WELLS FARGO | ASSET MANAGEMENT

Wells Capital Management

Economic and Market Perspective

February 7, 2017 — Bringing you national and global economic trends for more than 30 years

Markets on the cusp ...?

James W. Paulsen, Ph.D
Chief Investment Strategist,
Wells Capital Management, Inc.

The U.S. has a new president and the country finds itself on the cusp of a new leadership era. Perhaps accordingly, financial markets also appear to be on the cusp. The Dow Jones Industrial Average recently broke the 20,000 barrier and could be embarking on a third leg in an eight-year-old bull market? Rising yields may be signaling the end of a 30-year bond bull. Inflation expectations embedded in inflation-indexed Treasury inflation-protected (TIP) bonds are nearing their highest level since at least the 1990s. While most anticipate continued strength in the U.S. dollar, its two-year sideways trading range could alternatively suggest a peak? Finally, the price of crude oil, while clearly bottoming from its vicious collapse a couple years ago, now threatens to again surpass $60.

This note highlights several contemporary trends across the stock, bond, currency and commodity markets that could soon breach important milestones. With so many financial markets on the cusp, investor perceptions and portfolio actions could be abruptly altered this year.

A third leg for the bull market?

As illustrated in Chart 1, the stock market has enjoyed two sustained advances so far in this bull market. The initial recovery beginning in March 2009 paused between 2010 and 2012 before embarking on another leg lasting until 2014 followed by yet another pause. In both cases, once stock market momentum stalled, investors questioned whether the bull market was ending.

Most recently, after about a two-year pause, the stock market again has reached new highs raising the specter of a third leg for this bull market? That is, the stock market is on the cusp! Investor attitudes and ultimately portfolio actions will be shaped in the months ahead by whether the stock market falls back into its trading range since 2014 or whether the recent upside breach becomes more widely accepted as a third bull market leg?

Chart 1

S&P 500 Composite Stock Price Index

Natural log scale.

Are inflation worries back?

For the last couple decades, investors have worried most about deflation. Recently, however, several factors raise concern about potential inflation risk. The U.S. has finally returned to full employment, the pace of both consumer price and wage inflation has accelerated, commodity prices have risen significantly in the last year, both U.S. and global real economic growth has improved, U.S. fiscal policy seems poised to turn accommodative and global officials continue to employ unconventional and massive monetary policy stimulus. That is, after an eight-year recovery focused primarily on deflation risk, are inflation expectations on the cusp?

Chart 2 illustrates the embedded inflation expectation in 10-year TIP bonds. Currently, bond investor inflation expectations are about 2.05%, up by about 1% in the last year, at the highest level in 28 months and only about 0.5% below the highest inflation expectation in more than 20 years! Perhaps inflation expectations are just moving toward the upper-end of their range since 2002 (i.e., between 2% and about 2.5%). However, investors should consider the reaction across the financial markets should embedded bond market inflation expectations surprisingly rise to the highest levels ever recorded since TIP bonds were introduced in the late-1990s. With wage inflation likely to surpass 3% to 3.5% this year while both headline and core consumer price inflation approach 3%, it would not be shocking to experience a mini-inflation panic pushing inflation expectations to new highs above 2.75%.

How would the Federal Reserve respond if inflation expectations suddenly reached 20-year highs? Would wage demands accelerate? How much agitation would this cause among bond vigilantes? What would it mean for the U.S. dollar, commodity prices and defensive versus cyclical stocks? After nearly two decades of chronic deflation worries, suggesting the possibility of a spike in inflation expectations seems absurd. However, a 0.5% to 0.75% increase in inflation expectations this year is not unrealistic in a fully employed U.S. economy whose growth rate is accelerating after a multi-year period of artificially pegged and extremely low interest rates and massive monetary stimulus. This year, therefore, "inflation expectations on the cusp" represent both a risk and an opportunity for investors.

Is the bond bull over?

The 10-year U.S. bond yield has risen by about 1.25% since last summer and is essentially unchanged since late 2008. Most importantly, as illustrated in Chart 3, the U.S. bond market is "on the cusp" of breaching a 30-year bull market trendline!

Chart 2

Bond investor inflation expectation*

*10-year inflation expectation embedded in the 10-year inflation protected Treasury (TIP) bond yield.

