



# Perspective

## Economic and Market

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### Some Guesses About 2014???

The new year will certainly be characterized by the Federal Reserve finally backing off from its full throttle approach toward the monetary accelerator. However, we also suspect U.S. and global economic growth will quicken more than most anticipate. Stronger economic growth combined with a further tightening in the resource markets (i.e., expect the unemployment rate to decline toward 6% by year-end and for the factory utilization rate to rise above 80% during the year) may lead to a modest rise in the U.S. inflation rate and produce the first “inflation scare/overheat/can the Fed exit fast enough” panic of the recovery. Consequently, the methodical and well-controlled monetary tapering which greets us here at the beginning of the year may turn to a “panic taper” as the year progresses wreaking havoc again in the bond market, creating a volatile but essentially flat stock market and perhaps producing solid returns for commodity investors.

### Could U.S. Nominal GDP Growth Approach 6%?

In the U.S., we expect both real GDP growth and price inflation to accelerate this year. Real GDP growth should reach about 3.5% in 2014. Combined with a rise in the rate of GDP deflator index inflation to about 2.5%, the pace of nominal economic growth may prove the strongest of the recovery close to 6%. Several positive forces should help lift economic growth.

First, the pace of “private sector” real growth is already above 3%. Although overall real economic growth has only been 2% in the last year, excluding the public sector, private real growth has risen by 3.1% in the last year, 3.5% annualized since year-end and by a robust 5% pace in the latest quarter! Therefore, a significant improvement in overall economic growth is forthcoming this year simply because of a smaller decline in the government sector. Since sequester is ending, although public sector spending is not likely to grow much, it also will not likely collapse again as it did in 2013.

Second, both the U.S. and global economic recoveries are broader and more synchronized than at any time in this recovery. For the first time in the U.S., both housing activity and the manufacturing sector are expanding, slow but steady employment gains have led to a chronic decline in the unemployment rate, and consumer confidence is near a five-year high. Slow but synchronized growth is also evident about the globe. Currently, economic growth is positive and accelerating simultaneously in the U.S., Europe, Japan, and among emerging economies. While slow growth continues to characterize the world economy, as we enter 2014, most parts of most economies are finally “growing again” in sharp contrast to the spotty economic record in earlier years of this recovery.

Third, we suspect the new year may finally produce a noticeable improvement in capital spending. The corporate capability to drive a massive investment cycle has been evident throughout this recovery. However, in recent years, when CEOs looked about the globe, they saw a struggling U.S., contractions in both European and Japanese economies, and a significant slowing in emerging economic recoveries, hardly conducive to expanding operations. By contrast, today slow but positive growth is obvious nearly everywhere. In addition, while capacity is still ample, it is beginning to tighten. The labor unemployment rate should decline to about 6% this year and the factory utilization rate should soon breach the 80% level which historically has led to improved capital spending. Finally, throughout this recovery economic growth has been hovering about the widely perceived “stall speed” of about 2%. If real GDP growth finally sustains this year above 3%, corporate animal spirits should begin to awaken.

Fourth, money supply velocity, which has been a chronic contractionary force during this recovery is about to turn supportive for economic growth. The impact of monetary policy is dependent both on how fast the Federal Reserve increases the money supply and on how many times the money supply is turned over during the year with transactions. A single dollar of the money supply will create a dollar of nominal GDP if spent once a year but this same dollar can produce \$4 of GDP if turned over (spent) four times during the year. Thus far, velocity has persistently declined during this recovery reducing if not neutralizing the positive impact of quantitative easing. In a research note we wrote in November (Economic & Market Perspective, November 11, 2013), we made our case for why velocity might begin rising this year. If this occurs, monetary conditions may become more conducive for economic growth even as the Fed tapers its quantitative easing program.

Finally, back in September (Economic & Market Perspective, September 13, 2013) we highlighted several under-appreciated forces which are poised to begin “juicing” economic activity including a recent steepening in the yield curve, much improved balance sheets both in the corporate and household sectors, a near record high homebuyer affordability index, continued low inflation stretching consumer purchasing power, a near record low U.S. broad trade-weighted dollar index within the context of a global recovery which has broadened and synchronized, a unique U.S. energy independence dividend, considerable pent-up demands building over the last decade, and finally, after facing this recovery with near record low consumer confidence, we enter 2014 with the highest household confidence in five years!



