Wells Capital Management

Economic and Market Perspective

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Bottom Fishing?

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The S&P 500 hit fresh new intra-day and closing lows for this correction yesterday. We certainly do not know where or when this stock market will finally bottom and would not be surprised if the S&P ultimately breaches the 1800 level before a sustaining rally commences. However, we do think a bottom is nearing. As this trio of charts illustrates, the character of a market bottom is forming. Values have been significantly cheapened, investor sentiment has turned decidedly more fearful, and a potential positive catalyst of better economic news may be on the horizon.

Chart 1 highlights that the trailing S&P 500 PE multiple has not been this low since October 2013 and at about 16.4x is substantially cheaper than it was at around 19x near the stock market peak last year.

Chart 2 shows investor sentiment has turned decidedly more bearish this year. Indeed, at least by this American Association of Individual Investors (AAII) measure, individual investor sentiment has not been this bearish since the recovery began. We also notice that investor behavior has seemingly turned more fearful recently. During the near correction selloff of September 2014 and again during the correction last August, investors never exhibited the "rush to safety" behaviors that are evident today. Unlike the last two pullbacks in 2014 and 2015, today, gold prices have surged and bond yields have plummeted as investors have rushed to safe haven assets. Finally, the discourse surrounding this year's selloff is much more panicky. Few are describing the correction this year as a refreshing pause or a good buying opportunity as was commonplace during last year's correction. Rather, today there are many more calls for a recession, a global financial calamity, and for a bear market. After essentially the third correction in only about 16 months, investors finally seem to be much more chastised.

Chart 1

Trailing S&P 500 P/E Multiple

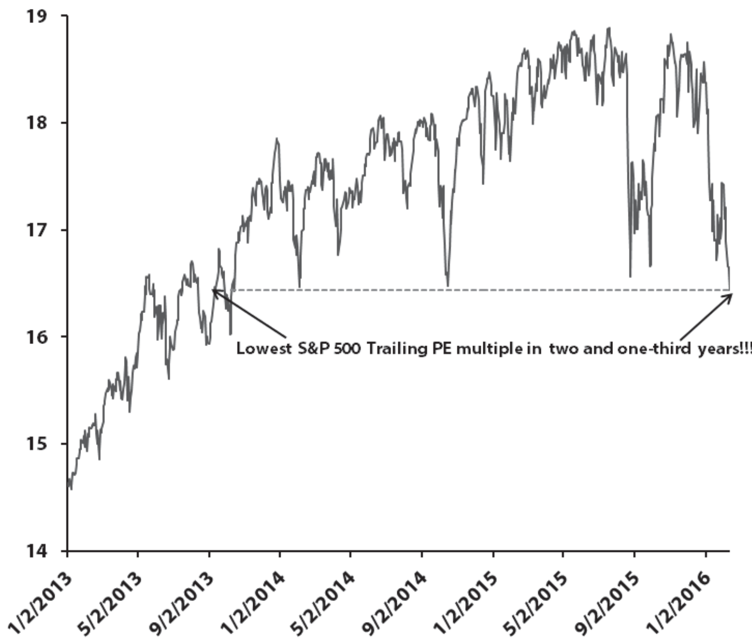
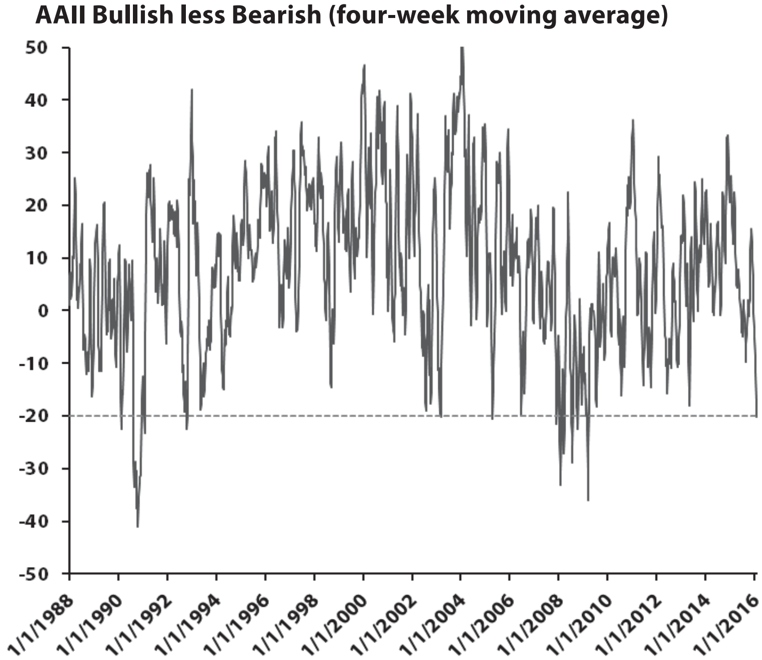


