these investment themes to commodity prices in the last couple years. Obviously, the relative performance of each investment theme has been strongly correlated to disinflationary/deflationary economic trends. Chronic and intensifying deflation has hurt producer/industrial companies (whose selling prices have fallen much more than consumer prices), smaller capitalization companies (which typically run lean and consequently have less cost-cutting possibilities relative to larger companies during disinflationary times), international companies (i.e., foreign economies tend to be much more manufacturing/industrial oriented than is the U.S. economy), and finally low dividend payers have suffered relative to high payers as competitive interest rates and yields have remained low or declined even further in recent years.

As Exhibit 4 suggests, should commodity prices begin to trend higher, many of the most popular investment themes of this bull market could be turned upside down during the balance of this recovery.

Exhibit 3: Inflation expectations and bond yields?

Chart 4

Implied inflation rate embedded in 10-year yield*
*10-year nominal Treasury bond yield less 10-year Treasury inflation-indexed yield.

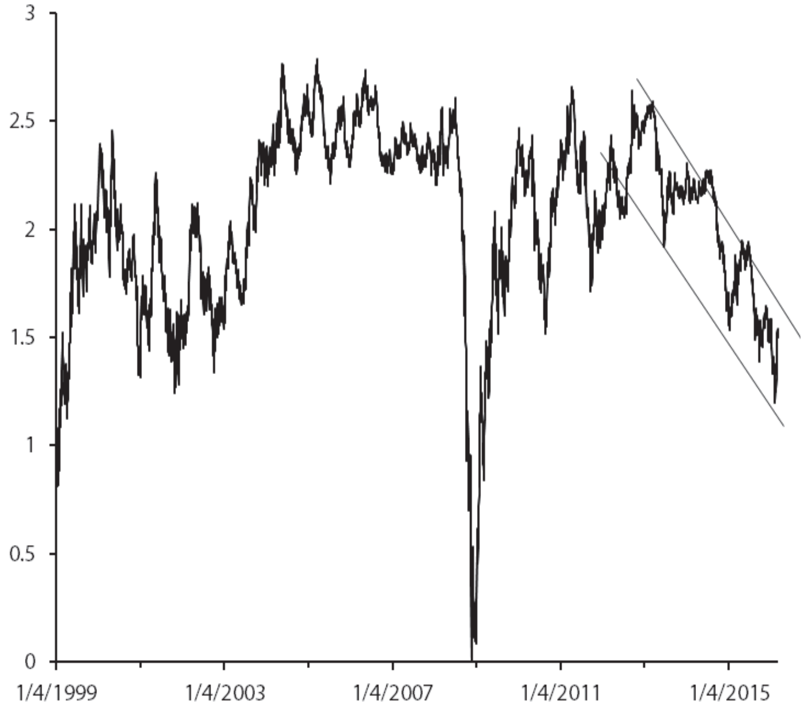
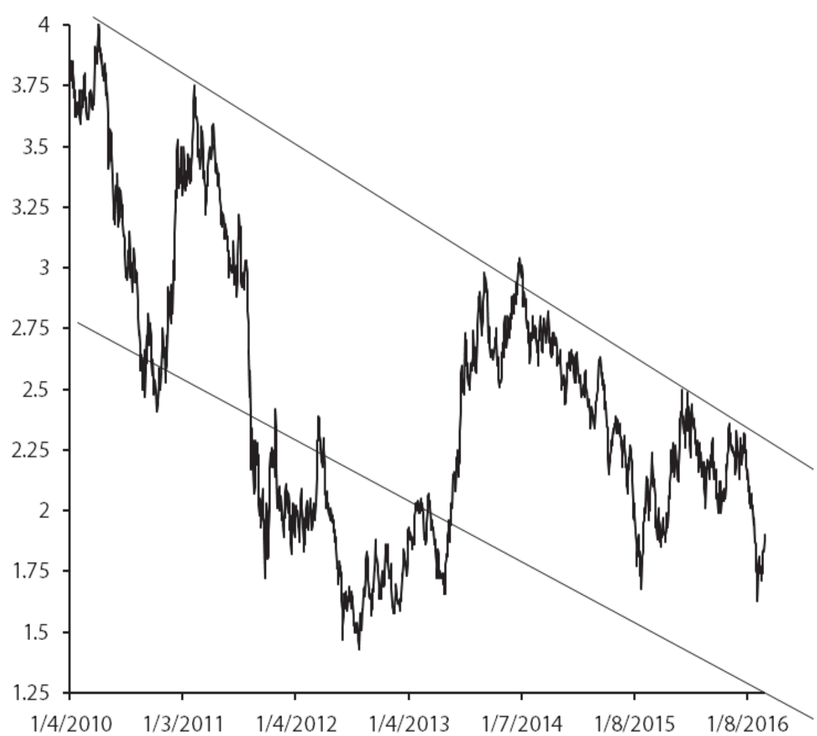


Chart 5

10-year U.S. Treasury bond yield



Will these Finally Establish RISING TRENDS?!?