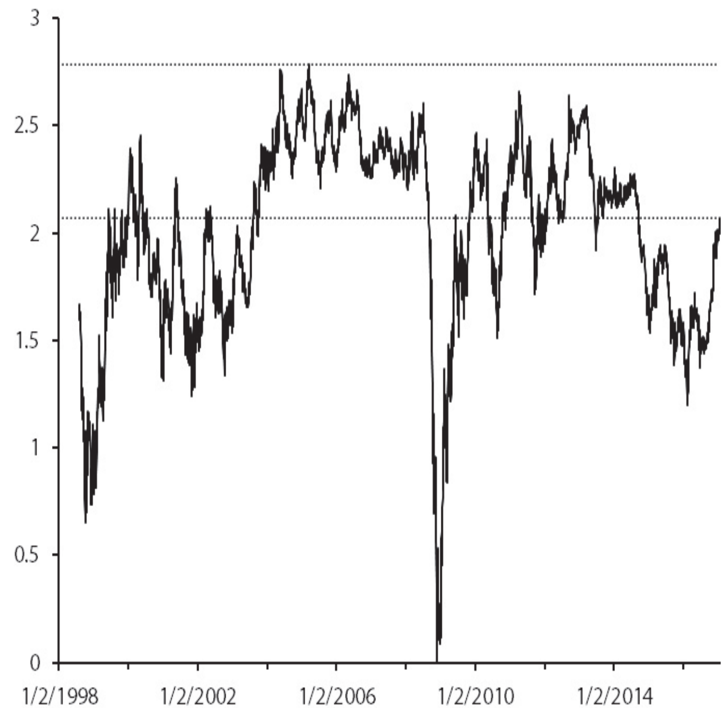


Chart 3

10-year U.S. Treasury bond yield

Even a relatively modest rise of about 50 basis points would be enough to push the 10-year yield to 3% and breach its 30-year downward sloping trendline. Moreover, by rising to just 3.5% (i.e., by simply returning to where the bond yield was in 2010 and 2011), it would exceed its trendline by more than anytime during the entire 30-year bond market bull!

The bond market is definitely on the cusp. How will investors react should yields clearly breach the 30-year trendline and broadly convince most that the great bond bull has ended?

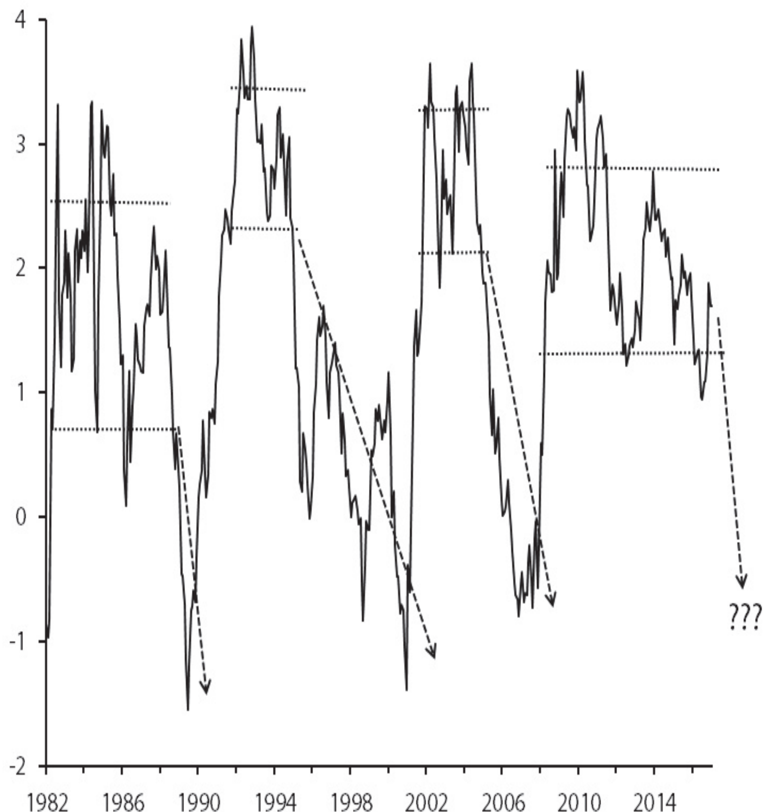
Yield curve "on the cusp" of flattening?

