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Economic and Market Perspective

May 19, 2014

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A Technician's Tsunami Meets Main Street's Momentum!

Several financial market technicals have broken down in recent weeks amplifying investor anxieties. Although not a technician, I too am unnerved by the number of recent "breaks" in various financial markets. Are they a signal the stock market overall is about to suffer a correction or perhaps something worse? Will the growing "technical tsunami" eventually overwhelm this bull market? Or, is the other big elephant in the financial arena—ongoing and improving Main Street Economic Momentum—enough to quiet the recent technical market storm?

A technical tsunami

The charts in Exhibit 1 illustrate five major technical breakdowns which have market watchers on edge. First, in recent months, high-flying momentum stocks which had been leading the stock market suffered a 20% bear market collapse. Such a decisive break in the leadership of the stock market is always concerning. Second, last week, the Trade-Weighted U.S. Dollar Index declined to a new low for the year and is now lower than at any time since 2012. What does it say when the world is shunning the U.S. dollar? And then, in recent days, small-cap stocks entered full blown correction territory (i.e., the Russell 2000 Index dropped 10% from early-year highs), the 10-year Treasury yield fell below 2.5% causing investors to wonder "what bonds know that stocks don't?", and the S&P 500 failed at an attempted rally to new all-time highs above 1900!

This tidal wave of market breakdowns has certainly raised cautionary signals for most technicians and has even been pervasive enough to quicken the heart-rate among fundamentalists! Although market internals currently suggest caution, U.S. economic momentum remains mostly favorable for the stock market. So, what will drive the stock market in the next few months? Worsening technicals or improving fundamentals? Our best guess is investors should stay focused on the economic fundamentals which we expect will calm market anxieties in the coming months.

Main Street momentum

Exhibit 2 shows the U.S. Economic Surprise Index. It rises when economic reports begin to outpace expectations and consequently shows the degree of "unexpected" economic momentum. Obviously, U.S. economic reports were mostly disappointing earlier this year as bad weather about the country restricted Main Street activities. However, since spring has started to show, the economic momentum index has risen smartly since early April. The array of economic reports which have surpassed expectations in recent months include a new low in unemployment insurance claims, continued solid job gains and a new cycle low in the unemployment rate, recent healthy gains in both personal income and spending, consumer confidence reaching and hovering about a six-year high, impressive retail sales results since year-end, better capital goods and shipment reports, small biz confidence recently rising to its highest level since 2007, a substantial recovery in household net worth to a new record high above $80 trillion, solid ISM manufacturing and service sector readings in the mid-1950s, the fastest growth in bank loans since late last year of the entire recovery, back-to-back household total annual debt gains in the last two quarters for the first time in the recovery, and new housing starts rose above one million again for the first time this year in April!

We think the U.S. economy, after flat-lining in the first quarter due mostly to extremely bad weather, is likely rising between a 4% to 5% pace in the current quarter. Moreover, we expect U.S. real GDP growth to sustain above a 3% pace on average in the balance of this year and believe such a performance will be enough to calm and improve sentiment surrounding the stock market.

Stock market reflects economic momentum

Finally, although many technical indicators have soured, Exhibit 3 illustrates some internal market action suggesting the stock market remains healthy. Indeed, the stock market continues to be led this year by some of the most economically cyclical sectors. Has economic growth finally bottomed among emerging world economies? That may be the message from the strong surge in the last couple months in the relative price performance of emerging market stocks. Emerging stocks have now outpaced the S&P 500 since year end. If the emerging world economy has finally bottomed, how much would this improve investor confidence? Moreover, the stock market seems to foresee underlying and continual health in this economic recovery (despite what the bond market may be saying) as evidenced by the significant outperformance of transports, industrials, and materials stocks in recent months.