Exhibit 4: Stock market leadership change?

Chart 6

Relative S&P 500 dividend Aristocrat stock performance and commodity prices

*Solid line (left scale) — Relative stock price performance. S&P 500 Dividend Aristocrat Index compared to S&P Composite Index. Dotted (right scale) —S&P GCSI Spot Commodity Price Index, natural log scale.

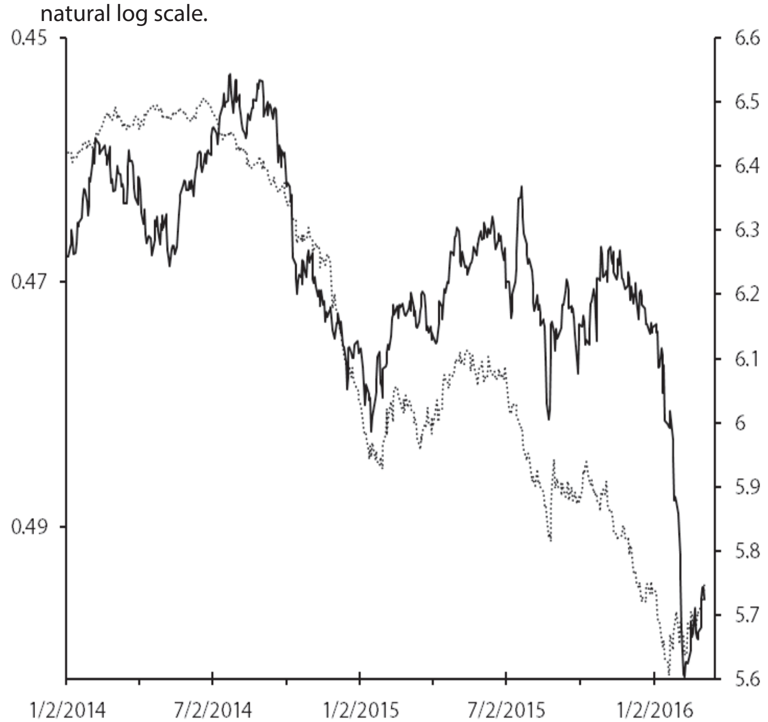


Chart 7

Relative producer to consumer stock performance and commodity prices

*Solid line (left scale) — Relative price performance of U.S. producer sectors compared to consumer sectors. Producer sectors include the fo following: transports, industrials, materials and energy. Consumer sectors include the following; consumer discretion, consumer staples, and health care. Both indexes are goe-weighted.
Dotted (right scale) — S&P GCSI Spot Commodity Price Index, natural log scale.

If Commodity Prices Do Bottom...
... Stock Market Leadership Will Change!?!

Chart 8

Relative small cap to large cap stock performance and commodity prices

*Solid line (left scale) — Relative stock price performance. Russell 2000 Small Cap Index compared to S&P 500 Composite Index.
Dotted (right scale) — S&P GCSI Spot Commodity Price Index, natural log scale.

