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Economic and Market Perspective

January 18, 2017 | Bringing you national and global economic trends for more than 30 years

A Unique Constellation of Confidence!

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This short note highlights a pictorial illustration of a unique (for this economic recovery) constellation of CONFIDENCE! Charts 1, 2 and 3 show measures of confidence among investors, businesses and consumers during the last 30 years. Each shows the monthly confidence level as a percentile ranking since 1987. The percentile ranking runs from 0% (lowest confidence reading) to 100% (highest confidence reading). Recently, confidence among major private players in the U.S. economy has simultaneously surged to some of its highest levels of the last 30 years!

Chart 4 is an average of these three confidence indexes and represents a proxy for overall private sector confidence. Currently, this measure of economy-wide confidence is in the 90th percentile. That is, confidence among investors, businesses and consumers has only been higher than it is today 10% of the time since 1987. Are the recent gains in confidence sustainable and what are the implications for the rest of this recovery?

Many attribute the surge in confidence to the unexpected victory of President-elect Donald Trump in November. While this surprising election outcome certainly appears to have boosted economic confidence, we believe the underlying foundation for its dramatic improvement is due to a confluence of favorable factors far beyond the election including:

1. U.S. economic growth accelerated! After a year of sub-2% real growth and relatively subdued annual growth for almost two years, U.S. real gross domestic product (GDP) growth jumped to 3.5% in the third quarter and is on pace to do 2.8% in the fourth quarter according to the current Atlanta Fed GDP Now estimate.

2. The U.S. economic recovery finally reached Middle America and Main Street, USA! Real median income, after declining during most of this recovery, surged in 2015 illustrating that this recovery has finally broadened to include most parts of the economy. Perhaps this reflects that in the last 12 to 18 months, the U.S. has finally returned to some semblance of full employment (sustained regular job creation, low unemployment, less layoffs and rising wage gains).

3. For the first time, the global economic recovery has broadened and synchronized! During the last couple years, economic policies nearly everywhere have been harmonized as most have adopted “Ben Bernanke Stimulus” (e.g., expanding central bank balance sheets and pushing yields to record low levels) leading to a synchronized pickup in economic recoveries around the world. The Citigroup global economic surprise index recently surged to its highest level in more than six years.

4. A refresh and restart of the earnings cycle! After declining for more than a year, annual S&P 500 profit growth finally returned to expansion in the third quarter!

5. Global deflation (and fears of a deflationary abyss) is finally easing! The SPGSCI Commodity Price Index has risen by almost 50% in the last year and industrial commodity prices (those most sensitive to economic growth) are up by more than 25% from recent lows. U.S. wage inflation has risen to a recovery high 2.9% and core producer and consumer price inflation rates are also close to recovery cycle highs. Finally, the 10-year inflation expectation embedded in 10-year inflation-protected TIP bonds has risen from a low near 1.2% last year to slightly more than 2% today.

6. The global manufacturing recession evident in the last couple years has ended! Across the globe, manufacturing ISM reports show most of the world is seeing a renewed manufacturing recovery.

7. Yields are finally moving back above zero around the world! Negative yields significantly damaged confidence in the last couple years whereas today it is being resurrected as sovereign yields lift above zero again.

8. The U.S. Federal Reserve has begun to normalize monetary policy! Even the U.S. Fed is finally showing confidence that the 2008 crisis has passed.

9. Finally, the U.S. elected a pro-biz president promising less regulations and lower corporate taxes!

This is an impressive list of positives, which for the first time in this recovery may be juicing animal spirits. The question is whether this surge in confidence is sustainable?

Chart 1

***Percentile ranking of U.S. investor confidence since 1987.** Conference Board's consumer expectation stocks rise less consumer expectation stocks decline.

