WELLS CAPITAL MANAGEMENT

Economic and Market Perspective UPDATE

"Bringing you national and global economic trends for more than 25 years"

July 24, 2012

Baffled???

Many are baffled by a stock market which had a total return through mid-year of about 10 percent and is currently off by only about 6 percent from its recovery high. How is this possible given the contemporary U.S. economic soft patch, widening recession fears, an ongoing European crisis, further slowing in China, uncertainty about the upcoming election, and a looming fiscal cliff? Is the stock market crazily mispricing things and simply ignoring a knowledgeable bond market which appears more appropriately impressed by the challenges? Or, is the stock market—in its invisible hand way—suggesting the underlying fundamentals in the U. S. economy are much healthier than widely perceived?

The U.S. economy is currently growing very slowly. After rising by 3 percent in the fourth quarter, real GDP growth slowed to a pace between 1.5 and 2 percent during the first half of this year. While we expect economic growth to improve some in the second half of this year, what is it about a first half economic performance of sub-2 percent growth which scared bond investors but which seemingly impressed stock investors? Could it be the bond market is more focused on the recovery's "speed" while the stock market is more focused on its "character"?

What follows is a list of 10 aspects surrounding this economic recovery suggesting that even though its pace remains sluggish, its character is today far more mature, more broadly based and therefore far less vulnerable to external shocks than at any time since the recession ended. Could the "baffling stock market" simply be appropriately reflecting an increasingly sustainable recovery?

1. Job Market?

Job creation slowed considerably in the second quarter and more than any other factor has ignited recession fears. We think the pattern of job creation this year has more to do with weather than it does with economics. Unusually mild winter weather across the country artificially overstated first quarter growth and borrowed from (reduced) second quarter results.

Despite the second quarter slowdown in the job numbers, the year-to-date average monthly job gains in both nonfarm payrolls (150,000) and for the household survey (271,000) were among the best six month average job gains of the entire recovery! Moreover, during much of this recovery, many have claimed the unemployment rate was simply declining because individuals were leaving the labor force in frustration. Well, during the first six months of this year, the U.S. labor force rose on average by 213,000 a month—the strongest six month labor force gains of the entire recovery! Finally, despite 213,000 new entrants to the job market each month this year (the best gains of the recovery), the U.S. still managed to lower the unemployment rate by 0.3 percent from 8.5 percent to 8.2 percent!

Somehow, in the last six months, one of the best periods of job gains in the entire recovery combined with the best rise in the labor force and a further decline in the unemployment rate is widely being considered as evidence the job market has stalled. Charts 1, 2, and 3 illustrate just how much the job market has improved in recent months. All three aspects of the job market—total employment, labor force growth, and the unemployment rate—were indeed slow to recover during the first couple years of this recovery. However, as these charts make clear, since last fall, the trajectory of job market improvement is noticeably stronger and represents the best showing of the entire recovery!

Despite the recent (at least somewhat weather distorted) slowdown in employment, the character of the U.S. job market since last fall looks stronger and more sustainable than ever.

Chart 1
Total U.S. Household Employment
In Millions

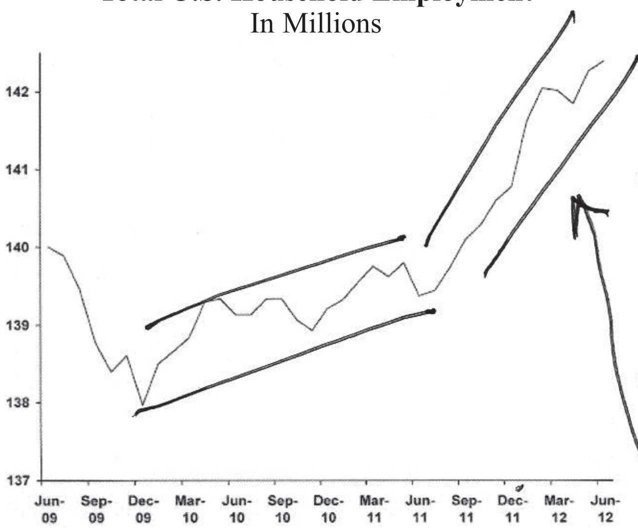
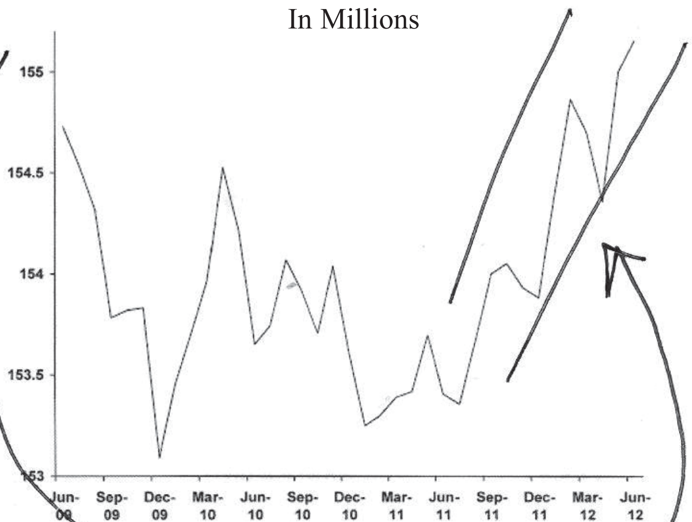
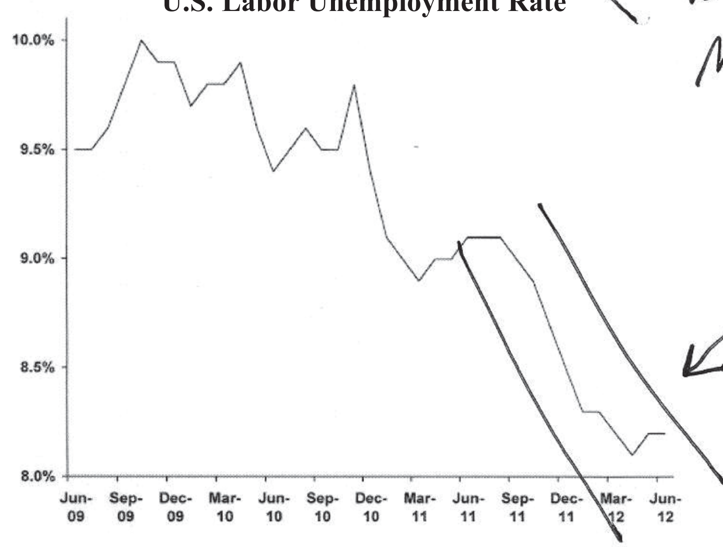


