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Fundamental or farce?

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

As the stock market roars ahead to new record highs, investors are becoming increasingly anxious about the so called "Trump Rally". Indeed, the S&P 500 Index has risen almost 12% from its pre-election low last November. Is this a sustainable move due to improving fundamentals? Or, does it simply represent overzealous optimism surrounding Trump campaign promises (i.e., less regulations, tax cuts, fiscal infrastructure spending), which if dashed could make the recent rally a farce?

Given how far and how fast the stock market has recently risen, it would not be surprising to see stocks pause or suffer a mild correction in the next couple of months. However, the enclosed chart is a good reminder for investors that this rally appears much more fundamentally based than most perceive. It compares the S&P 500 Stock Price Index with a U.S. economic fundamental indictor widely used to assess economic momentum. The dotted line is a ratio of industrial commodity prices divided by initial weekly jobless claims. A rise in this ratio signify periods of improving economic and earnings growth. And, as illustrated in the chart, at least since 2000, this economic fundamental indicator has had a very close relationship with the U.S. stock market.

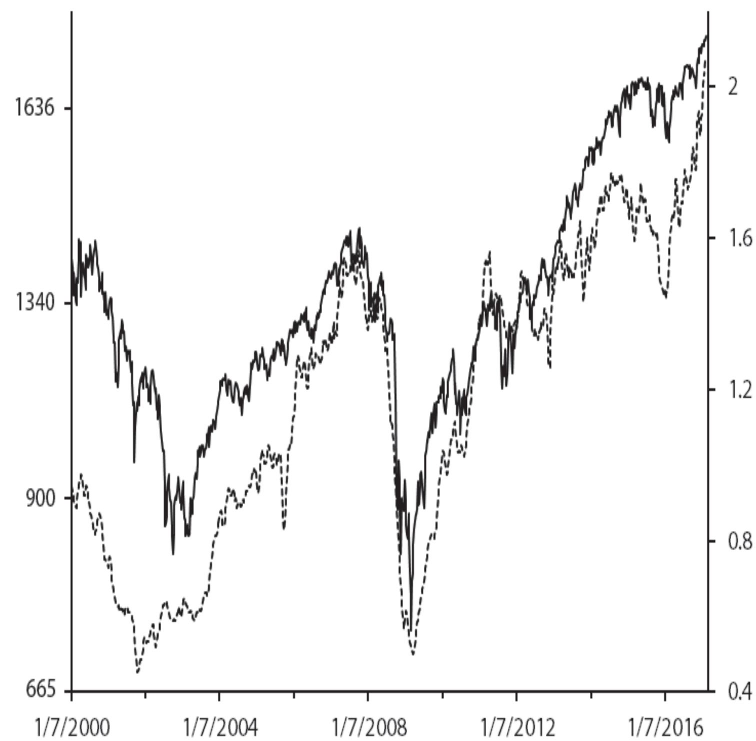
Except for when the U.S. first exited the 2008-2009 recession, the fundamental indicator has risen more in the last year than at any other time in this recovery. Moreover, about half of its advance during the last year has occurred since the presidential election. Accordingly, the strong stock market rally in the last year and since the election appears to be driven primarily by impressive improvement in economic and earnings momentum. Although a temporary pause or pullback at some point seems likely, the current stock market rally does appear to be on a much more solid fundamental foundation than most currently believe.

Chart 1

U.S. stock market versus U.S. economic fundamental indicator

Solid (left scale) — S&P 500 Composite Stock Price Index, natural log scale.

Dotted (right scale) — Ratio of CRB Raw Industrial Commodity Price Index divided by initial weekly unemployment claims, four-week moving average.



Finally, the fundamental indicator has not yet peaked suggesting a correction is not imminent. As shown in the chart, often economic momentum has stalled before stock market rallies pause. For example, the economic indicator peaked in April 2000 and the stock market did not suffer any sustained decline until September 2000. Likewise, the economic indicator peaked in August 2014 and although volatile, the S&P 500 continued to new highs and did not suffer a sustained decline until August 2015.

Who knows when the current stock market rally will pause? However, investors should take comfort in the fact that fundamental economic improvements and not simply Trump expectations have been providing buoyancy for the current stock market run. That is, this rally appears more fundamental than farce!

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.