

THE MARKET AND THE ECONOMY

One of the astute market and economic minds in our industry is James W. Paulsen Ph.D. who is the Chief Investment Strategist at Wells Capital Management, a wholly owned subsidiary of Wells Fargo Bank. His comments below are worth considering in this quarters Review and Outlook.

For some time, most have expected a significant economic slowdown, a substantial correction in the stock market, a final end to Fed tightening and the start of an easing campaign. Many traditional leading indicators of the economy have long been flashing yellow suggesting dire conditions lie ahead. Although both the housing and auto industries collapsed last year, the overall economy remains quite healthy. Indeed, real GDP growth actually accelerated slightly to 3.3 percent in 2006. Helped by the better than expected February jobs report, consensus estimates on first quarter real GDP growth are around 3 percent. Despite the recent sell-off, stock markets about the globe remain close to all-time record highs, corporate profits continue an amazing story of out-performance, consumer resiliency is still in tack, both the housing and auto industries are exhibiting signs of bottoming, and expectations of imminent Fed easing have mostly vanished. Globally, emerging economy growth remains spectacular (e.g., booming conditions in China, India and Mexico) and real GDP growth is accelerating in both Europe and Japan.

Conventional leading economic indicators, have not worked well in this recovery. For almost two years, they have persistently suggested a broad-based, major economic slowdown or recession which simply hasn't occurred. True, the auto and housing industries did collapse last year, but these two sectors only comprise a very small portion of the overall economy (less than 10 percent of real GDP) and the vast majority of U.S. real GDP remains quite healthy. We believe there are other forces, unique to the contemporary recovery, which are proving more important than conventional indicators and which are dominating and shaping the economic and financial character.

Traditional Indicators Suggest Caution!??!

Several widely trusted economic indicators have been and continue to suggest a significant slowdown or even recession. First, the recovery is now in its sixth year—long by historic standards. Second, the Federal Reserve has been increasing interest rates for almost three years with seventeen hikes by a total of 4.25 percent! Third, the treasury yield curve has been flat for much of the last two years and has been inverted for about one year! Fourth, debt service loads facing the household sector remain near record levels while the savings rate has turned negative! Finally, energy prices, have soared in this recovery.

Based on historic standards, this is an impressive and frightening list for future economic growth. It is therefore understandable why many long ago turned cautious on the

economy and the stock market. However, despite the housing and auto slowdown, we believe these traditional indicators are not working.

Housing and autos comprise about 9 percent of real GDP and growth in these two sectors contracted by 10 percent last year! Despite this eye-catching contraction however, the rest of real GDP (the remaining 91 percent of the economy) expanded by 4.3 percent. Overall economic growth remains solid, because while housing and autos have suffered a significant collapse, real GDP growth in the rest of the economy has accelerated from about a 2.5 percent growth rate in mid-2004 to its current robust 4.3 percent growth rate (its fastest growth in this recovery). At a time when most believe the economy is weaker and more vulnerable than at any time in this recovery, it is ironic that 91 percent of real GDP is currently growing faster than at any time in this recovery!

Traditional economic forces (e.g., Fed tightening, inverted yield curve, rising oil prices) may well have contributed to the severe collapse in autos and housing. However, these forces cannot explain why 91 percent of real GDP is still growing at 4.3 percent! Why has this much larger part of the economy accelerated to its fastest growth rate of the recovery three years after multiple Fed tightenings, a year after the yield curve has inverted and three years after significantly elevated energy prices? How can more than 90 percent of the economy be expanding this robustly entering the 6th year of the recovery and when the consumer is supposedly strapped with excessive debt burdens and no savings? Why, about the globe, given these traditional contractionary economic forces, do stock markets and non-energy commodity price indexes remain near all-time record highs? Why are stock markets still being led by some of the most cyclical economic sectors like transports and basic materials stocks? Why, if these traditional restrictive economic forces are working, has household job growth risen 1.8 percent in the last year and why does the unemployment rate remain at a recovery cycle low of 4.5 percent? If conditions have been as restrictive as suggested by traditional leading indicators, why is household real disposable income still growing close to 3 percent, why did household net worth recently rise to an all-time record high, why did consumer confidence recently rise to its highest level of the recovery, why are corporate profits coming off yet another double-digit growth quarter, and why do corporate balance sheets remain healthier than at any time since the 1960s?

Certainly, the U.S. economy has its weak spots—i.e., housing and autos and their corollaries like sub-prime lending. Traditional contractionary economic forces probably contributed to the slowdown in these areas of the economy. But traditional forces cannot explain the continued solid performance throughout more than 90 percent of the economy. Why does so much of the economy still show so much resiliency after such a prolonged period of supposedly very restrictive conventional economic forces?

“Exception Forces” Rule!!!