Chart 2
Total U.S. Labor Force
In Millions



"Better" Job Market...
... Not Worse...
... Since Last Fall!!!

Chart 3
U.S. Labor Unemployment Rate

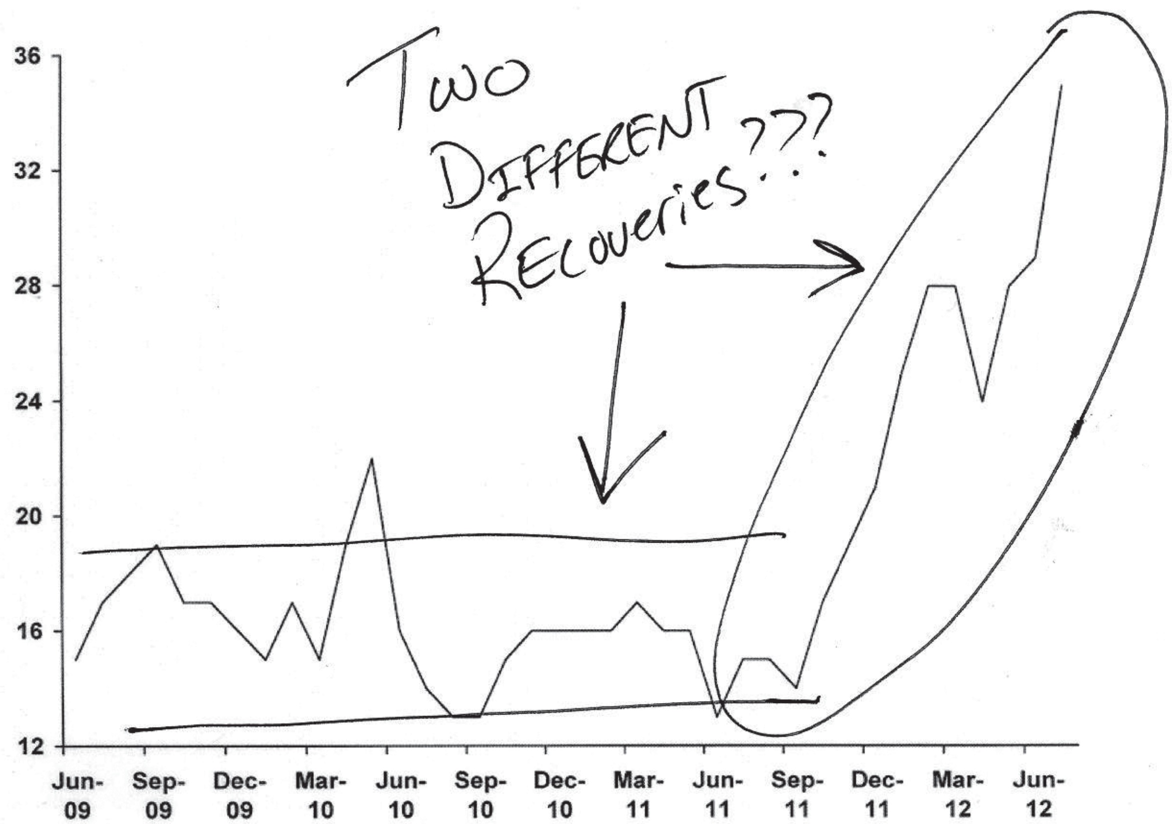


2. Finally...Housing Activity!

For the first time in this recovery, the housing industry has come to life. While still far below historic norms, many housing indicators (housing starts, sales, and permits) have recently exhibited their greatest level of activity of the recovery. Chart 4 illustrates just one such indicator—homebuilder confidence. After being stuck near all-time record lows during the first couple years of this recovery, confidence among homebuilders has surged almost three-fold since last fall.

Unlike any in the post-war era, the contemporary economic recovery has unfolded without the housing industry. This may finally be in the process of changing. Through the first 11 quarters of this recovery, real GDP has managed to rise at an annualized pace of 2.4 percent despite a dysfunctional housing industry. How much will the "character" of this recovery improve (both its speed and its sustainability) as housing now joins the recovery?