A positively-sloped yield curve has been a staple of this recovery. However, as illustrated in Chart 4, the curve appears to be on the cusp of flattening. Ultimately, a flatter yield curve signals the beginning of the end of an economic recovery. Will we start this process in 2017? How would this change the character of the yield curve alter stock and bond strategies and impact recession anxieties?

Chart 4

U.S. yield curve*

*10-year U.S. Treasury yield less target federal funds rate.



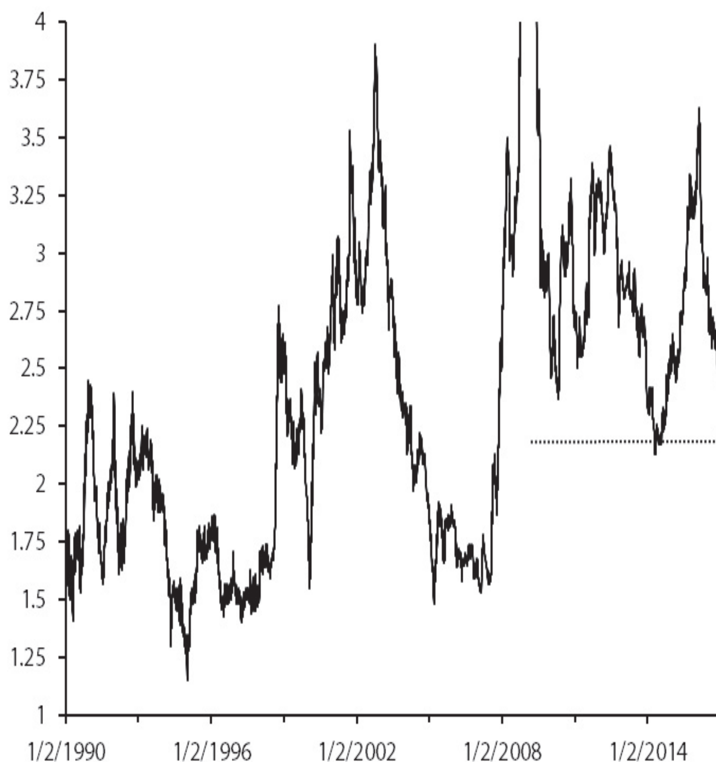
Yield spreads "on the cusp" of recovery tights?

Investment grade yield spreads (Chart 5) have narrowed from almost recovery wides to recovery tights just in the last year. Currently, they are on the cusp of narrowing to new record recovery tights. If the Moodys Baa bond yield spread does reach new narrows below 2.25%, will investors begin to eye the 1.5% spread levels reached in each of the last two recoveries? Or, will this breach of the recovery spread range be met with increasing anxieties that corporate bonds are getting richly priced and increasingly signal rising risk?

Chart 5

Investment grade U.S. bond yield spread*

*Moodys Baa bond yield less 10-year Treasury bond yield.



Will U.S. dollar break a two-year trading range?

Although the trade-weighted U.S. Dollar index (Chart 6) has risen by about 8% from its low last spring, it currently remains at the upper end of a sideways trading range which has been evident since early 2015. The question for 2017 is whether this trading range is simply a pause in an ongoing advance or whether it represents a peaking of the

U.S. dollar after its strong rise during 2014? That is, the U.S. dollar is on the cusp and our guess is it will surprise the consensus this year by breaking to the downside.

Primarily because the Federal Reserve has finally begun to raise interest rates, most expect the dollar to rise this year. However, the Fed is beginning to hike interest rates, as they usually do, because of heightened inflation risk. And, as illustrated in Chart 7, higher inflation often tends to erode the value of the U.S. dollar. It overlays the U.S. dollar index with investor inflation expectations (dotted line shown on an inverse scale). During this recovery, major U.S. dollar movements have been closely correlated (inversely) with changes in expected inflation.

When the U.S. dollar surged in 2014, it was not because the Fed raised the funds rate (it was unchanged during this period). Rather, it was due to a significant decline in inflation expectations from about 2.5% to about 1.2%. Since late last year, the U.S. dollar has continued to climb even though inflation expectations have worsened resulting in the large gap shown in Chart 7. We expect inflation expectations to rise further this year and eventually force the dollar to break lower.

How will the Federal Reserve and stock and bond investors react to a dollar on the cusp perhaps breaking in an unexpected direction (down)?