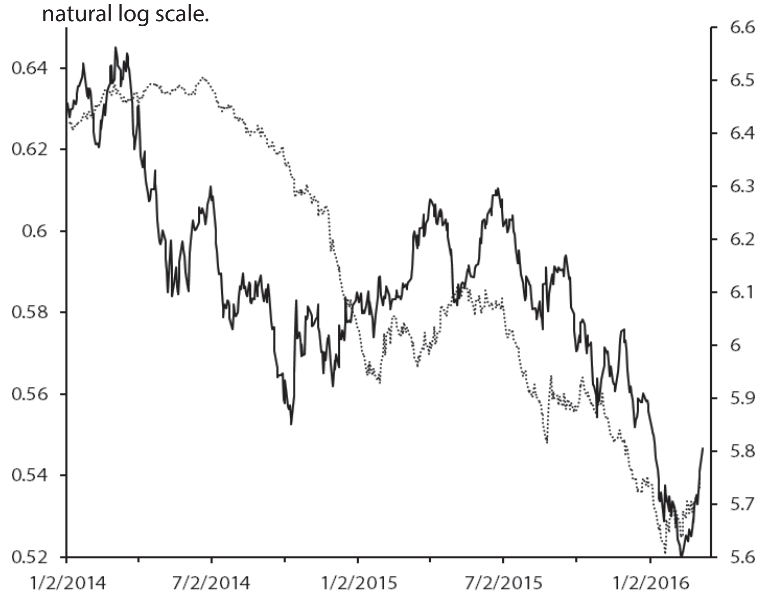
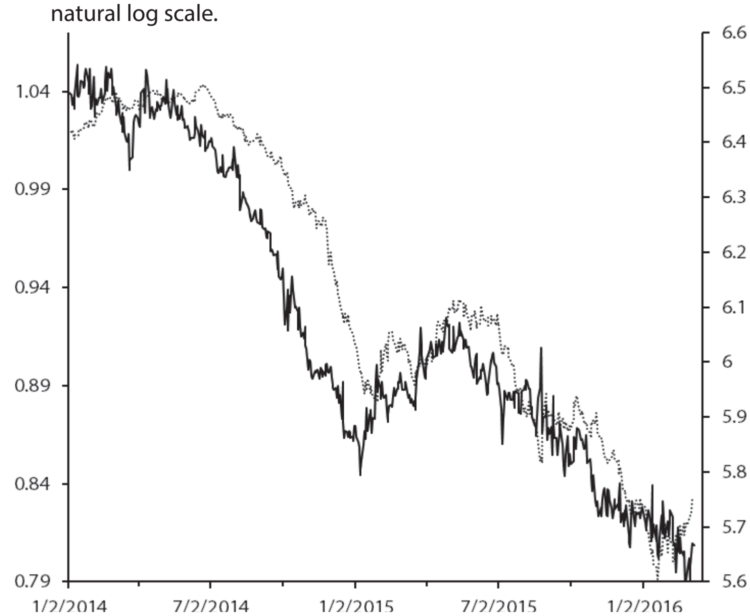


Chart 9

Relative foreign stock performance and commodity prices

*Solid line (left scale) — Relative stock price performance. MSCI world excluding U.S. index relative to S&P 500 Composite Stock Price Index.
Dotted (right scale) — S&P 500 GSCI Spot Commodity Price Index, natural log scale.



No longer a value-driven stock market?

Exhibit 5 illustrates just how much this bull market has depended on improving valuations. It compares the trailing 12-month price-earnings (P/E) multiple on the S&P 500 Index with the "Rule of 20." The Rule of 20 suggests the stock market is fairly valued when its P/E is equal to 20 less the annual rate of core consumer price inflation (the dotted line in Exhibit 5).

As shown, although the Rule of 20 has not been perfect in tracing out actual P/E multiple changes, it has provided a central value which the stock market has returned to over time. Until 2015, the P/E multiple was chronically below fair value and its steady advance during this bull market has contributed significantly to overall performance results. Now however, the actual P/E multiple is almost equal to its fair value based on the Rule of 20 (i.e., with core inflation at 2.2%, the fair value P/E is 17.8 and the actual trailing P/E is currently 17.9). Consequently, for the first time in this recovery, investors can no longer expect solid investment results simply from expanding P/E valuations. Indeed, if core consumer inflation is now beginning to accelerate, the fairly valued P/E multiple may decline during the balance of this recovery.

A more challenging profit cycle?

Top-line sales growth has been persistently below average throughout this recovery. However, profits have risen almost 25% above previous recovery highs primarily because companies have been able to significantly raise profit margins. As illustrated in Exhibit 6, however, profit margins will now likely contribute far less to profitability and indeed may contract during the rest of this recovery.

Margins rose to near all-time record highs mainly because labor cost as a % of sales declined to near record lows. Since the economy recently returned to full employment, labor cost have begun to rise and margin pressures should worsen as labor regains a larger share of the sales dollar.