# Economic and Market Perspective

2

## Controlled Taper to a “Panic” Taper?

We believe a mini-“inflation/overheat can the Fed exit fast enough” panic will likely come to dominate the 2014 economic and financial market climate. If, overheat fears do eventually grip mindsets, what is now a well-controlled, methodical monetary tapering may quickly become a panic tapering.

After years of worrying over sluggish economic growth, potential problematic deflation and a recovery speed which has been chronically disappointing, it is hard to imagine a cultural mindset worried about inflation or overheated conditions. However, traditionally, years when monetary policy finally turns more restrictive have frequently been volatile and characterized by rising anxieties. Moreover, we believe the U.S. economy is slowly stirring a cocktail of overheated fears.

We enter 2014 with the most massive and unconventional monetary policy ever employed in U.S. history with an incoming Fed chair widely perceived as dovish. The U.S. dollar has been very weak in recent months, short-term interest rates remain near zero, long-term yields are still close to record lows, the unemployment rate will soon have a 6-handle, the factory utilization rate will likely break above 80% in a few months, and the six month average annual wage inflation rate is currently at its highest level of the recovery at about 2.1%. Moreover, after declining in the last couple years, most commodity prices bottomed last summer. The CRB raw industrial commodity price index recently rose to its highest level since April and the Baltic Freight Rate Index has surged higher in recent months. Additionally, the growth rate in the M2 money supply has recently accelerated, the U.S. economy is firing on more cylinders than ever, and its annual growth rate may soon rise to the fastest pace of the recovery. Finally, for the first time, real economic growth is positive and improving simultaneously in the U.S., Europe, Japan, and in the emerging world.

Such an environment may be unremarkable with a consensus who has come to expect weak growth and deflationary pressures. However, it could quickly take on a whole new connotation should monetary velocity surprisingly turn higher for the first time in this recovery (see Economic & Market Perspective, November 11, 2013 for why velocity may turn higher this year). Considering the economy possesses an unprecedented almost \$4 trillion in excess bank reserves, how would an about face in velocity (given the rest of the inflationary cocktail) change the conversation both inside and outside of the Federal Reserve? Wouldn't the controlled taper be abandoned in favor of just “liquidating excess reserves as soon as possible” (i.e., a panic taper)? What would it do to inflation expectations, the U.S. dollar, commodity prices, the price of gold, and wage demands? How high could bond yields rise if concerns suddenly shifted from getting the unemployment rate down to ensuring inflation does not get out of control? What would this cocktail do to the stock market? Would stocks rally on stronger economic growth or would heightened inflation fears and rising yields produce a correction?

Historically, a major change in the direction of monetary policy has seldom been completed in the controlled, linear, methodical, and calm fashion which today the Fed suggest they can accomplish. Rather, the reversal of an unprecedented and massively stimulative monetary policy is likely to be met with some trepidation if not outright panic.

Do not misunderstand. We are not suggesting the economy faces a significant inflation risk next year even if the cocktail combined with rising velocity stirs such fears. Nor are we suggesting real economic growth is set to explode. Currently, we expect only about 3.5% real growth this year—solid, but hardly explosive. While the inflation rate is likely to rise some this year as global growth and velocity increase, a serious imminent inflation problem within the U.S. or about the globe is not very likely. However, we do believe the cocktail which is currently being stirred does increase the likelihood of a serious “fear of inflation” this year. As history has often demonstrated, an actual inflation problem is not required (simply a change in inflation expectations) to cause considerable fluctuations in the financial markets.

## Good Year for Commodities?

Among the three major asset classes (stocks, bonds, and commodities), commodities may provide the best investment results in 2014.

First, value has been restored among most commodity prices as they have underperformed during the last couple years and are no longer over-extended. The “safe-haven” premium embedded in precious metals during the early years of this recovery was dissolved in the last year as evidenced by the price of gold collapsing from almost \$1900 to about \$1200. A year ago many agricultural commodities prices were artificially elevated because of drought conditions which have subsequently been reversed. Industrial prices have weakened along with emerging economic growth in the last couple years and have cheapened considerably from recovery highs. Finally, after surging earlier in the recovery, most energy prices have been range-bound since 2010.

Second, the biggest challenge facing the commodity markets has been spotty and weak global economic growth. In the last couple years, many economies were either still in contraction (Europe and Japan), experiencing a major recovery slowdown (emerging economies), or were growing but only very sluggishly (U.S.). Global economic activity has synchronized and strengthened nearly everywhere as we enter 2014 which should produce a much better year for commodity investors.