Commodity markets on the cusp?

In the last year, commodity prices (Charts 8 and 9) have been recovering from a collapse during 2014 and 2015. Oil prices have nearly doubled from their lows in early 2016 but still remain almost 50% lower than their peak in 2014. Industrial commodity prices have recovered by more than 25% since late-2015 and now are less than 10% below their 2014 peak.

Both oil and industrial prices are on the cusp of breaching significant levels which could capture the attention of investors this year. The price of oil has remained below $60 for the last two years. Currently, at about $54, the price of WTI crude oil would gain considerable attention if it finally breaks into the $60s. Likewise, as shown in Chart 9, industrial commodity prices have recently recovered back to the lower end of a trading range evident prior to 2015. Moreover, industrial commodity prices are now only about 10% below their highest level in more than six years!

If the price of crude oil soon trades with a six-handle while industrial prices near a six-year high, inflation and interest rate expectations are likely to be adjusted upward.

Chart 6

U.S. Major World Currency Index (DXY Index)

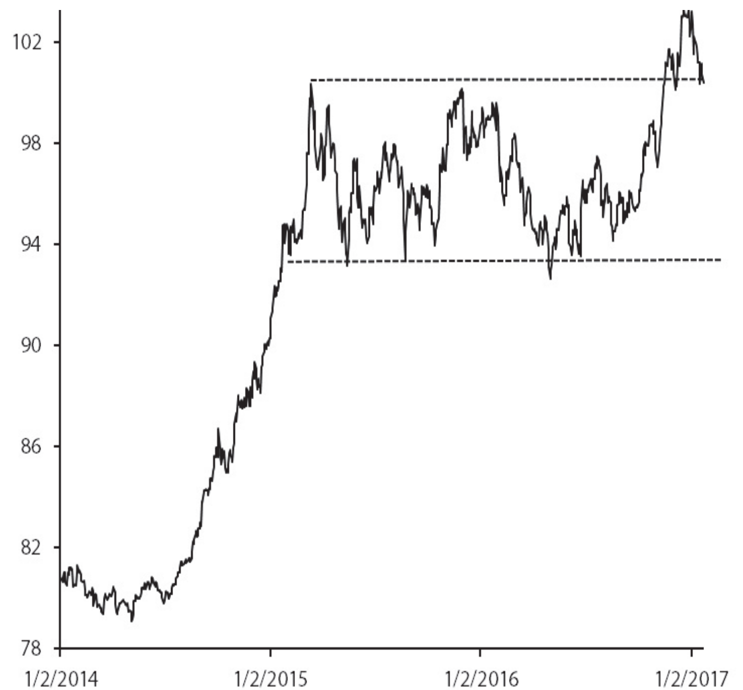


Chart 7

U.S. dollar and inflation expectation

Solid (left scale) — U.S. Dollar Major World Currency Index (DXY Index).

Dotted (inverted, right scale) — Embedded inflation expectation in 10-year U.S. Treasury TIP bond.