Chart 4
National Association of Homebuilders
Market Survey Index



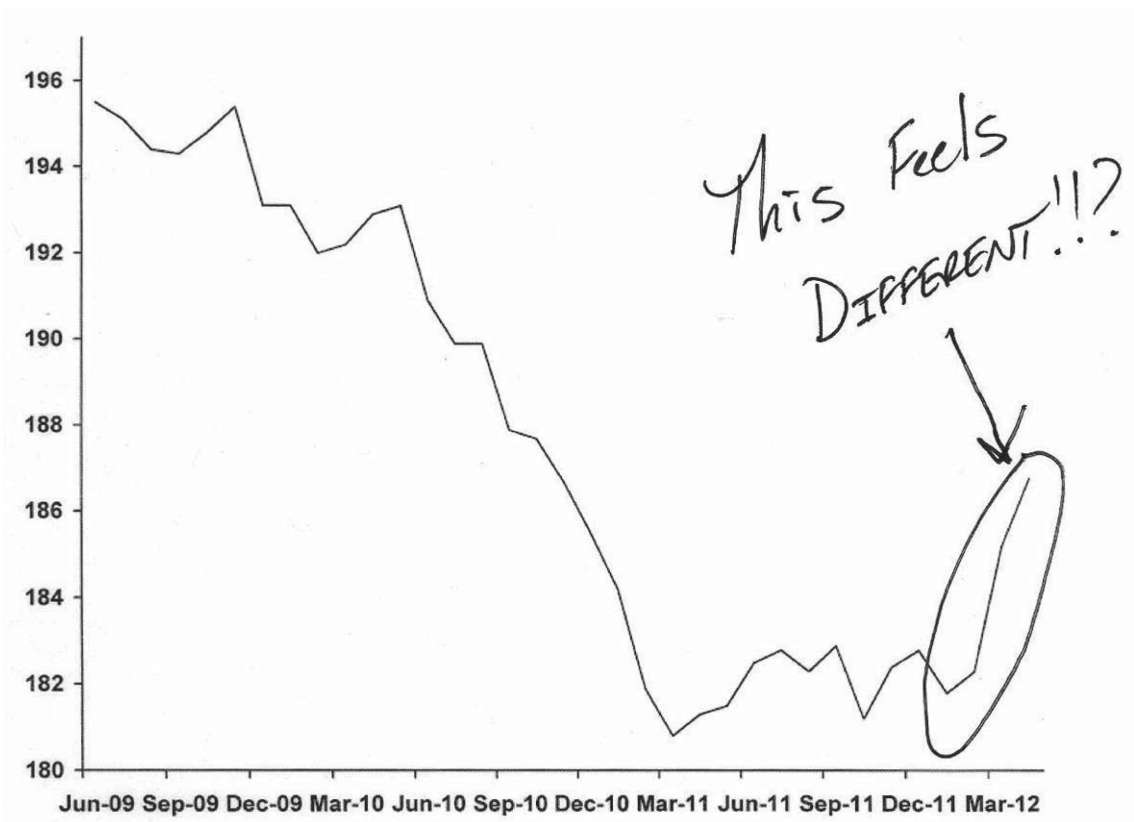
3. Huh....Rising Home Prices?

Declining home prices has perhaps been the biggest obstacle holding back this recovery. For a culture habitually expecting a constant "rise" in house prices (even through recessions), the colossal and persistent decline in the value of U.S. household's biggest asset has been unique, frightening, and likely a major factor keeping consumer confidence depressed.

If this is true, Chart 5 suggests household attitudes may soon become much more aggressive. For the first time since they began declining more than five years ago, home prices seemingly have not only bottomed but are beginning to rise again! This could importantly alter the character of the recovery in several ways. First, rising home prices should help improve confidence throughout the economy as a sense of returning to "normal" emerges. Second, higher home prices will help reverse the loss in net worths so many households experienced in recent years. Third, a rise in prices may allow many homeowners to refinance or exit oppressive mortgages. Fourth, evidence home prices are rising again may bring forth housing demands which are pent-up, patiently waiting for prices to bottom and not wanting to miss "getting in" before prices rise again.

A return to the "normality" of rising home prices should significantly alter the feel of this recovery in a manner which simply has not existed in the last three years.

Chart 5
FHFA U.S. House Price Index



4. Confidence Has Improved This Year!

While most measures of confidence are off from earlier year highs, they remain significantly higher than the declines in confidence which occurred in either the 2010 or 2011 economic soft patches. Indeed, as shown in Chart 6, the Conference Board's Present Situation Consumer Confidence Index is currently near recovery highs at more than 75 percent above its level last fall!

Overall, confidence (while still low by historic standards) is persisting this year near its highest level of the recovery. Perhaps this reflects a job market which is indeed better than widely perceived, the strongest showing yet of improved housing activity, and reports that for the first time in this recovery, home prices are rising. In any event, assessment of present economic conditions (from Chart 5) oscillating this year between 40 and 50 makes the character and vulnerability of the recovery far healthier compared to the last couple years when this confidence index ranged mostly between 20 and 35.