Third, global economic activity has broadened and improved at a time when slack in the U.S. resource markets is beginning to lessen. The labor unemployment rate should near 6% during the year and the U.S. factory utilization rate is set to rise above the 80% level which historically has been associated with cost-push pricing pressures.

Fourth, as it has since the summer, we expect the U.S. dollar to weaken further in 2014. A weak U.S. dollar directly drives dollar-based commodity prices higher. It also should improve U.S. net exports,



# Economic and Market Perspective

3

boost U.S. manufacturing activity and increase the domestic demand for commodities.

Fifth, should money velocity rise and a mini overheat/Fed panic emerge, the commodity markets would be primary beneficiaries of such fears. In fact, a position in commodities would provide investors some protection and diversification against any consensus mid-cycle inflation fear.

Sixth, commodity markets are already showing signs of bottoming. Since October, commodity markets are being led by a surge in industrial prices suggesting improved economic growth is starting to favorably impact commodity prices. The CRB raw industrial commodity price has recently risen to its highest level since early April! Moreover, materials stocks are also doing well. The S&P 500 materials sector stock price index has been outpacing the overall stock market sharply since late summer. Finally, the Baltic freight rate index (a measure of the global rates charged to move materials) has surged since last summer suggesting international commerce in commodities is strengthening.

We are not implying commodity prices are returning to the secular advance they made during the last decade. That is probably over. Rather, we simply believe 2014 will prove a cyclical opportunity to profit from commodity investments. Investors may want to consider some allocation to this class if only for diversification purposes.

## Why a Weak U.S. Dollar?

Most expect the U.S. dollar to strengthen as the Fed begins tapering its QE (quantitative easing) program. For several reasons, we suspect the U.S. dollar will surprisingly weaken this year.

First, while QE has been a massive program, it has not noticeably changed the growth of the U.S. money supply. If huge QE additions did not bloat the money supply, why should tapering or even reducing QE balances slow the money supply? And, if the relative growth of the U.S. money supply does not change much vis-à-vis its trading partners, why should ending QE have much impact on exchange rates?

Second, if money velocity begins rising this year, the Fed may not be able to prevent the growth of the money supply from accelerating even if they begin draining QE balances. The biggest monetary surprise this year may be that the money supply accelerates even though the Fed tapers and then reduces its QE program. A rising U.S. money supply (juiced by stronger velocity trends) relative to foreign money supplies would tend to weaken the U.S. dollar.

Third, it is difficult to know how much of a safe-haven premium, if any, has been imbedded in the U.S. dollar during the early part of this recovery and whether it has yet been dissolved. Like gold, we think the value of the U.S. currency has been at least partially elevated by the global economic fears which have persisted since the 2008 crisis. However, as confidence about the sustainability of the global recovery improves, safe-haven premiums are likely to diminish.

Consequently, as confidence about the globe improves, the value of the U.S. dollar may surprisingly weaken.

Finally, we expect changes in relative global economic growth rates to impact the U.S. dollar this year. U.S. real GDP growth will likely rise above 3% this year and in isolation this would strengthen the U.S. dollar. However, most other economies are also experiencing acceleration in their recoveries. And, in most cases, improvements in foreign growth rates are more dramatic and by comparison to the U.S., should lead to a weaker dollar. In both Europe and Japan, economic growth is moving from contraction to expansion, a much more dramatic change than the mild acceleration in growth within the U.S. Similarly, most emerging world economies are finally reaccelerating after slowing dramatically during the last couple years. In our view, even though U.S. economic growth will improve this year, foreign economies will likely enjoy more “dramatic” improvements adding to U.S. dollar weakness.

## Another Year of REPRICING the Bond Market!?

Throughout this recovery, bond yields have been distorted by persistent Armageddon fears and because of the unprecedented quantitative easing policy enacted by the Federal Reserve. Both have kept yields below normal equilibrium levels which would more appropriately reflect a sustainable economic recovery. Last year, however, the bond market began to normalize because the consensus economic outlook finally “gave up the Armageddon ghost.” As household confidence rose to a five-year high, the 10-year bond yield increased from a low early last year of about 1.5% to about 3%. Although the influence of fear in the bond market is starting to diminish and bond yields are more fittingly reconnecting with the economic cycle, we believe this “repricing process” is only about half way completed. Several factors suggest another difficult year in the bond market as the 10-year Treasury yield may rise to about 4%.

First, historically, the 10-year Treasury yield has traded about 2% to 4% above the annual rate of core consumer price inflation. We expect core consumer inflation to rise above 2% this year, suggesting the 10-year bond yield could rise to about 4% just to reach its normal historic range relative to the cyclical inflation rate.

