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Leading Indicators Suggest 3% Growth

Real GDP increased 1.9% in 2013 (that is, from the 2012 annual level to the 2013 annual level), compared to an increase of 2.8% in 2012. We believe that 2014 will be more like 2012 – with no tax hikes and minimal sequestration during an election year – and that the expansion's duration means that lower levels of unemployment will make Main Street feel better. Severe weather has dampened economic activity early in 2014, but we think the underlying trends indicate ongoing growth in hiring, investment, and consumption, as reflected in a range of leading indicators (see Weekly Chart).

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For example, weekly unemployment claims have averaged about 340,000 over the last month – low by historical standards – and are consistent with first-quarter GDP growth of around 3% year over year. Moreover, the US Markit 'flash' manufacturing Purchasing Manager Index rose to its highest level in four years as both new orders and employment subcomponents expanded at a faster rate, with 85% of survey responses in for February. Furthermore, core durable goods orders (excluding defense and aircraft) are rising at a 6% rate. Businesses appear undeterred from investing, encouraged by the low cost of capital, rising earnings, plenty of cash on hand and increasing confidence as policy uncertainty fades. Mergers and acquisitions are also picking up as companies seek to position for future growth. Finally, credit spreads continue to trade near record lows, signaling a favorable funding environment.

As we have pointed out in the past, aggregate payrolls (hours worked times hourly earnings) at 4% are rising comfortably ahead of 1.6% inflation, while debt service ratios are at record lows. With home prices nationally up about 13% from a year ago, we think households have the income and confidence to raise consumption levels, particularly as weather-related disruptions fade, allowing people to spend. In short, we see little evidence that recent economic weakness is anything other than temporary, with households and businesses in good financial shape, inflation quiescent, and the Federal Reserve still focused on buoying employment.

We remain bullish on stocks and bearish on bonds. The S&P 500 rose to within a couple of points of its mid-January record high last week, making the 5.8% early-2014 correction (when Fed tapering began) similar to the June 2013 correction (when the idea of tapering was introduced). Crowd sentiment reached a pessimistic extreme early in February, suggesting better than average odds of the S&P 500 rising over the next one and three months (see *The Weekly View*, 2/10/14). It has now risen back to neutral. This is the typical progression for sentiment in a rising market, and we expect it to eventually become optimistic. Thus, the S&P 500's behavior so far in 2014 is consistent with our view of a deceleration in last year's 24% annualized run rate to a more sustainable rate of 5% to 10%.

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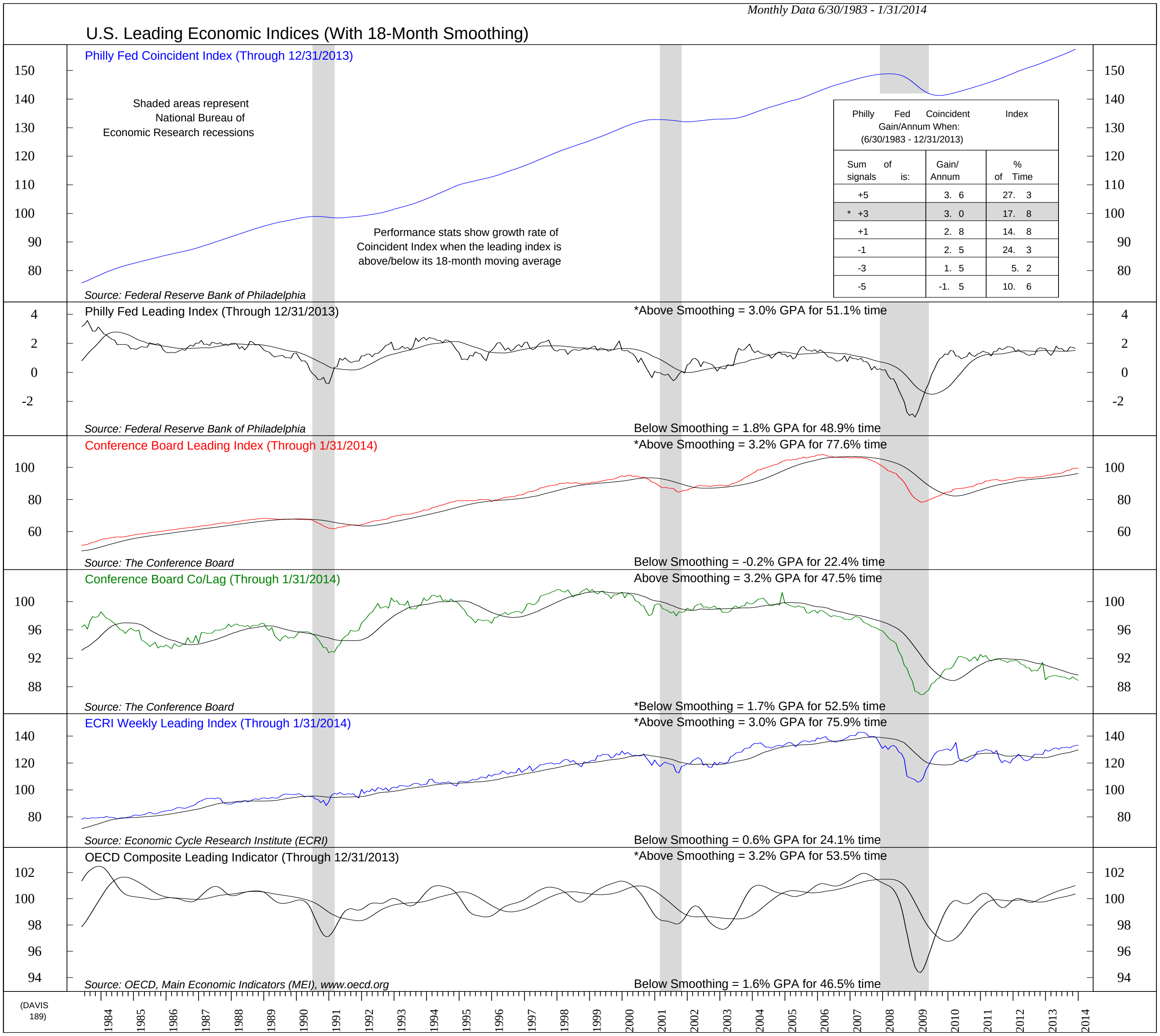
THE WEEKLY CHART: FOUR OUT OF FIVE LEADING INDICATORS ABOVE RISING TRENDS



The Weekly Chart combines five prominent leading indicators for a broad look at potential underlying economic trends. Each leading indicator is compared to its longer term average, and currently four out of five are above their moving average and thus rated bullish. As calculated by Ned Davis Research, this is consistent with 3% economic growth as measured by the Philadelphia Fed's Coincident Index – which offers a monthly gauge of economic growth. The Conference Board's falling coincident to lagging index (Co/Lag) is the exception. Both indexes are rising, but the Co/Lag is falling because the lagging indicator is rising faster than the coincident indicator, which is heavily influenced by employment and manufacturing.