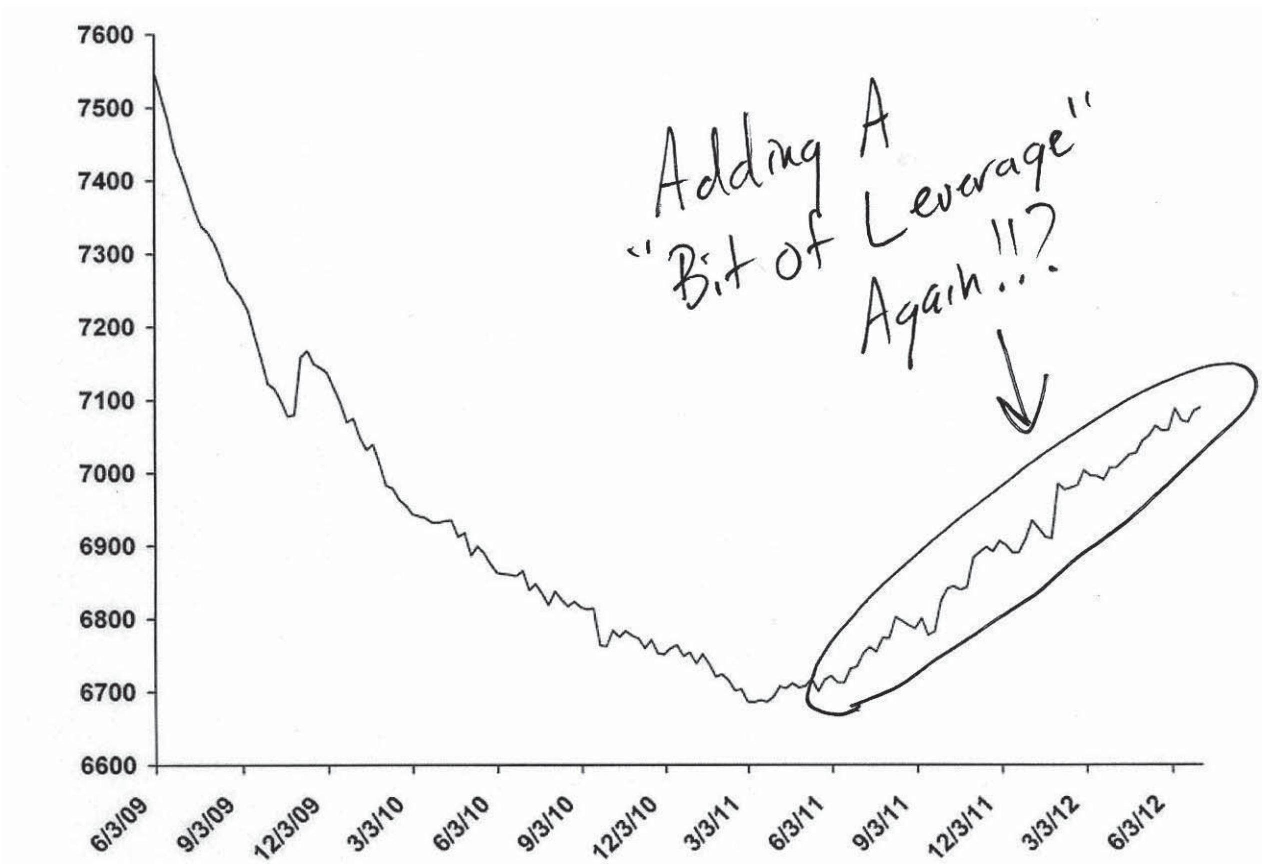
Chart 6
Conference Board Consumer Confidence
Present Situation Index

5. Borrowing & Lending are Now Finally Contributing to This Recovery!

Similar to the housing industry, until about a year ago, credit creation was nonexistent in this recovery. However, as illustrated in Chart 7, after declining until last summer, bank lending has risen steadily in the last year! In addition to bank loans, while mortgage lending is still anemic, consumer credit gains have also steadily increased rising on average by about $13 billion each month this year!

Compared to even a year ago, the recovery has taken on a much more "normal" character. The housing industry is expanding again, home prices are rising again, and finally, the recovery has now added a bit of "leverage" to domestic spending which should quicken the overall pace of growth and improve the sustainability of this recovery.