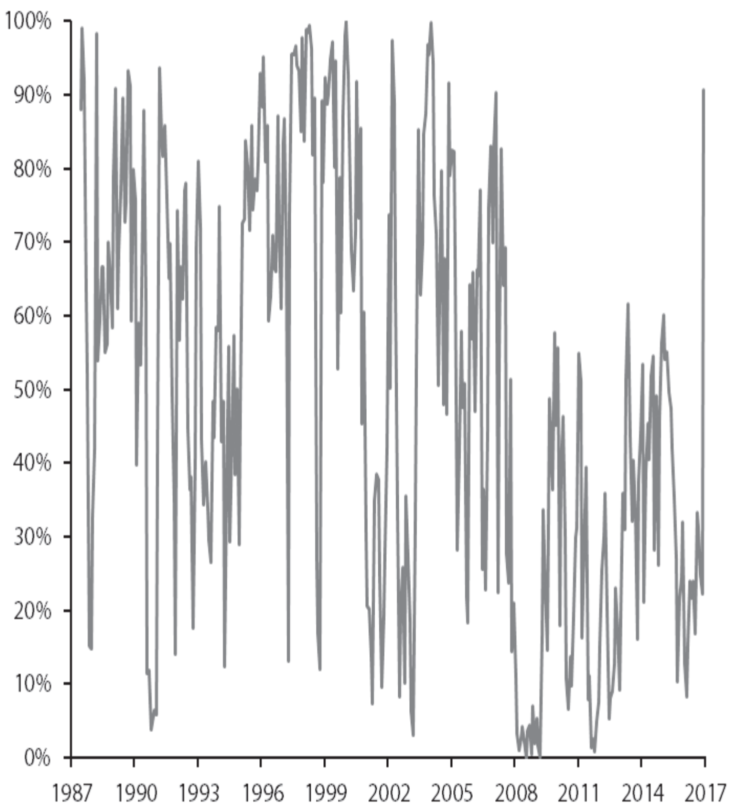


Chart 2

***Percentile ranking of NFIB Small Business Optimism Index since 1987.**

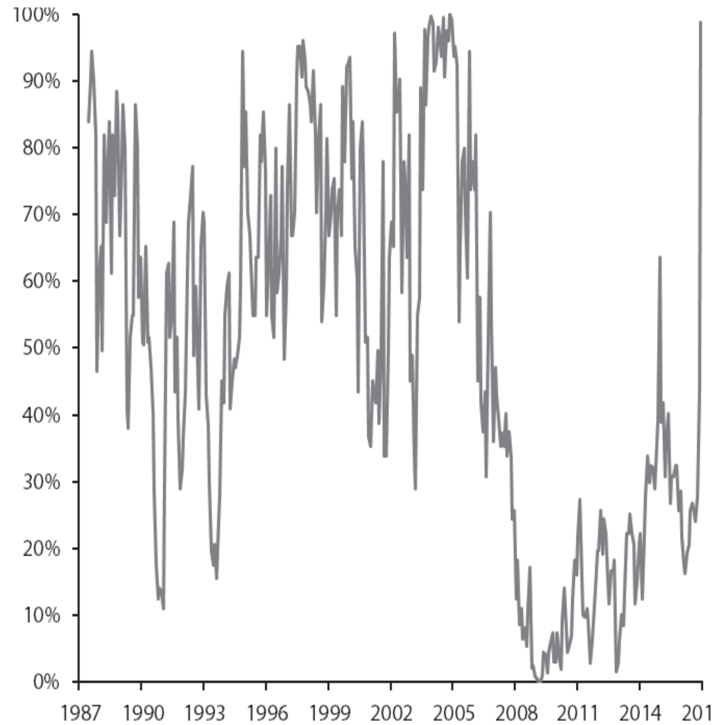


Chart 3

***Percentile ranking of Conference Board's Consumer Confidence Index since 1987.**

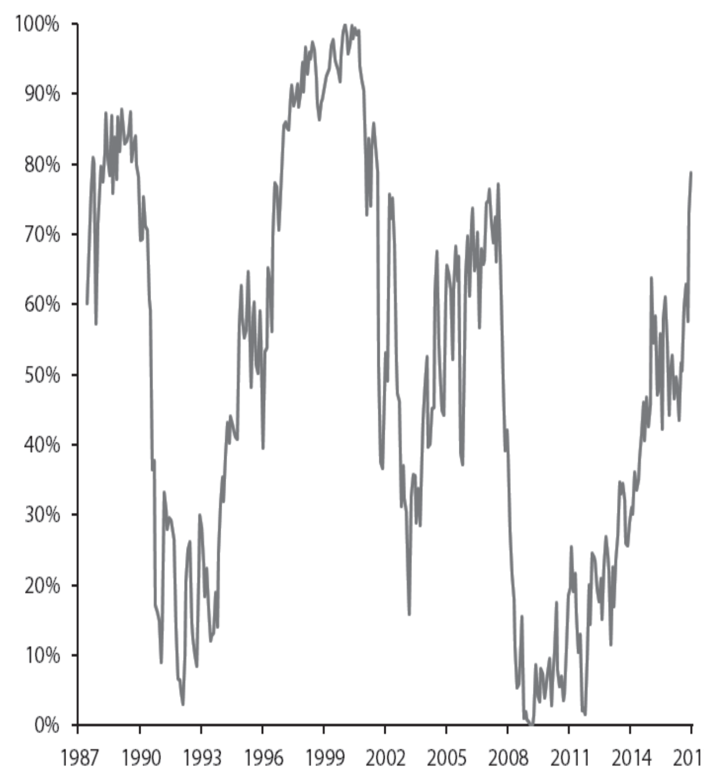
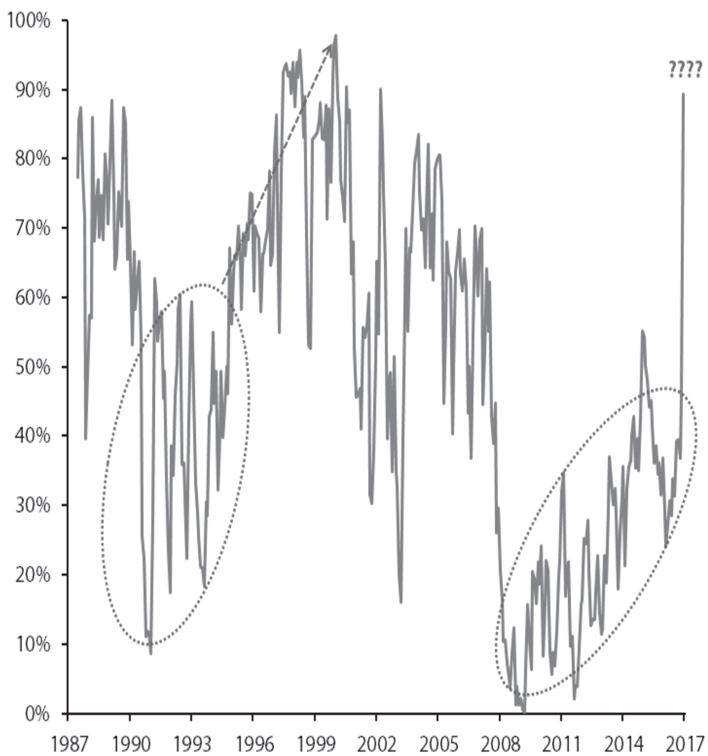


Chart 4 shows that until the last few months, the U.S. has spent the entire recovery with a below average (i.e., below the 50th percentile) private player confidence level. This is similar to what happened during the first half of the 1990s recovery but confidence surged in 1995 and remained strong during the balance of the 1990s. That is, in the 1990s, the economic recovery enjoyed a second leg with much stronger confidence among its private players. Is this happening again in the contemporary recovery?

Chart 4

U.S. private player confidence*.
*Average percentile ranking since 1987 of U.S. Investor, Consumer and Business Confidence Indexes.



Because of persistently low confidence, this recovery has been without any animal spirit behaviors. It has never been driven by solid lending or borrowing, it has never produced a major capital spending cycle, a significant housing boom or been led by a dramatic public investment run into the stock market. However, could the recent widespread jump in confidence be signaling the beginning of a second leg in this recovery? A leg similar in character (but not as robust) to the late-1990s whereby confident economic behaviors and optimism about the future is much more prevalent? Undoubtedly, the confidence measures shown in Charts 1, 2 and 3 will ebb and flow during the rest of this recovery.

Indeed, both investor and business confidence have probably spurted to unsustainable levels recently. Although both may decline somewhat again, given the impressive confluence of factors (shown above) which have recently formed to provide a foundation for this renewed optimism, it seems possible that overall private player confidence might remain much stronger during the balance of this recovery.

Investors may want to ruminate a bit on whether they are prepared and positioned for a potential second "confidence-driven leg" to this economic and financial market recovery?

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.

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