Chart 2

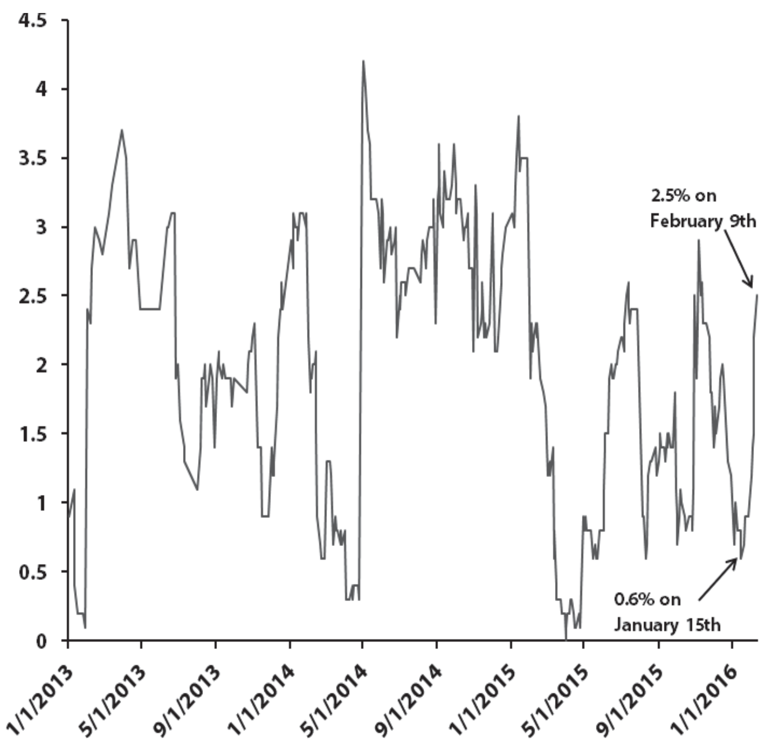
Investor Sentiment
AAII Bullish less Bearish (four-week moving average)



Finally, Chart 3 suggest a white knight may potentially be riding into this stock market correction. Most believe the stock market needs a "policy catalyst" to stop the bleeding. That is, many expect the Fed, the ECB, or perhaps Chinese policy officials will announce a policy shift in support of the financial markets. However, it may simply be economic reports which turn out better than most fear which ultimately help the stock market to find a bottom. The Atlanta Fed calculates an ongoing measure of U.S. quarterly real GDP growth illustrated in Chart 3. This measure was declining steadily since early November but has spiked upward again since mid-January. Currently, stocks are being battered by intensifying recession fears. However, could first quarter economic reports reassure that a recession is not forthcoming and provide the catalyst which ends the recent stock market route?

Chart 3

Atlanta Fed GDPNow GDP Forecast*
***This concept provides an estimate of overall economic activity. It is an estimate of current quarterly GDP growth updated daily as information is released during the quarter.**



Who knows how much longer this correction will last and if it will yet turn into a bear market. However, for those who believe the U.S. is not headed for an imminent recession, this trio of "correction bottoming charts" (i.e., revalued stocks, renewed pessimism, and a potential positive catalyst) is encouraging. We would be redeploying cash on weakness and repositioning portfolios toward international stocks, toward industrial/producer/capital goods sectors and away from defensive (utilities and telecom) and consumer sectors (i.e., consumer discretionary, consumer staples, and health care). Finally, we would recommend adding some of those financial stocks currently being priced for a repeat (not likely in our view) of the 2008 financial crisis.

Thanks for taking a Look!!
Jim

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.