Chart 7
Total U.S. Bank Loans

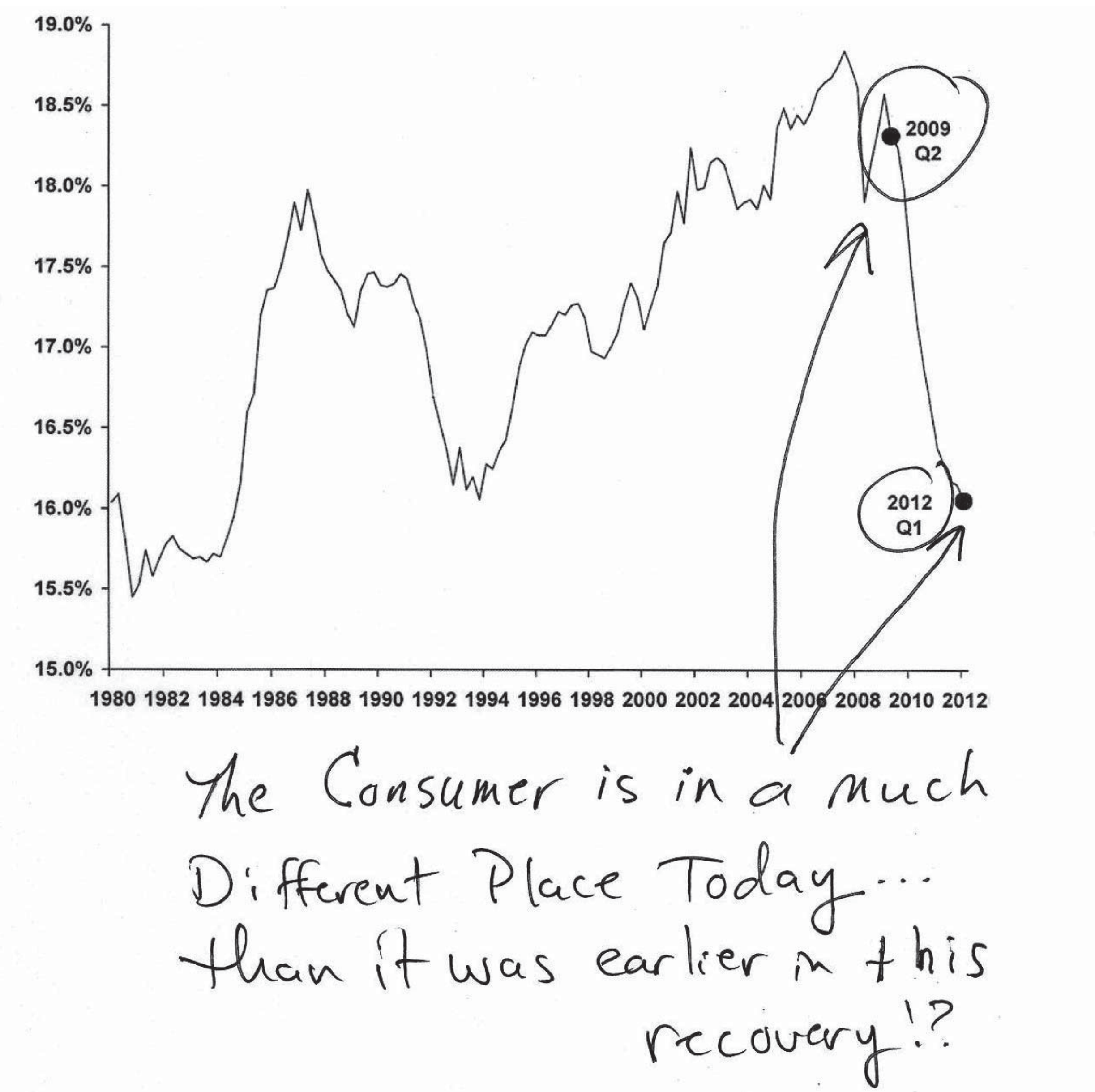


6. The Consumer is No Longer Nearly as Burdened!

As illustrated in Chart 8, when this recovery began in 2009, the U.S. household was stymied by an almost record-setting debt service burden (the financial obligations ratios includes principal and interest payments on debt as well as other regular monthly expenses including lease and rental payments, property taxes, and homeowners' insurance all as a percent of disposable personal income). This burden reached an all-time high in 2007 of almost 19 percent, and was still 17 percent in mid-2010, but is now much closer to a record low at only about 16 percent.

At the start of this recovery, many believed it would take years before U.S. households would improve balance sheets and lessen debt burdens enough to return to "normal." While balance sheet constraints were certainly noticeable in the early years of this recovery, the deleveraging process among U.S. consumers may be nearing an end. Perhaps this is why auto sales have risen from a 12 to 14 million annual rate in the last year, why consumer credit has been steadily rising each month this year, why consumer confidence remains near recovery cycle highs and why home prices are rising again.

Chart 8
U.S. Household Financial Obligations Ratio

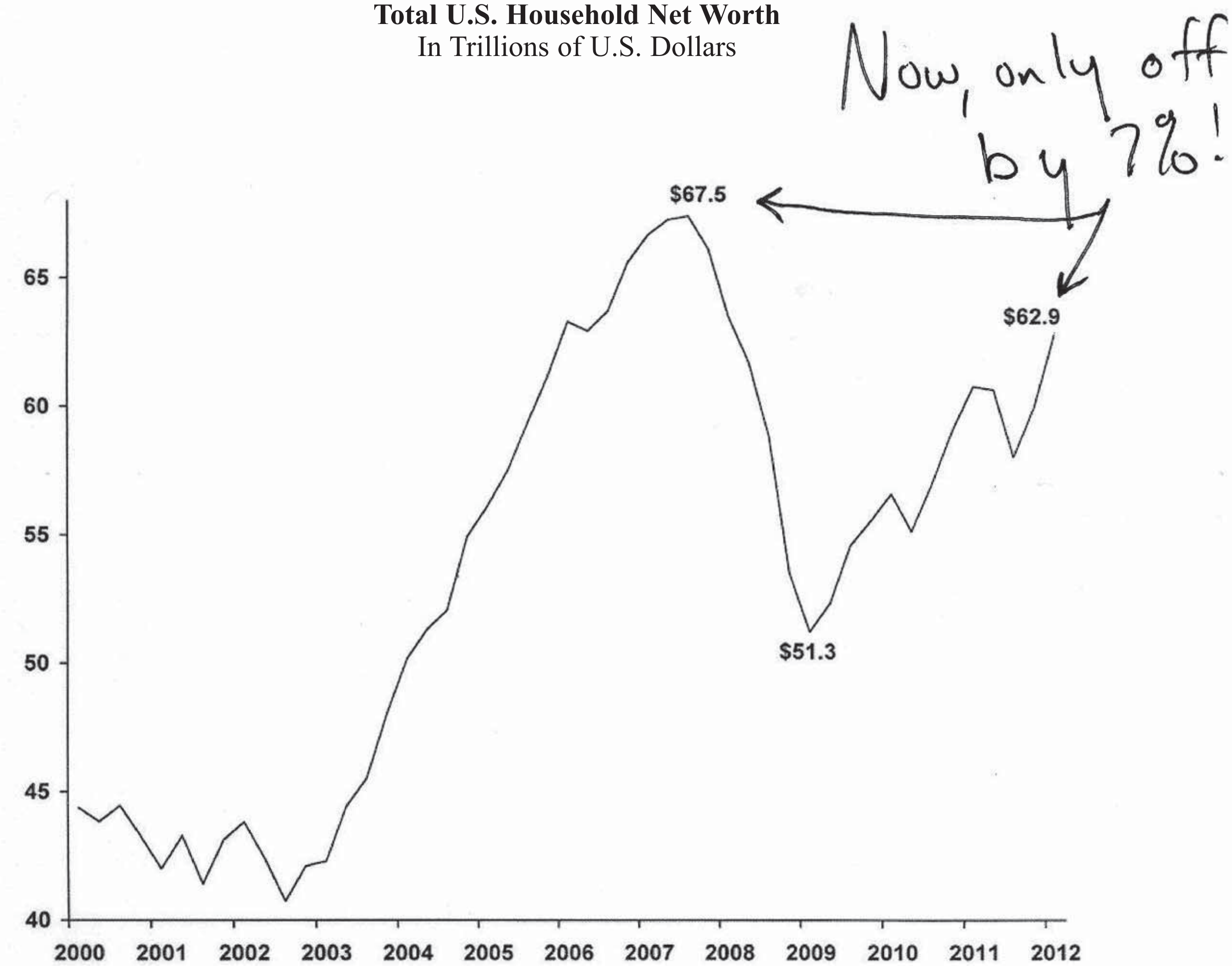


7. Household Net Worths also Being Rebuilt!

As highlighted by Chart 9, the 2008 recession caused a massive 25 percent loss in U.S. household net worth as both stock prices and home prices suffered significant declines. While recessions have often reduced household wealth for a period, never had a post-war recession created such a widespread "feeling of being poorer." Certainly lower net worths initially reduced consumer spending propensities and dampened economic spirits.