The earnings story is challenging going forward. If economic growth remains subpar, and sales trends anemic since profit margins cannot improve much further, overall earnings growth will also remain disappointing. Alternatively, should economic growth quicken and improve top-line sales results, labor cost will rise even faster causing profit margin erosion mostly offsetting better sales. Either way, earnings growth, which until last year had been solid in this recovery, is likely to be far less robust going forward.

Exhibit 5: Valuation to EPS driven?!?

Chart 10

P/E multiple vs. Rule of 20

*Solid — Trialing S&P 500 P/E multiple, natural log scale

Dotted — Rule of 20 -- 20 minus annual core consumer inflation rate, natural log scale

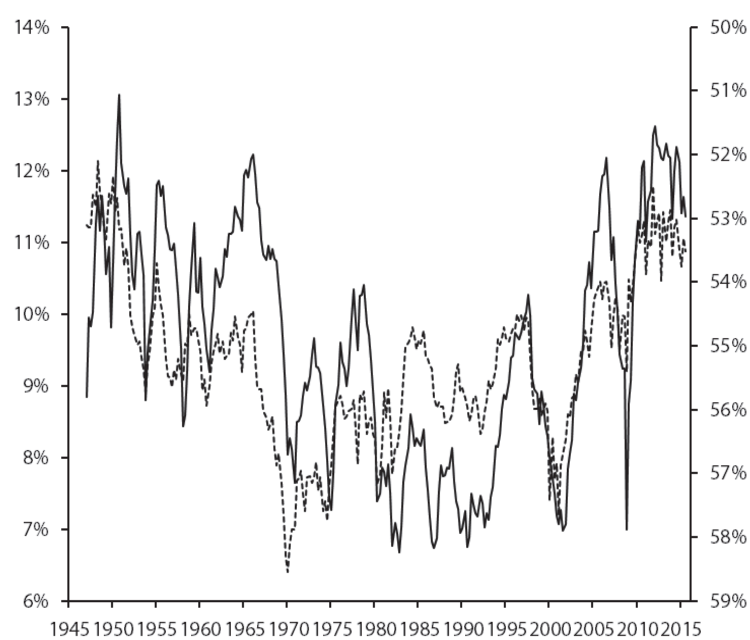
Exhibit 6: A new profit cycle???

Chart 11

U.S. corporate profit margin vs. U.S. labor income share

*Solid (left scale) — U.S. corporate NIPA profits as a percent of nominal GDP.

Dotted (right inverted scale) — U.S. total labor compensation as a percent of nominal GDP.



Summary

The primary question facing investors today is not simply whether the stock market has finally bottomed. Rather, since the economy has recently returned to full employment, investors should prepare for a cascade of change in the character of the financial markets. The dominant themes are no longer likely to be disinflation, low and falling yields and Federal Reserve accommodation. Rather, if commodity prices are finally nearing a low, expect a number of different cultural mindset changes.

A bounce in commodity prices combined with an already evident acceleration in core inflation should extinguish deflation fears and usher in a period of mildly rising inflation. Combined with surprising U.S. dollar weakness, inflation expectations are likely to awaken forcing the Fed to quicken its pace of interest rate hikes. Consequently, bond investor may finally face the first sustained rise in yields in many years.

These new full employment trends are also likely to invade the character of the stock market. Expect bond-like dividend plays to underperform, for leadership to shift toward industrial, producer and capital goods sectors rather than consumer sectors, for global performance to move away from the U.S. stock market toward international developed, and emerging markets, and for small and mid cap stocks to begin outpacing larger company stocks.

Finally, valuation is no longer a friend of the stock market and the earnings cycle has matured. At best, stock investors should only hope current P/E valuations can simply be maintained and sustainable earnings growth is not likely to be much better than overall nominal GDP growth. That is, the best of this bull market is probably already behind us. Bond investors should prepare for some downside risk and while the bull may yet last several more years, return expectations for the stock market should be significantly curtailed to about 5% to 7% annually.

Thanks for taking a Look!!

Written by James W. Paulsen, Ph.D.

An investment management industry professional since 1983, Jim is nationally recognized for his views on the economy and frequently appears on several CNBC and Bloomberg Television programs, including regular appearances as a guest host on CNBC. *BusinessWeek* named him Top Economic Forecaster, and *BondWeek* twice named him Interest Rate Forecaster of the Year. For more than 30 years, Jim has published his own commentary assessing economic and market trends through his newsletter, *Economic and Market Perspective*, which was named one of "101 Things Every Investor Should Know" by *Money* magazine.