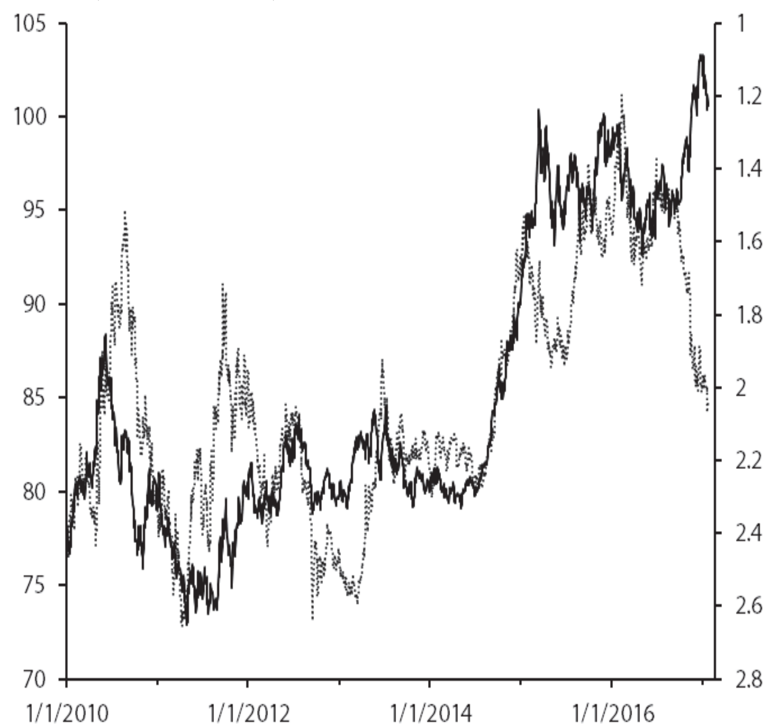


Chart 8

WTI crude oil price

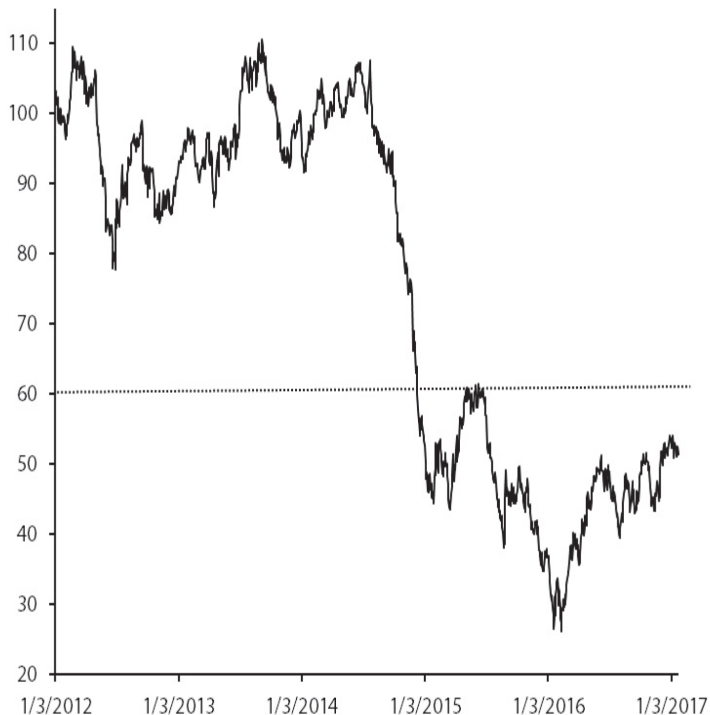
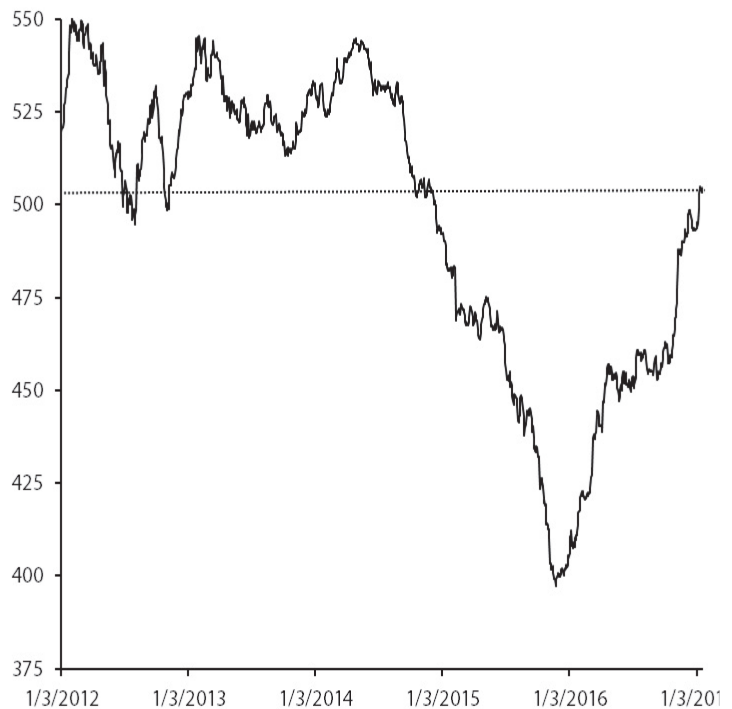


Chart 9

CRB Raw Industrial Commodity Price Index



Equity leadership on the cusp?

Recently, leadership in the stock market has shifted toward risk-on investments and away from conservative equities. Charts 10, 11 and 12 illustrate the relative performance of cyclical stocks, low volatility stocks and small capitalization stocks.