However, despite very little recovery yet in home prices, total U.S. household net worth has already recovered about 72 percent of its recessionary loss and total net worth is now only about 7 percent below its all-time record high. Armed with much lower debt burdens and a nice recovery in net wealth, U.S. consumers are far healthier today than they have been at any point in this recovery.

Chart 9
Total U.S. Household Net Worth
In Trillions of U.S. Dollars



8. U.S. Exports are a Growing Positive Force!

As shown in Chart 10, the growth in real U.S. international trade has slowed from its pace early in the economic recovery. Moreover, until early 2011, U.S. real imports and exports grew at about the same pace. Finally, many do not expect much contribution from the international trade sector because global growth has slowed. In the last year, however, U.S. real exports have persistently outpaced real imports despite the slowdown in global growth.

We expect U.S. real exports to continue outpacing imports boosting overall real GDP growth. Why? Chart 11 shows that the inflation-adjusted value of the U.S. dollar—a primary determinant of U.S. international trade flows—continues to hover near all-time record lows keeping U.S. commerce highly price competitive on a global basis. With strong productivity and a highly price competitive dollar, the U.S. will likely gain global market share making U.S. net exports a bigger contributor to domestic growth compared to earlier in this recovery.

Chart 10
U.S. Real Exports vs. Real Imports
3-Month Moving Averages

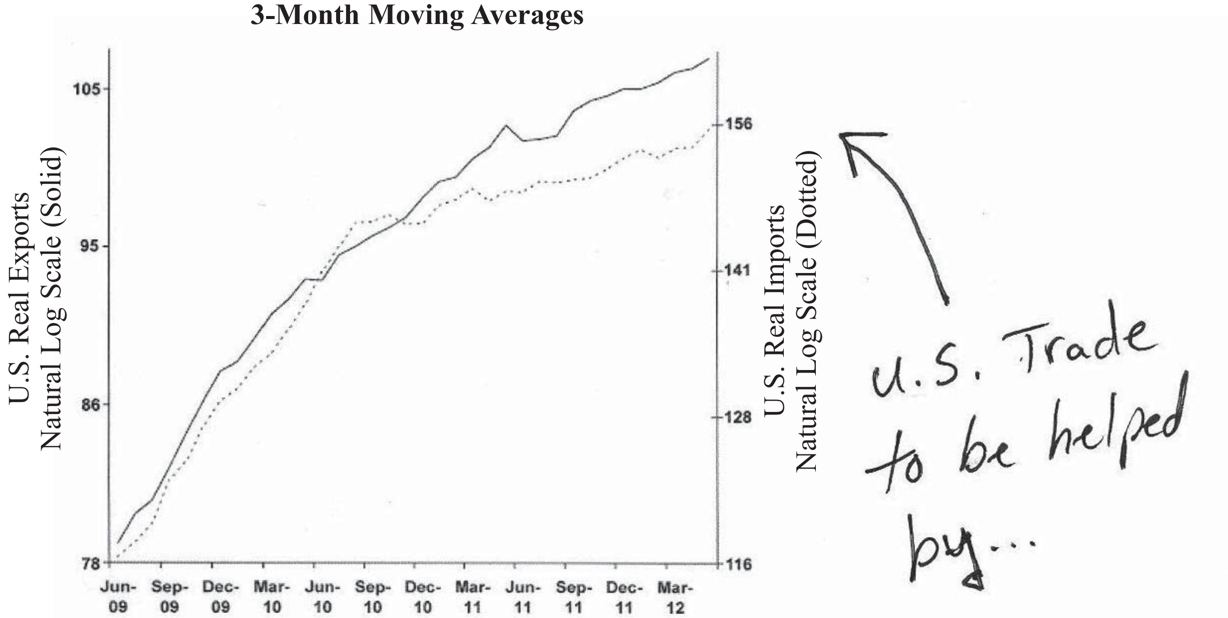
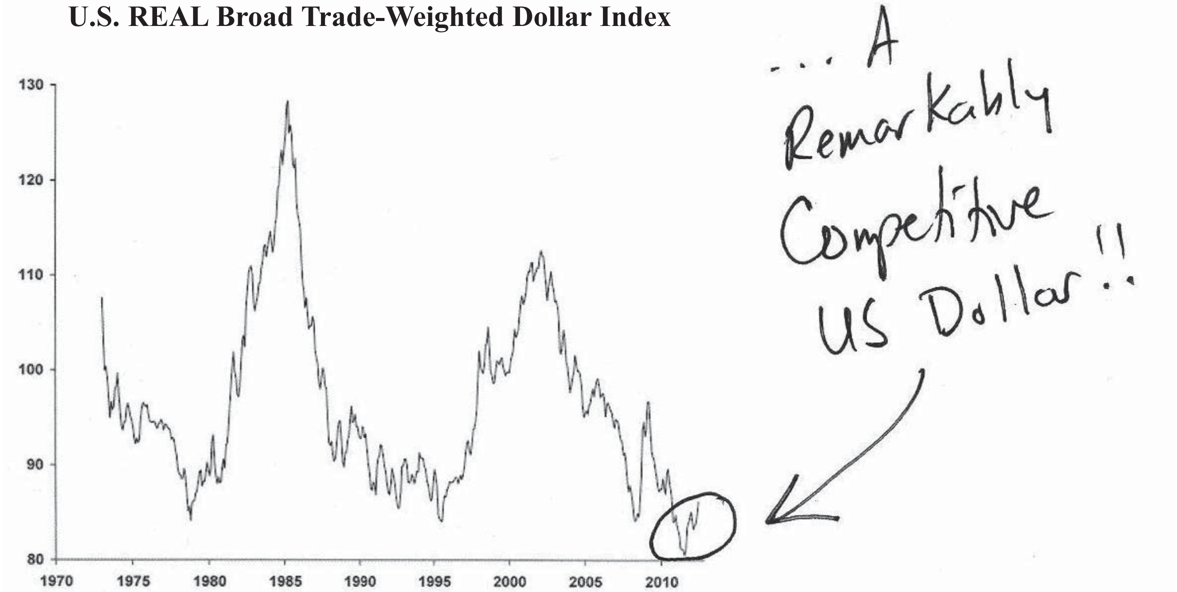