Second, Treasury yields have also had a close relationship with overall nominal economic activity (i.e., nominal GDP growth). When nominal economic growth was rising on a secular basis (e.g., from WWII until about 1980), the 10-year Treasury bond yield typically averaged about 2% less than the annual rate of nominal GDP growth. Since 1980 however, as nominal GDP growth has been slowing on a secular basis, the 10-year bond yield has traded very close to the annual rate of nominal GDP growth. We expect annual nominal GDP growth to accelerate this year possibly approaching 6% by year-end. Assuming the old relationship between rising nominal GDP growth and Treasury yields rules (i.e., before 1980 when the 10-year yield tended to trade about 2% less than nominal GDP growth), 6% GDP growth would imply a 4% 10-year yield.



# Economic and Market Perspective

Third, as the unemployment rate declines towards 6% this year, we think the rate of wage inflation may finally accelerate modestly. While we do not expect a serious wage inflation problem, any uptick in the annual wage inflation rate to between 2.5% to 3% would likely be met with concern among bond investors adding to the upward pressure on yields.

Finally, it is probably reasonable to assume some turbulence in the bond market this year as the Fed begins to taper. The Fed has sold its tapering process and outlook for interest rate policy as well-controlled, well-communicated, methodical, and linear. However, this is not typically how monetary policy works. Usually, at the point in an economic recovery when the Fed finally moves from accommodation towards a more restrictive policy, the bond market has struggled and often a mini-panic results.

The good news for bond investors is the quicker the bond market is reconnected with the economic recovery, the sooner bonds will once again become a viable investment. That is, unlike today, one with reasonably good value and without excessive risk. If inflation stays well controlled in this recovery (say annual core inflation remains 3% or less for most of this recovery), a 10-year bond yield with a 4-handle may again represent a competitive investment alternative. For now, however, portfolios should be minimally allocated to fixed income, keeping bond duration below average and overweighting yield spread markets (which offer some buffer to a rising yield environment) including international bonds, lower credit quality, and structure plays.

## Stock Market Turbulence in 2014 .... But Long-Term Bull Still has More Left!?!

We expect a volatile but essentially flat year for stocks in 2014, but also believe the bull market is likely to last several more years.

The velocity of the money supply will likely prove the dominant force behind the stock market this year (for a more detailed analysis of the impact of money velocity on the stock market see the Economic and Market Perspective report from November 11, 2013), and historically, when money velocity first rises in a recovery, the stock market typically has been volatile. We expect this may be the case again in 2014.

Usually, a faster turnover of the money supply initially leads to improved economic momentum and a higher stock market. Is this happening now as we begin 2014? Once it becomes obvious velocity has indeed turned up, however, both investors and the Fed begin to worry over potential inflationary fallout. Bond yields adjust higher in anticipation of potentially greater nominal activity and Fed policy is altered appropriately. This rather abrupt change in the landscape, combined with an already extended rise in the stock market leading up to the increase in velocity, forces investors to reassess and ushers in a more difficult period for stocks.

In the post-war era, there have been three major recovery cycles, which like today, saw monetary velocity decline during the first several years of the recovery before finally and surprisingly improving. In each case, the stock market typically did well in the months leading up to the bottom in velocity but often struggled once velocity actually began rising. This occurred in the 1960s recovery, the 1980s recovery, and the early-2000s recovery. In the 1960s recovery, velocity first bottomed in 1965 and the stock market suffered a correction in 1966. Similarly, velocity first bottomed in the 1980s recovery in early-1987 and the stock market collapsed that fall. Finally, velocity first bottomed in 2003 and the stock market was flattish in 2004 (and almost experienced a 10% correction).

In the last year, the S&P 500 index has risen almost 30% and money velocity is still widely perceived as declining. However, economic activity has broadened and strengthened in a manner which may suggest velocity has already begun to improve. U.S. real economic growth clearly appears to be rising above 3% and globally real growth is positive and accelerating simultaneously in the U.S., Europe, Japan, and among emerging world economies.

Moreover, the improving global economic recovery has probably been the primary force driving stock markets higher. However, if velocity is indeed beginning to rise, this positive force may eventually turn negative for the financial markets similar to past velocity recovery cycles. That is, could 2014 rhyme a bit with 1966, 1987, or 2004? If velocity rises, will overheating fears surface, will the Fed focus shift exclusively toward its exit strategy, will the 10-year bond yield surge higher toward 4%, and will the stock market after perhaps rising even higher in the first part of the new year (say to around 2000ish) eventually struggle and maybe suffer a correction before the year is over (ending at about where it started the year around 1800ish)?