As shown in Charts 10 and 11, between the end of 2013 until last summer, defensive sectors dominated the leadership of the stock market. Between the end of 2013 and July 2016, the total return of the S&P 500 Low Volatility Index outpaced the overall S&P 500 Index by more than 16%! During the same time, the relative price performance of U.S. economically-cyclical stocks (Chart 10) underperformed the overall S&P 500 Index by about 13%. Similarly, between September 2013 and February 2016, the relative total return of small cap stocks (Chart 12) underperformed the overall large cap S&P 500 Index by almost 14%. By contrast, since last summer, those stocks most sensitive to the economy and small cap stocks have significantly outpaced while conservative low volatility stocks have trailed the overall market.

Not only has leadership in the stock market recently changed, but risk-off versus risk-on stock market leadership is on the cusp of breaching some significant milestones. Chart 10 shows the relative price of cyclical stocks is less than 7% from a new high for this recovery whereas low volatility stocks relative total return performance (Chart 11) is only about 7% above a new recovery low! Finally, as shown in Chart 12, small cap stocks only need to outpace the S&P 500 Index by about 10% for their relative total return index to breach an all-time record high surpassing the current record high reached in 1984!

In 2017, could the relative performance of risk-on equity investments (i.e., economically-sensitive, high beta and small cap) break to new recovery highs? And, how would investors perceive a broad-based and increasingly persistent show of positive leadership momentum among the more aggressive parts of the stock market?

Chart 10

U.S. economic cyclical stocks*
Relative price performance
*MS Cyclical Stock Price Index prior to 1/31/2013 and FTSE U.S. Cyclical Stock Price Index thereafter. Both relative to the S&P 500 stock price.

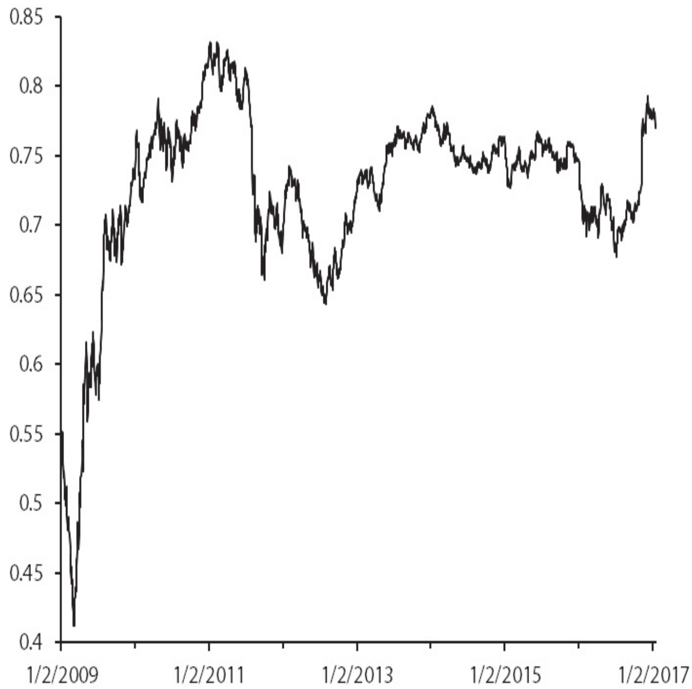


Chart 11

U.S. low volatility stocks*
Relative total return performance
*S&P 500 Low Volatility Total Return Index divided by S&P 500 Composite Total Return Index.