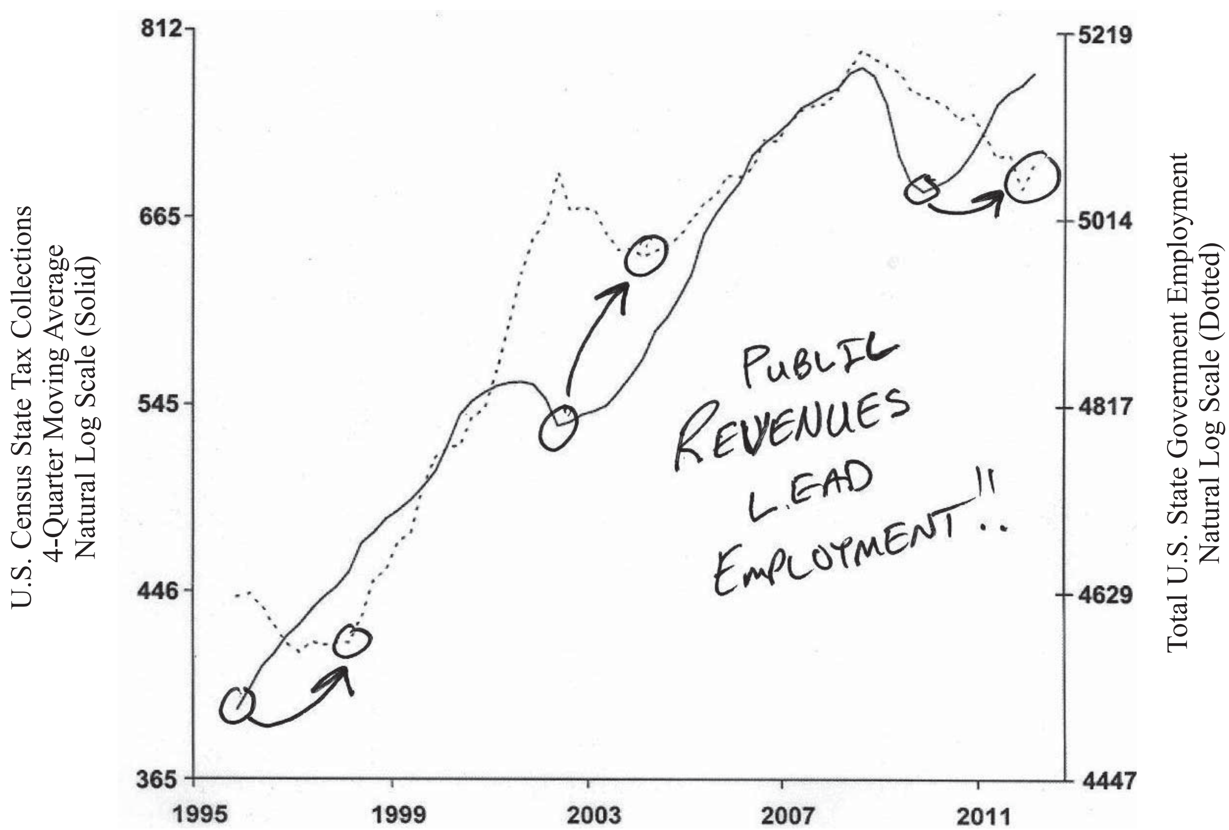
Chart 11
U.S. REAL Broad Trade-Weighted Dollar Index



9. Is State Government Employment Starting To Rise?

Throughout this recovery, the job market has suffered from a chronic loss of public jobs primarily because states have struggled with realigning budgets to a much lower level of revenue. As Chart 12 shows, however, state job losses may be coming to an end. In the last couple decades after recessions, states have cut employment until state tax collections begin to recover. Currently, aggregate state tax collections have recovered to near all-time record highs. If state government revenue trends continue, not only will state job losses suspend but many states may soon begin to replenish payrolls!

Chart 12
State Government Total Tax Collections vs.
State Government Employment



10. Crisis Sensitivity is Diminishing!

Ever since the 2008 crisis, this recovery has been bombarded by continual bouts of panic. “Stories of Armageddon” have persistently arisen and the skittish investment and economic culture which emerged from the Great Recession of 2008 have reacted to each story with great caution. A chronic safe-haven mindset has certainly kept animal spirits in check and curtailed economic growth.

While it may seem hard to believe—particularly with European fears again dominating the financial markets—the sensitivity of the financial markets (and thus the economy) to “crisis” is diminishing. Charts 13 and 14 offer two quantitative measures suggesting a diminished sensitivity to crisis stories.