We see four economic forces we believe are driving the unusual character of this recovery. Each of these forces are unique to the contemporary recovery and thereby represent “exceptions” to the traditional cycle. These “exception forces” include: 1) liquidity won’t dry up, 2) bond yields won’t go up, 3) it is the first ever “G-25” global economic recovery and finally, 4) stock prices keep rising but keep getting cheaper!

Liquidity Won’t Dry Up?!?!

Liquidity usually rises during recessions since the economy throws off more as economic activity slows and because the Federal Reserve augments the money supply to ward off recession. Once a recovery emerges however, liquidity typically contracts as the economy utilizes more to finance growth and as the Fed restricts the money supply. By contrast, in the contemporary recovery, liquidity has grown persistently faster than economic growth throughout this decade and continues to accelerate as the recovery enters its sixth year. By our estimates, annual U.S. liquidity growth is currently rising faster than at any time in this recovery and at one of its fastest rates since the early 1980s! By traditional standards, the rate of liquidity growth should of decelerated long ago. Its continued strong growth rate this late in an economic cycle and after such a long period of Fed tightening is simply unprecedented.

The tracks of excess financial liquidity are everywhere! Persistent liquidity growth has fueled global stock markets, kept bond yields low and bond yield spreads tight, produced a global real estate boom, a non-energy commodity price surge, and encouraged stock buybacks, dividend hikes, mergers and acquisitions and surging private equity deals. Excess liquidity also shows evidence of moving beyond financial market prices. The annual rate of core consumer price inflation has risen from a cycle low of 1.1 percent to a current rate of 2.7 percent and wage inflation has increased from a low of 1.5 percent to its current rate over 4 percent. The oddity of massive and persistent excess liquidity is a central force which is keeping this global economic cycle stronger for longer than most had anticipated.

Bond Yields Won’t Go Up?!?!

This is the only recovery in the post-war era which has not produced a rise in long-term bond yields—at least not yet! The current 10-year treasury bond yield at about 4.5 percent remains in the same trading range established since the last recession, and this range represents a four-decade low in long-term borrowing cost. Normally, periods of Fed tightening, inverted yield curves and surging oil prices are associated with rising long-term bond yields. Since bond yields have not risen both the businesses and the household sector probably remain far healthier than they would be normally by this point in the recovery. Moreover, flat long-term bond yields has eliminated one of the most dominant braking mechanisms inherent in past economic cycles.

The “G-7” Recovery Is So Yesterday?!?!

This is no longer your father’s old G-7 global recovery. Rather, it is the first “G-25” global recovery! It is comprised by many more players making it far stronger, more diverse and much more sustainable compared to any recovery in the past 50 years. Currently, even though the U.S. economy has slowed to a 3.3 percent real GDP growth rate, the overall global rate of real GDP growth is still north of 5 percent! This is a remarkable result when only a few years ago most felt the U.S. was the “sole locomotive” for global growth. Not this time! Indeed, in the contemporary recovery, the “rest of the world” may be pulling along the relatively slow growing U.S. economy. China is still growing more than 10 percent, India close to 8 percent and economic growth in both Japan and Europe has recently accelerated. In the new G-25 world, the old mechanics of the “G-7” recovery may no longer apply. What does Indonesia, Malaysia or China care about an inverted yield curve in the U.S.? They don’t. Rather they just keep growing. The “old” contractionary forces may simply no longer work in the new G-25 global recovery.

Stock Market ... Cheapening by Rising?!?!?

In traditional expansions, the stock market eventually stops rising once it becomes too expensive. In this recovery, by contrast, even though stock prices keep rising about the globe, they keep getting cheaper, since earnings have persistently risen even faster! The “chronically cheapening stock market” is unique to the contemporary recovery.

Traditionally, a withering stock market and rising bond yields eventually destroy confidence among both businesses and consumers. And normally after three years of Fed tightening both bond and stock prices would be in the tank. In this cycle, however, bond yields simply haven’t risen and stock markets keep rising since they keep getting cheaper. Even with the recent minor sell-off in February, stock markets about the globe remain very close to all-time highs.

Financial Market Outlook????

Throughout this recovery, financial market leadership has remained remarkably persistent – stocks beat bonds, small cap stocks outpace large cap stocks, cyclical stocks beat more economically-defensive stocks, non-energy commodity prices keep rising as do emerging market stocks, international stocks dominate domestic exposure and interest rates, albeit mildly and irregularly, keep crawling slowly higher. Despite many and frequent calls for an imminent end to this financial market leadership, its character has changed little throughout the recovery. While these leadership trends will continue to ebb and flow, we see no reason to expect a sustainable change soon. Indeed, the character of the financial markets will likely persist for as long as the “exception forces” do not change. For now, we suggest investors relax and ignore all the “chicken little talk.” Instead, stay bullish, stay small cap, stay cyclical, stay international, enjoy the ride, and may the (exception) “Forces” be with you!!!