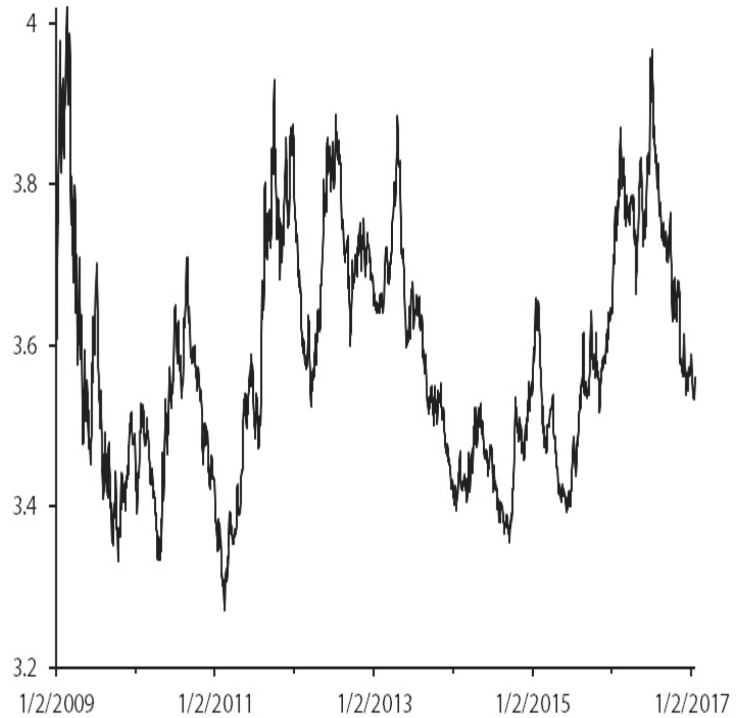


Chart 12

Small cap versus large cap stocks*
Relative total return performance

Summary

Trends matter, for among other reasons, because they impact the impressions, expectations and actions of policy officials, investors, consumers and businesses. For this reason, we think investors should be aware of just how many financial market trends are on the cusp this year threatening to breach significant milestones.

Undoubtedly, not all of the trends we highlighted will actually break new ground this year and perhaps none will reach levels that draw much investor focus. However, in 2017, the following list of financial market trends are worth monitoring because they are "on the cusp"…

1. Evidence of inflation is broadening and inflation expectations embedded in the 10-year Treasury TIP bond is only about 0.5% below the highest level in at least 20 years.

2. Three major themes are on the cusp in the U.S. stock market. First, is the recent breach of a two-year old trading range in the S&P 500 Index to a new recovery high possibly suggesting a third leg in this bull market? Second, the relative total return performance of conservative investments is nearing its lowest level of the entire recovery. And finally, the relative performance of small cap stocks is within 10% of rising to a new all-time record high relative to large cap stocks.

3. Bond investors face several important trends on the cusp including the potential end of a 30-year bond bull, a flatter Treasury yield curve and investment grade yield spreads about to reach new narrows for the recovery.

4. The U.S. dollar is in a two-year old trading range which, with a break, will settle whether this is just a pause in an ongoing dollar bull market or the start of a fresh dollar bear market.

5. In the commodity markets, crude oil is on the cusp of breaking out of a two-year old trading range above $60 and industrial commodity prices are within 10% of rising to a new six-year high.

So far, this year has been dominated by political news and what it means for future economic and regulatory policies. Perhaps, however, in a year with so much on the cusp, investor mindsets will eventually become more impacted by financial market trends breaking outside old recovery trading ranges?

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.

Wells Fargo Asset Management (WFAM) is a trade name used by the asset management businesses of Wells Fargo & Company. WFAM includes but is not limited to Analytic Investors, LLC; ECM Asset Management Ltd.; First International Advisors, LLC; Galliard Capital Management, Inc.; Golden Capital Management, LLC; The Rock Creek Group, LP; Wells Capital Management Inc.; Wells Fargo Asset Management Luxembourg S.A.; Wells Fargo Funds Distributor, LLC; and Wells Fargo Funds Management, LLC.

Wells Fargo Securities International Limited, First International Advisors, and ECM Asset Management Limited are authorized and regulated by the U.K. Financial Conduct Authority. First International Advisors and ECM Asset Management are also registered with the Securities and Exchange Commission in the U.S.

Wells Capital Management (WellsCap) is a registered investment adviser and a wholly owned subsidiary of Wells Fargo Bank, N.A. WellsCap provides investment management services for a variety of institutions. The views expressed are those of the author at the time of writing and are subject to change. This material has been distributed for educational/informational purposes only, and should not be considered as investment advice or a recommendation for any particular security, strategy or investment product. The material is based upon information we consider reliable, but its accuracy and completeness cannot be guaranteed. Past performance is not a guarantee of future returns. As with any investment vehicle, there is a potential for profit as well as the possibility of loss. For additional information on Wells Capital Management and its advisory services, please view our web site at www.wellscap.com, or refer to our Form ADV Part II, which is available upon request by calling 415.396.8000.

Wells Capital Management, Inc. | 525 Market Street | San Francisco, California 94105