Exhibit 1

Chart 1: iShares NASDAQ Biotech (IBB) ETF Index

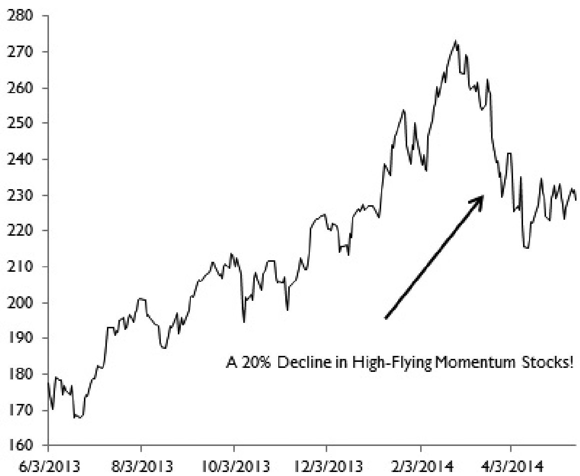


Chart 2: U.S. Trade-Weighted Dollar Index

Chart 3: Russell 2000 Small Cap Stock Price Index

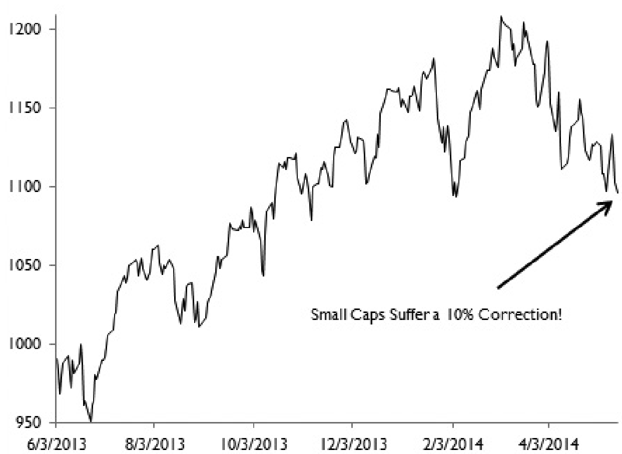


Chart 4: U.S. 10-Year Treasury Bond Yield

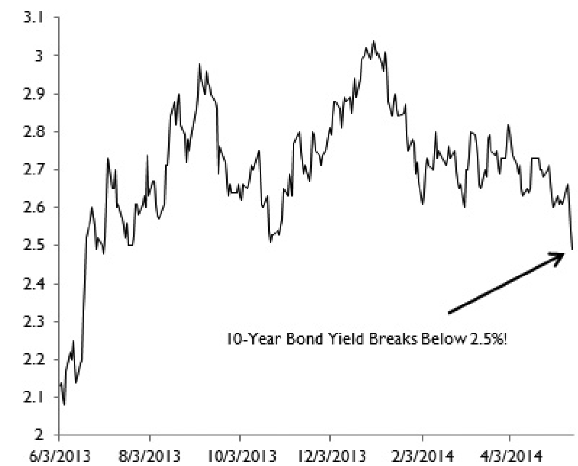


Chart 5: S&P 500 Composite Stock Price Index

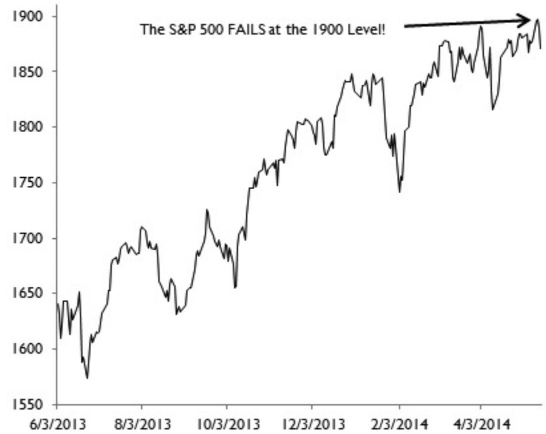


Exhibit 2

Chart 6: Citigroup U.S. Economic Surprise Index

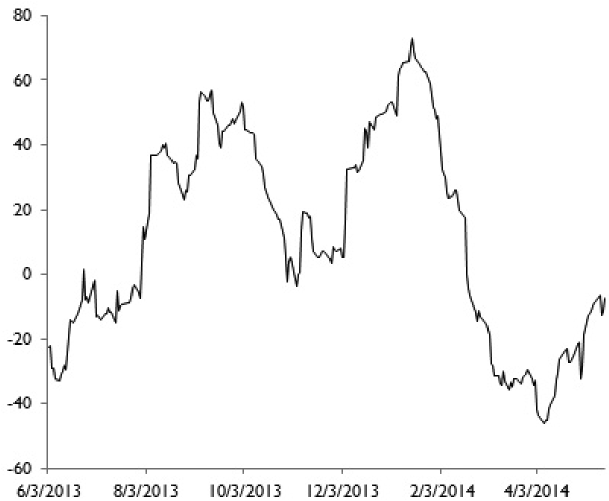


Exhibit 3

Chart 7: Emerging Market Stocks Relative (to S&P 500) Price Performance

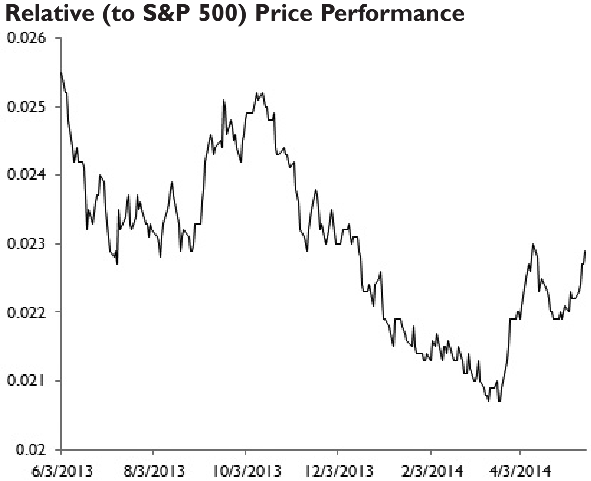


Chart 8: Dow Jones Transport Stocks Relative (to S&P) Price Performance

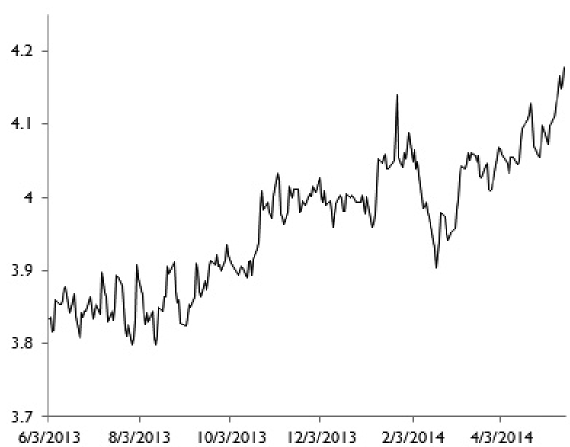


Chart 9: S&P Industrial Sector Relative (to S&P 500) Price Performance

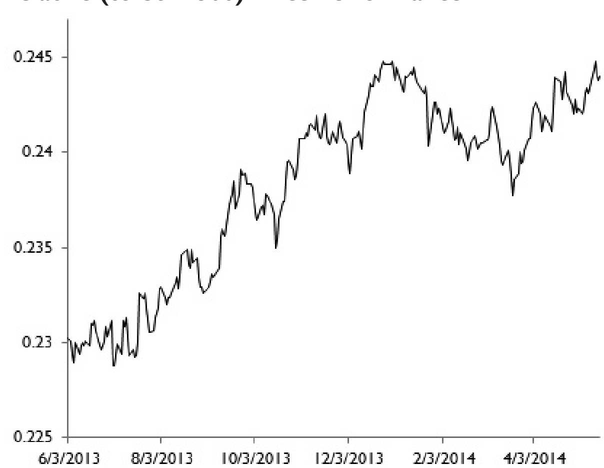
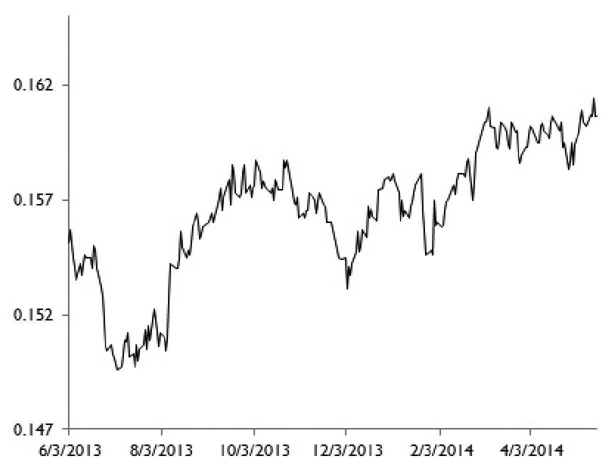


Chart 10: S&P 500 Materials Sector Relative (to S&P) Price Performance



Summary

While we too are nervous about recent financial market performance, our best guess is for continued Main Street momentum (particularly if it is bolstered by improved emerging economic momentum) to soon overshadow recent financial market technicals and bring investors back to the stock market. Indeed, is the recent technical tsunami simply a "refresher" for this bull market? Consider what it has accomplished thus far. The sharp and severe declines among small caps and the NASDAQ have extinguished any excessive investor optimism that may have been developing at year end. It refreshed the valuation among high-flying mo and small cap stocks which had probably got a bit over their valuation skies. The unexpected rally in long-term bonds has reduced the threat to the stock market (which may have been building last year) from interest rates rising too far too fast. Since the S&P 500 has been roughly flat this year while earnings have continued to climb, its PE multiple has stopped rising while yields have declined and the economy has improved. Moreover, a flattish stock market this year has bought time for this bull to adjust and get more comfortable with higher valuations, higher bond yields, and Fed tapering which could represent a major stock market hurdles.

So remain vigilant because we continue to expect 2014 to prove a volatile and challenging year. But don't get too bearish since the long-term outlook remains favorable for equities and because we still suspect the S&P 500 may make a run on the 2000 level before the year is over. Will better-than-expected economic momentum on Main Street soon act as a brick wall to this recent technical tsunami and restart a perhaps "refreshed" stock market?

Thanks for taking a Look!!