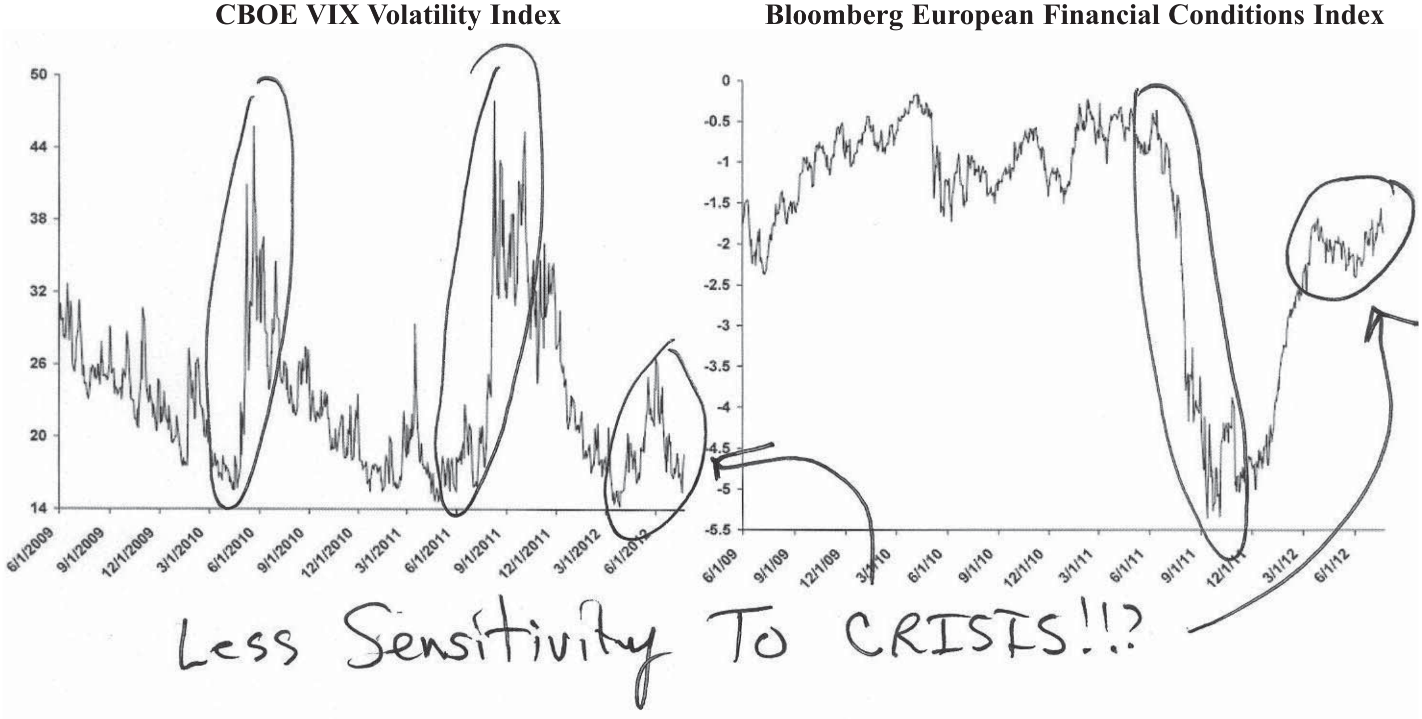
Chart 13 shows the VIX volatility index. Typically during economic panics, the VIX index spikes. Since this recovery began in mid-2009, there has been a panic each year. The VIX index spiked significantly during both the 2010 and 2011 panics. However, despite this year’s economic soft patch, another round of European crisis fears, concerns over a potential hard landing in China, an upcoming uncertain election, and a looming fiscal cliff, the VIX index remains near its lows of the entire recovery!

A similar “desensitization to crisis” can be seen in Chart 14 which illustrates the Bloomberg European Financial Conditions Index. This index is comprised by a number of different financial market indicators—e.g., stock, bond, and commodity prices and intra and inter market spreads—and attempts to record the financial markets’ assessment of potential for a financial crisis. Last year, when euro region fears intensified, this financial conditions index collapsed. Once fears calmed late last year, this index stabilized and rose significantly between December and March. In recent months, however, even though fears have again been heightened, the financial conditions index has hardly budged and indeed is currently near its highest levels of the year.

Many of the issues which have turned occasionally into panics during this recovery will be with us for many years and will surely continue to flare from time to time. However, as these charts illustrate, the chronic calls suggesting the “sky is falling” are starting to lose their bite! If investors, consumers, and businesses do eventually tire of persistent panics, economic growth may be less negatively impacted going forward. At the very least, a less sensitized “culture of crisis” implies the economic recovery is far less vulnerable to external shocks.

Chart 13
CBOE VIX Volatility Index

Chart 14
Bloomberg European Financial Conditions Index



Summary

Certainly, there is no shortage of problems to worry over. Nor is the economy growing fast enough to please anyone. But despite the endless array of "Armageddon stories" throughout this recovery, both the stock market and the economic recovery have managed to plod along.

Lurching from crisis to crisis can also obscure that progress is being made. While the speed of this recovery is currently disappointing, its character continues to improve. Indeed, the U.S. economic recovery is today far more mature, more broadly based and therefore far less vulnerable to external shocks than at any time since the recession ended. The job market is actually doing much better so far this year than widely perceived. Housing indicators suggest the greatest level of activity of the entire recovery. Home prices are rising in recent months for the first time in this recovery. Consumer confidence regarding the present economic situation remains near its highest level of the recovery. For the first time, bank lending and borrowing have risen steadily in the last year. Consumer debt burdens now reside close to record lows and household net worth is only 7 percent below all-time peak levels. Although international trade has slowed, U.S. real exports continue to outpace imports. Total state tax revenues have recovered to pre-recession peak levels and consequently state job creation has recently turned positive. And finally, while new crises never seem in short supply, the sensitivity of investors and economic players to "stories of Armageddon" appear to be diminishing.

Perhaps the stock market's positive performance this year is not so much at odds with underlying economic performance. While the economic recovery is currently in a soft patch, its overall character and sustainability continues to improve and the stock market accordingly continues to rise.

Thanks for taking a Look!!