How should investors play a volatile but flattish stock market in 2014? While pregnant with possibilities, volatile markets are very difficult to trade profitably. For those who are adventurous, and wish to attempt to benefit from the likely market oscillations, timing will be everything. Our advice is to begin the year overweighting economically sensitive sectors (e.g., materials, industrials, financials, and technology) and if and as the S&P 500 rises toward the 2000 area, if investor optimism/euphoria surges and if the 10-year treasury yield breaks above 3.5%, start to alter equity exposure toward more defensive sectors (e.g., consumer staples, utilities, low beta, and high dividend payers). Good luck!

Another approach is to simply ignore what may prove to be an uninspiring overall stock market year. Focus instead on positioning the portfolio during the year to be appropriately allocated for a renewal of the bull market cycle by 2015. If your current portfolio is out of sync with where you would like to be by this year end, consider investing about one-twelfth of the required shift each month during



# Economic and Market Perspective

5

the year. Perhaps it is best not to stress over 2014 and instead use any market volatility during the year to “average in” toward your desired portfolio headed into next year.

## Longer-Term Stock Market Potential Still Significant!?

Most importantly, investors should avoid getting too cute attempting to time the volatility this year lest they miss what will likely prove only a pause in an ongoing bull market during the next several years. If inflation spirals out of control (not our forecast), the Fed and bond vigilantes would aggressively increase interest rates and prematurely abort both the recovery and the stock market run. However, should inflation remain reasonably contained (e.g., the annual inflation rate remains 4% or less), the economic recovery will most likely last several more years, and while certainly not a straight line, the ultimate peak of the contemporary stock market bull should prove considerably higher.

With only a single exception (1980), U.S. post-war economic recoveries have not ended before the output gap—the percentage difference between current and potential GDP (currently a very wide -3.5%)—has turned positive. Today, excessive resource slack should allow the economy to grow for some time before shortages and cost pressures emerge. Moreover, confidence among most economic players remains too low to produce serious problems. Recessions are typically the result of stupid economic behaviors. Those which result from excessive confidence, if not cockiness, including excessive spending, overusing credit cards and bank borrowings, stretching into high-priced homes, running down savings and over-allocating portfolios into risky investments. Likewise, confidence among businesses leads to overstaffing and overbuilding operations. While economic players are becoming more comfortable than earlier in this recovery, the full-out “animal spirits” behaviors almost always obvious before recoveries end have yet to surface.

For the stock market, like the overall level of economic confidence, valuations remain only slightly above average compared to historic norms. As confidence continues to rise back to traditional recovery peak levels, so will stock market valuations. A numerical example suffices to illustrate remaining potential. Assume in the next five years nominal GDP growth averages about 5% per year (maybe about 3% real and 2% price inflation?) and S&P 500 earnings grow at about the same pace. Currently, trailing S&P 500 earnings per share are about \$106. If they grow about 5% annually in five years, they will be close to \$135. If the recovery persists for the next five years (making the recovery only one year longer than in the 1980s and one year shorter than the 1990s recovery), confidence will rise toward peak levels and so would valuations. Assume the price-earnings multiple rises to a peak of about 21 times. This would imply a target price for the S&P 500 index of about 2800 providing investors an annualized return of slightly more than 10% with dividends!

## Happy 2014!???

This year will likely prove exciting for the stock market. Perhaps the S&P 500 will reach as high as 2000 before succumbing to a correction returning it close to where we begin the year. Isn't it just like the stock market to turn more difficult just as most are finally beginning to return to stocks for the first time in this recovery? While it may be enjoyed by traders or timers, we suspect it will prove quite challenging and frustrating for most investors. Compared to the bond market, though, a flat stock market may represent a safe haven. At 3%, the 10-year Treasury bond yield is still probably about 1% below a fair equilibrium yield which more appropriately reflects the ongoing economic recovery. Finally, a year characterized by overheating/inflation overtones may surprisingly make the commodity markets the best performing investment.

Most importantly perhaps, investors should remain mindful that while 2014 may prove challenging, we are not likely facing a major inflation risk, we will likely survive beyond the Fed beginning to tighten monetary policy and while we may pause in 2014, the stock market probably still offers considerable upside beyond this year.

*Thanks for taking a look!!*  
*DL*



# Economic and Market Perspective

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